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Azerbaijan
Country Economic Memorandum
A New Silk Road: Export-led Diversification

December 23, 2009

Poverty Reduction and Economic Management Unit
Europe and Central Asia Region

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CURRENCY EQUIVALENTS

(Exchange Rate Effective December 22, 2009)

Currency Unit = New Azeri Manat (AZN)

AZN 1.00 = US$ 1.2429

US$ 1.00 = AZN 0.8033

Fiscal Year

January – December 31

ACRONYMS AND ABBREVIATIONS

A&P	Agriculture and processing
ACG	Azeri-Chirag-Guneshli Oil Field
ADDY	Azerbaijan Railway (Azerbaijan Dovlet Demir Yolu)
AGROPROM	A state bank
AIC	Azerbaijan Investment Company
AIOC	Azerbaijan International Operating Company
ARS	Azerbaijan Road Services
AZN	New Azeri Manat (Azerbaijan, unit of currency)
BCM	Billion cubic meters
BEEPS	Business Environment and Enterprise Performance Survey
BP	British Petroleum
BSL	Budget Systems Law
BTC	Baku-Tbilisi-Ceyhan Pipeline
BTE	Baku-Tbilisi-Erzurum Pipeline
CE	*Conformité Européenne* (EU)
CEE	Central and Eastern Europe
CEM	Country Economic Memorandum
CIS	Commonwealth of Independent States
CIT	Corporate Income Tax
CPAR	Country Procurement Assessment Report
CPI	Country Performance Indicator
DB	Doing Business (IFC)
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia
EDU	Education
EMA	Enterprise Management Associates
EMS	Energy Management System
eop	end of period
ETF	European Training Foundation
EU	European Union
FDI	Foreign direct investment
FID	Foreign Investment Department
FSU	Former Soviet Union

FX	Foreign exchange
GAO	General Accounting Office (US)
GDP	Gross domestic product
GED	General Employment Department
ha	Hectare
HK	Human capital
IBA	International Bank of Azerbaijan
IBFD	International Bureau of Fiscal Documentation
ICR	Implementation Completion Report
IDP	Internally displaced person
IEG	Independent Evaluation Group
IFC	International Finance Corporation
IFRS	International Financing Reporting Standards
ILO	International Labor Organization
IMF	International Monetary Fund
IPO	Initial public offering
IPP	Independent power producer
ISCO	International Standard Classification of Occupations
LAC	Latin America and Caribbean
LTU	Large Taxpayer's Unit
JSAN	Joint Staff Advisory Note
KEI	Knowledge Economy Index
LFS	Labor Force Survey
LPI	Logistics Performance Indicator
LTORMS	Long-Term Oil Revenue Management Strategy
MED	Ministry of Economic Development
MoA	Ministry of Agriculture
MoED	Ministry of Economic Development
MoF	Ministry of Finance
MoLSPP	Ministry of Labor and Social Protection of the Population
MoT	Ministry of Taxes
MoTr	Ministry of Transport
MSME	Micro, small and medium enterprise
MTEF	Medium-Term Expenditure Framework
n.a.	Not applicable
NBA	National Bank of Azerbaijan
NEER	Nominal effective exchange rate
NEF	National Entrepreneurship Fund
NGO	None Governmental Organization
NPL	Non Performing Loans
NPV	Net present value
OECD	Organization for Economic Co-operation and Development
OF	(*See SOFAZ*)
OPEC	Organization Petroleum Exporting Countries
OTC	Over the counter
PEFA	Performance Evaluation and Fiduciary Assessment
PI	Permanent income
PIP	Public Investment Program
PISA	Program for International Student Assessment (OECD)
PIT	Personal income tax
PPA	Power purchasing agreement

PPP	Purchasing Power Parity and also Public Private Partnership
PROMINVEST	A state bank
PRSC	Poverty Reduction Support Credit
PSA	Production Sharing Agreements
PWC	PricewaterhouseCoopers
R&D	Research and development
RCA	Revealed comparative advantage
REER	Real effective exchange rate
RR	Reduced rate
RTSD	Road Transport Service Department
SAC	Structural Adjustment Credit
SCMSP	State Committee for the Management of State Property
SCADA	Supervision Control and Data Acquisition
SECO	State Secretariat for Economic Affairs (of Switzerland)
SME	Small and medium enterprises
SOCAR	State Oil Company of Azerbaijan Republic
SOE	State-owned enterprise
SOFAZ	State Oil Fund of Azerbaijan (Oil Fund)
SP	Social protection
SPF	Social Protection Fund
SPPRED	State Program for Poverty Reduction and Economic Development
SPS	Sanitary and phyto-sanitary standards
SPSEDR	State Program for Socio-Economic Development of the Regions
SSC	State Statistical Committee
SST	Social Security Tax
STR	Simplified tax regime
UNDP	United Nations Development Program
US	United States of America
TA	Technical assistance
TIMS	Treasury Information Management System
VAT	Value-added tax
VET	Vocational education and training
WDI	World Development Indicators
WTO	World Trade Organization
YEN	UN Secretary General's Youth Employment Network

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FORWARD FROM THE FORUM ON ECONOMIC AND SOCIAL DEVELOPMENT OF AZERBAIJAN

A High Level Forum on the Economic and Social development of Azerbaijan was held in Baku on October 21, 2009. The Forum was co-chaired by Mr. Artur Razi-zadeh, Prime Minister of the Azerbaijan Republic and Ms. Ngozi Okonjo-Iweala, Managing Director of the World Bank. The purpose of the Forum was to discuss strategies for Azerbaijan's growth in the post crisis period. Distinguished external participants included Mr. Garret FitzGerald, former Prime Minister (Toiseach) of Ireland; Professor Ricardo Hausmann, Kennedy School of Government, Harvard University; Mr. Ivan Miklos, Parliamentarian of the Slovak Republic and Former Deputy Prime Minister, Minister of Finance, and Minister of Economic Development; and Prof. Ed Walsh, Founding President of the University of Limmerick, Ireland. Distinguished Azeri participants included Mr. Yagub Eyyubov, First Deputy Prime Minister; Mr. Abid Sharifov, Deputy Prime Minister; Mr. Elchin Afandiyev, Deputy Prime Minister; Mr. Ali Hasanov, Deputy Prime Minister; Mr. Ziyad Samadzade, Chief, Parliament Economic Policy Standing Commission; Mr. Shahin Mustafayev, Minister of Economic Development; Mr. Samir Sharifov, Minister of Finance; Mr. Fuzuli Alakabrov, Minister of Labor and Social Protection of Population; Mr. Elman Rustamov, Chairman, Central Bank of Azerbaijan; Mr. Shahmar Movsumov, Executive Director, State Oil Fund; Mr. Rufat Aslanli, Chairman, State Securities Committee; Mr. Mail Rahimov, Head of Economic Policy Department of Executive Office of the President; Mr. Shahin Sadigov, Head of Economic and Financial Credit Policy Department, Cabinet of Ministers, and Mr. Ismail Sadikhov, Head of Department of Science, Culture, Public Education and Social Issues at the Cabinet of Ministers of Azerbaijan Republic.

The discussants at the Forum set out a central thesis that summarized Azerbaijan's diversification challenges. If Azerbaijan wishes to develop an upper middle-income economy of about $20,000 per capita (in $PPP terms) in 10 years, it will have to do so by expanding its non-oil exports (as has been accomplished by some commodity-rich and by EU accession comparators). While oil exports will, at best, be able to cover half of the country's export revenue needs, the non-oil exports will have to cover the other half, at least; this implies that the country will have to increase its non-oil exports per capita by almost 50 times in 10 years. This dramatic increase can only be achieved with substantial non-oil FDI inflow –as has been demonstrated by Ireland and Slovakia.

In order to adapt Azerbaijan's growth model, from "oil driven" at a time of booming oil revenues, to "non-oil driven" after the global crisis sharply drove down oil prices and led to severely contracted GDP growth rates for the region, the country's macroeconomic policies, its business environment, and its human capital policies will need to be completely aligned with the goal of developing non-oil exports and attracting Foreign Direct Investment. At the same time, fiscal policy will need to be more predictable and public spending will have to be less ambitious in order to support a stable macroeconomic environment and a less appreciated exchange rate. The government's policy on business environment will have to be more dynamic and aggressive aimed at removing all the obstacles (infrastructure, knowledge or regulatory shortcomings) that

hinder non-oil exporters and turn away potential foreign investors. In essence, Azerbaijan will have to earn an international reputation as a choice destination for non-oil FDI, as measured by the US$ invested and number of investors attracted. The country's tertiary level education policy will also have to be adjusted, so that training establishments respond directly to the needs of enterprises –with many degrees and curricula driven by business needs. Azerbaijan will have to balance these new requirements against the need for some reliance on domestic markets, as its own circumstances dictate.

Adapting Azerbaijan's growth model to the changing circumstances will require that the government also adjust its role, from provider of infrastructure (something that was critical before the global crisis) to enabler and facilitator of non-oil exports (and of FDI). Sustainable per capita growth will require not only more exports, but exports of higher value added products. Research shows that countries become as rich as their export competitors are. That is to say, when countries produce export items that are produced by richer countries, they too get richer. The implication of this research is that while Azerbaijan can increase its export revenues in the short term by exporting tomatoes and nuts, learning to export higher value added products (i.e. products that countries with higher income than itself produce and consume), such as air conditioners, high quality confectionaries, or software, is what is really needed for Azerbaijan to develop a sustainable non-oil economy and to establish itself among the upper middle income countries. At the same time, experience has shown that it is very difficult for governments to identify the potentially successful non-oil export products. Given that fact, the only good policy for the government to follow is to: (a) work on improving the business environment across the board to make the country more attractive to domestic and foreign investors; and (b) aggressively resolve problems, once they are identified by investors. The government has the power to convene all the public agencies that can resolve administrative or infrastructure bottlenecks pose to investors –it should make use of that "convening power". In short, the government needs to create the conditions for the private sector to operate freely.

The analysis presented in this Country Economic Memorandum identifies challenges that Azerbaijan must address in order to ensure that the country's per capita income continues to rise. The report also contains many recommendations and examples from other countries. These are offered in the hope that they help the country to achieve its bold and ambitious goals for the next decade.

PREFACE

The World Bank is engaged in a large partnership program with Azerbaijan intended to assist the country achieve its development objective of becoming an upper middle income economy and further its gains in poverty reduction by insuring long-term sustainability and diversification of its economic activities. While the bulk of the World Bank program involves co-financing of critical social and economic infrastructure, the remainder of the program involves dialogue and knowledge-sharing to strengthen institutions and polices that help Azerbaijan transition to a market-based economy with a more diversified and sustainable economic base. The non-lending products of the Bank that have supported the partnership with Azerbaijan include technical assistance services and analytical reports such as this one. In the implementation of the partnership strategy, the Bank and the government stand to benefit from collaboration with other development partners. Already, fruitful exchanges of views have taken place with them during the preparation of this report.

The report's main message, which has become more relevant as the global economy has fallen into a deep slump, is that Azerbaijan needs to devote more efforts to pursue diversification (primarily measured by non-oil exports) aimed at reducing its dependence on oil revenue and ensuring sustainability of its hard-earned gains in poverty reduction. Furthermore, it must also focus on attracting foreign knowhow and strengthening of market institutions-- important ingredients for meeting the challenge. To this end, gradual but consistent fiscal adjustment is required to decrease the role of the state in the economy and to ensure fiscal sustainability. At the same time, modernization of public administration needs to be a top priority; this refers especially to agencies that deal with the private sector as those reforms need to drive improvements in the private sector environment. The government also needs to assure that public utilities-- like electricity and telephone-- are financially viable and they continue to improve their level of service to enterprises and households. Undoubtedly, the global crisis requires prudent support of the financial sector. But the report points out that the country's financial infrastructure needs further development (as was the case in the pre-crisis situation). Azerbaijan needs to also pursue upgrading of the skills of its labor force if it is to be competitive in the medium term. Globally, we see that while countries prepared stimulus packages to support their economies, the measures for improving each economy's efficiency abound (note the modernization of Chile's competitiveness group or the investments directed to improve the energy efficiency of US or European economies). Against this backdrop, Azerbaijan must prepare for a more competitive global economy after the crisis. The report also recommends that the government strengthen its coordination of different agencies so that implementation of existing and of new polices is evaluated against their potential benefits to diversification; monitoring progress made on diversification is also highly recommended.

The report is the result of more than a year of work that took place between October 2007 and December 2008 aimed at strengthening the economic management of Azerbaijan and improving its competitiveness. Much of the time after that has been taken on additional consultations on the findings and on securing a high quality (technically sound) translation. Most of the work was undertaken under the aegis of the Country Economic Memorandum (CEM). The report was also

supported by the Structural Reform TA task (which financed workshops on fiscal sustainability and transfer of the fiscal sustainability toolkit to the government), and the Programmatic Public Expenditure Review task, which supported the dialogue on public management and the MTEF in 2006-2008 and the 2008 Public Expenditure and Financial Accountability Assessment (co-funded with SECO), and the 2008 Country Procurement Assessment Review. Significant work on the private sector in 2008 had been undertaken by the IFC and had been incorporated herein. The 2008 Poverty Assessment was undertaken largely in parallel with the CEM, so those results could not be included here. Finally, the High Level Forum was held on October 21, 2009, to discuss the thrust of the policy recommendations with senior policy makers.

During the CEM preparation, several economic missions took place in Azerbaijan. The missions held a series of workshops on managing resource-rich economies and on fiscal sustainability (largely for government and academic audiences). The missions also held extensive discussions and workshops with government officials on the findings of the CEM's specialist teams, as the various components of the report were being developed. The approach served two purposes: (i) to inform counterparts of the findings; and (ii) to obtain feedback from the counterparts on the CEM assessment and the potential recommendations. Prior to the issuance of the report, several meetings were held with senior government officials. After the publication of the report, an extensive outreach effort to all levels of government, the private sector, the academic community, and civil society is envisioned.

Finally, this report has been prepared by the World Bank with a view to stimulating discussion on Azerbaijan's development. The report would not have been possible without the wholehearted collaboration of government authorities, who wrestle and seek to overcome the country's development challenges on a daily basis. The Bank's value added is to integrate and deepen analysis on the one hand, and to bring evidence on international experience to bear for Azeri authorities on the other, as they contemplate the next development milestones.

ACKNOWLEDGEMENTS

The World Bank is appreciative of the excellent collaboration provided by the Government of Azerbaijan in the preparation of the Country Economic Memorandum (CEM). The Bank team benefitted extensively from discussions with the four key economic agencies-- the Ministry of Finance, the Ministry of Economic Development, the National Bank of Azerbaijan, and the Oil Fund-- in the preparation of the report. The agencies provided feedback at the concept stage and during the preparation of the report. The Bank team also benefitted significantly from exchanges with the Cabinet of Ministers, the Ministry of Taxes, the State Customs Committee, the Ministry of Labor and Social Protection, the State Securities Committee, and other government agencies. Finally, the Bank team is also highly appreciative to the Azeri private sector for the many fruitful exchanges throughout the preparation of the report.

The team wishes to acknowledge the wholehearted support received from Asad Alam, Regional Director for South Caucasus from January 2009 and the steady guidance received from Donna Dowsett-Coirolo, Country Director for Azerbaijan through December 2008, who endorsed the Concept Note for the CEM, the consultative and knowledge-sharing approach taken by the task team, and provided her unwavering support throughout the preparation Green Cover. Gregory T. Jedrzejczak, Country Manager (ECCAZ), provided highly valued advice on the analysis of developments and on strategic issues in managing and disseminating the report. Many thanks are also owed to Saumya Mitra (Lead Economist, ECSPE), Michael Edwards (Lead Financial Sector Specialist, ECSPF), Christian E. Petersen (Lead Economist, ECSSD), Aleksandra Posarac (Lead Economist, HDNSP), and Anthony Cholst (Lead Country Officer, ECCU3) for their valuable comments on various drafts. Luca Barbone (Sector Director, ECSPE) and Kazi Matin (Manager, ECSPE) provided thorough review of the document and insightful advice, which strengthened the arguments. Alan Gelb (Director, Development Policy, DECVP) and Sergei Shatalov (Country Manager, ECCKZ) were peer reviewers; both provided excellent feedback, first at the concept stage, which served the team well during the preparation of the report, and later on the final report.

The CEM team was led by Christos Kostopoulos (Senior Country Economist for Azerbaijan, ECSPE). Contributors to the report were as follows: (a) macroeconomics: Sweder van Winjbergen (lead Consultant), Nina Budina (Sr. Economist, PRMED), Jan Marusinec (Consultant, ECSPE), Zafer Mustafaoglu (Sr. Economist, ECSPR), Jean-Francois Jamet (Intern/consultant, Corps des Mines, French Republic), Alexander Kitain (Consultant, ECSPE), Farid Talishly (Economist, ECSPE) and Christos Kostopoulos -- van Winjbergen and Budina, with help from Ying Li (Consultant, PRMED), prepared background papers on fiscal sustainability and designed a full-fledged fiscal sustainability toolkit for Azerbaijan, which was provided to the authorities; (b) infrastructure: Atsushi Iimi (Sr. Economist and lead contributor, FEU), with advice from Antionio Estache (Consultant), Bjorn Hamso (Sr. Energy Economist, ECSSD), Martha Lawrence (Sr. Transport Specialist, ECSSD), Oliver Le Ber (Lead Transport Specialist, ECSSD), Gerard Olivier (Sr. Infrastructure Specialist, ECSSD), Andreas Rohde (Sr. Sanitary Engineer, AFTU1), Sanyu Lutalo (Environmental Engineer, ECSSD), Hadji Huseynov (Infrastructure Specialist, ECSSD), and Nijat Valiyev (Infrastructure Specialist, ECSSD) --

Rufat Mahmud (WB Intern, Ministry of Economic Development, Azerbaijan Republic) prepared an important background paper on public investment expenditures; (c) business environment: Bart Kaminski (lead Consultant, ECSPE), Philip Schuler (Sr. Economist, PRMTR), Vito Intini (ET Consultant, ECSPF), Munawer Khwaja (Sr Public Sector Specialist, ECSPE), Mirtha Pokorny (Consultant, ECSPE), Martin Sgut (Consultant, ECSPE) with valuable advice from Aliya Azimova (Country Officer, CSEAZ) and comments from Boris Divjak (Operations Officer, CUETE) – Munawer Khwaja helped shape the work on taxation, Bart Kaminski and Phil Schuler prepared several background papers on trade and transport facilitation, and Bart Kaminski played a critical role in shaping the business environment chapter; (d) the financial sector, Valeriano Garcia and Carlos Rivas (lead Consultants), with advice from M. Edwards, A. Azimova, and B. Divjak; and (e) the human capital, Arvo Kuddo (Sr. Labor Economist, ESHD), Lire Ersado (Economist, ECSHD) made original contributions. Jean-Francois Jamet made significant contributions to the entire report, preparing: (a) initial drafts of the introductory, macro, and human capital chapters based on the aforementioned contributions, (b) a simplified fiscal sustainability model with Christos Kostopoulos and (c) pointed background papers and notes on economic diversification.

Luis Alvaro Sanchez (Consultant, ECSPE), Sweder van Winjbergen, and Gael Raballand (Senior Transport Economist, AFTTR) provided valuable comments on various aspects of the entire report. Rohit Malhotra (Consultant, ECSPE) provided comments and advice during the final stages of the report. Farid Talishly, the Bank's economist in Baku provided endless advice to incoming consultant teams, contributed to the preparation of meetings schedules, provided astute analysis of economic developments (much of which has found its way into chapters 1 and 2 of the report) and formed part of the macroeconomic team. Sarah Babirye (Program Assistant, ECSPE) headed production of the written document, and together with Nancy Davies-Cole (ECSPE) ably handled contracts and processed consultant travel. The document was edited by Alicia Hetzner (Consultant, ECSPE) and Inge Pakulski (Consultant, ECSPE). Natavan Mammadova (Research Analyst, ECSPE) aptly and gracefully coordinated the intense meetings schedules of all the CEM missions, helped guide consultants on local practices and customs and ensured translation quality. Zaur Rzayev interpreted for critical meetings, provided first level review of translated material and was a backstop on CEM communications. Farid Talishly ably took responsibility for the quality control of the entire translated document.

Valuable comments were also received from Valeria Fichera, Koba Gventadzade, Mayra Zermeno, and Shuang Ding (all IMF).

The dissemination strategy was developed jointly with Gregory Jedrzejczak, Kazi Matin, Sarah Babirye and Saida Bagirli (Senior Operations Offices, ECCAZ).

EXECUTIVE SUMMARY

1. **Azerbaijan's oil and gas boom presents a rare opportunity to accelerate improvements in the quality of life of all its citizens**. Its per capita income is $5,100 in 2008, up nearly 400 percent from 2004 in current USD terms; it could potentially exceed $6,500 by 2013 and higher beyond that. Consequently, poverty is likely to continue to fall, especially in the rural areas, and the entire population of nearly nine million can expect to benefit significantly from expanded access to better quality education and health services as well as more targeted social assistance. Most of this income growth is expected to come from non-oil output and exports, especially agriculture and light manufacturing, though high levels of oil revenues and public spending will continue to stimulate significant growth of construction and various services sectors. Fiscal revenues from oil and gas are expected to be $198 billion in net present value terms through 2024 (based on the oil production profile of June 2008).[1] This report outlines changes in policies and institutions that would be needed to realize this vision.

2. **The county's vision is to move toward a diversified, globally integrated market economy, based on a sustainable non-oil sector, which includes an expanded role for non-oil exports.** The vision of a diversified and integrated market economy was first outlined in the State Program for Poverty Reduction and Economic Development (SPPRED) 2003-05.[2] The government plans to develop several oil- and gas-related industries and sees its geographical position as ideal to further develop transportation and other transit-related services. Also the population's history of entrepreneurship and trade is a sound basis for developing a non-oil economy. Developing Azerbaijan as an expanded transportation hub, as a center for high value-added food processing industries and other light manufacturing, and even as a regional tourist destination, are all part of this vision. Significantly improved performance of the agricultural sector (aided by the country's famed nine climatic zones) is expected to support the food processing sector. The government's vision thus expects to broaden the country's export markets, now mainly limited to Russia and Turkey, to the rest of Europe and Asia. Azerbaijan can benefit from the lessons of successful resource-rich economies, as well as successful small economies without natural resources, which have created jobs and additional incomes for their populations through diversification and by expanding their non-oil exports.

3. **The global crisis has had important implications for regional growth.** The crisis has reduced access to international finance, lowered food and oil prices, affected foreign inflows (remittances, FDI and roll-over financing for commercial banks) and reduced demand for exports for many countries**.** According to the latest Global Development Finance report, (issued in September 2009, the Bank expects global GDP growth to slip from 1.9 percent in 2008 to -2.9 percent in 2009. Developing country growth is expected to decline from 5.9 percent in 2008 to 1.2 percent in 2009. Growth in high income countries in 2009 will likely be -4.2 percent. World

[1] This report uses four conventions: (a) the terms oil revenues and oil exports connotes revenues from the sale of oil and gas where as fiscal revenues from oil denote the government's revenues from oil, which includes Azerbaijan's share of profit oil; (b) non-oil exports comprise all exports except crude oil and gas in all forms; (c) the oil sector connotes the extraction of oil and gas, but excludes transportation of oil and gas, and also construction related to the oil and gas extraction sectors; (d) Azerbaijan's currency is denoted interchangeably as AZN (New Azeri Manat), preceding a figure, or "manat", following a numerical figure.

[2] The SPPRED was Azerbaijan's Poverty Reduction Strategy Paper.

trade volume is expected to contract by 12 percent, from 3.7 percent in 2008 to -9.7 percent in 2009. The global slowdown is expected to have a profound impact on poverty; early estimates by the World Bank suggest that a 1 percent decline in developing country growth rates is most likely to push an additional 20 million people into poverty. Already, 100 million people had been driven into poverty as a result of high food and fuel prices. At the same time, the slowdown in global demand and the burst of the speculative bubble for oil, have led the oil price to tumble, from a high of $147 per barrel in July 2008, to less than $40 in January 2009, and to neatly $70 in second part of 2009. Fortunately, the 2010 forecasts show some encouragement, with global growth expected to recover and for Azerbaijan's neighbors to take advantage of that recovery.

4. **Though Azerbaijan is less affected by the crisis than its neighbors, the external environment has become less supportive of diversification. But, weaker oil prices will require medium-term public spending, and stronger private sector growth.** Azerbaijan's development in recent years has been buoyed significantly by rising oil prices through mid-2008 and by increasing oil production since 2006. The economy has not relied significantly on inflows of foreign capital or foreign aid in 2007 and 2008. Despite the collapse of oil prices in the latter half of 2008, Azerbaijan's oil production is poised to increase in 2009 and 2010. At the same time, the financial sector has avoided a major crisis thus far; remittances are expected to hold steady in 2009, and non-oil exports alone are too small to precipitate a recession should external demand fall. At the time of writing this report, single digit GDP growth (in the order of 3-5 percent) is expected in 2009 and 2010. While the country's growth prospects have been dimmed by the global crisis, Azerbaijan has fared better than its neighbors. The gloomy external environment is likely to have a dampening effect on Azerbaijan's efforts to attract investors and to diversify its production and export base. At the same time, lower oil prices will likely lower pressures for appreciation of the manat, jeopardizing the banking sector's ability to repay foreign loans (as has happened in Kazakhstan in 2007 and 2008) and leaving them exposed to a worsening real estate market. Furthermore, while oil prices have recovered somewhat from the January 2009 lows, uncertainty still exists about the level at which they will stabilize. Fiscal revenues from oil will drop sharply in 2009, and may not reach the 2008 levels till 2012. As such, prolonged low oil prices will require the government to revise its medium-term expenditure plans if it wishes to ensure sustainability.

5. **Azerbaijan entered the global crisis much stronger than many other countries.** Since the transition began, Azerbaijan made commendable progress in stabilizing and reforming the economy; that progress, along with sizable oil revenues allowed the country to cope with the aftermath of its freedom from Soviet occupation in 1991, the conflict with Armenia, and the cumulative impact of economic decline through 1995 (when per capita income after independence hit bottom and inflation was high). All this left the country in poverty, with dismal infrastructure and few market institutions. The government launched a successful stabilization program in 1996-98 through reforms in various sectors to ensure better economic management and easier domestic and foreign private investments, especially in the oil and gas sectors. The government has been particularly active since 2003 when it embarked on accelerating the economic growth in various ways.

- **Social policies.** Since 2003, the government has placed significant emphasis on enhancing public sector salaries, increasing pensions, and establishing the country's targeted social assistance scheme. These efforts, together with the ability of the

economy to create jobs and the buoyancy of the region (including remittances from Russia), have resulted in significant poverty reduction. The national poverty rate dropped from 68.1 percent in 1995 to 24 percent in 2005; poverty almost halved between 2003 and 2005. While the drop in poverty has been greatest in Baku, it has been almost equal in other urban and rural areas. Since 2006, the surge in Azerbaijan's oil revenues has allowed the government to expand social transfers and public sector salaries. Social transfers are empirically found to play a significant role in poverty reduction. The government has also invested extensively in social sectors, especially in education (most schools have been refurbished) and in health. The investment program, together with the social assistance packages and increases in pensions and public sector salaries (albeit from extremely low bases), have amounted to significant public expenditures.

- **Infrastructure buildup**. The government has been gradually increasing capital investment since 2003, but since 2006, it has tripled the level of public investment using the country's growing oil revenues. Aside from the social sectors, investments have been directed at the country's core infrastructure projects-- power, roads, and water (early investments).[3] As a result, there has been a significant improvement in the quality of electricity supply throughout the country, helping to improve the livelihood of households by creating opportunities in food processing, light manufacturing and other industries (including modern wine production facilities). Investments in roads have sought to reduce the cost of transportation along the country's main corridors (North-South [Russia-Iran, via Baku], and East-West [Baku-Georgia]). This is likely to facilitate the transport of goods and promote regional trade—an important part of Azerbaijan's diversification strategy.

- **Economic management institutions.** While the quality of Azerbaijan's economic management institutions, as measured by the European Bank for Reconstruction and Development (EBRD) Transition Index, was much worse than CIS comparators in 1995, Azerbaijan accelerated reforms after 2001. Since then, the country has made good progress on first-generation reforms (more than the CIS average, bringing it on par with Kazakhstan and slightly surpassing Russia). On second-generation reforms, Azerbaijan has made some progress, but continues to lag behind the CIS average, and its Caucasus neighbors-- Kazakhstan, Russia, and the EU accession countries. To overcome this, Azerbaijan has placed significant emphasis, much more than the average CIS country, on developing institutions to manage the country's large oil inflows. One of the major initiatives in this regard that has received international attention is the establishment of the Oil Fund in 1999 in anticipation of forthcoming oil revenues—with assets of $11.2 billion at end 2008. The Oil Fund has been spearheading Azerbaijan's participation in the Extractive Industries Transparency Initiative (EITI), in which the country is an international leader. Alongside this, Azerbaijan has recently made progress in improving some business regulations, although they will take some time to pay off.

[3] Aside from adjusting the minimum wage from 30 to 75 manats per month since 2004, the government has set up a modern targeted social assistance system, which is fully operational and in 2007 covered 20 percent of households.

6. **The implementation of the government's vision has generally been proceeding according to plan, although there are important economic signals and changes in circumstances that suggest adjustment is warranted if diversification and sustainability are to be achieved**. The government has been supporting its aforementioned achievements with a significant amount of oil revenues, which originated in 2003–06 from escalating oil prices, and thereafter from increases in oil production (and oil prices of course). Between 2004 and 2008, government expenditure increased from 37 percent of non-oil GDP to a forecasted 83.8 percent (including the 2008 supplemental).[4] Azerbaijan's non-oil deficit is expected to reach 58 percent of non-oil GDP in 2008. As a result of previous policies and uncertain global environment, the following challenges have emerged for policymakers:

- **Macroeconomic management has become more difficult**. Over 2004–08, Azerbaijan's non-oil GDP grew at an average annual rate of 12.6 percent, buoyed largely by the fiscal stimulus. Its industrial, construction, and service sectors grew in double digits, while wages tripled in this period and productivity doubled, albeit from a very low level. The rapid increase in absorption (consumption and investment) contributed to an average growth rate of 12.6 percent for non-tradables (here broadly defined as services) and 5.9 percent for non-oil tradables (here broadly defined as agriculture and industry, less construction and mining) 2004-08. At the same time, the economy started to overheat. Inflation reached 19.7 percent by end-2007, and reached 15.8 at end 2008, due to large inflows of U.S. dollars that have supported the budget and the policy of managed exchange rate against the dollar; by end of 2008 inflation had begun to subside as the crisis was intensifying.

- **Diversification is stalling**. Azerbaijan's non-oil exports relative to non-oil GDP increased by 5 percentage points of GDP from 2001 to reach about 10 percent in 2005, but have declined thereafter reaching 8 percent in 2008. The increase in the early part of the decade came primarily from exports of agriculture and food products to Russia and Turkey. Azerbaijan's REER for non-oil exports increased by 5 percent in 2006-07, whereas the REER for all trade increased by 11 percent during the same period; for 2006-2008, the REER for all trade increased by 41 percent, owing in part to the devaluation polices of Azerbaijan's trading partners which took place during the crisis. The country's non-oil private investment and non-oil FDI peaked in 2005 and reached half their 2005 rates (when compared to GDP) in 2008. These recent reversals in trends of important indicators, as well as the increase in the share of non-tradables in non-oil GDP, suggest that Azerbaijan's attempts to diversify are stalling.

- **Fiscal sustainability is at risk**. The broad community of economic analysts in Azerbaijan (NGOs, government analysts, the Bretton Woods institutions, other donors) has recognized that continued large increases in public expenditures (average annual increase of 64.6 percent in 2006–08) are neither sustainable nor desirable.

[4] The analysis is presented in terms of non-oil GDP because Azerbaijan's oil revenues are expected to be temporary (approximately a 20-year life span). In this scenario, measures of government spending and other relevant flows look exceptionally good during the early phase of the boom and deteriorate sharply in the latter half. Relative to GDP, Azerbaijan's expenditures are expected to reach 31% in 2008, while its non-oil deficit is expected to reach 20%. In 2008, Azerbaijan's overall fiscal balance is expected to reach 24% of GDP and its external current account balance 36% of GDP.

Prudence argues that it be reduced. The finite nature of forecasted oil revenues for Azerbaijan on the one hand, and examples of entitlement-saddled OECD countries on the other argue for long-term government spending to be under 40 percent of GDP, akin to what Azerbaijan had before the oil boom.

- **Growth risks are looming, particularly given the global crisis**. In the medium term, overall GDP growth will slow in 2011 and beyond, as oil production peaks at 450 million barrels by 2010. Though oil revenue will remain substantial until 2020 and thus government spending out of that revenue will continue to be a stimulus for the economy, especially for its construction and services sectors, much more of Azerbaijan's future prosperity will have to come from growth of non-oil output and exports. The potential for such growth is high if appropriate changes in policies and institutions are implemented. But Azerbaijan needs to remain alert to the possibility that the trough of the global crisis could be prolonged ("U"-shaped instead of "V"-shaped) and that oil prices could stay low or particularly volatile for 2009-10, while markets for Azerbaijan's non-oil exports could stay suppressed.

7. **While the government had been willing to bear a short-term inflationary or competitiveness cost for the rapid infrastructure buildup, current outcomes suggest that delays in diversification are not simply a matter of time, but require acceleration of specific reforms that need to put diversification at center stage.** Azerbaijan's government seized the day, when oil prices were high, to launch an admittedly ambitious program, anticipating that the medium-term productivity gains accruing from the public investments would outweigh the short-term costs to the economy and the impact of real appreciation. Over the longer term, the authorities hope that new relative prices, upgraded infrastructure, and structural reforms will generate new areas of economic activity in the traded and non-traded sectors, and will serve to diversify the economy and ensure its sustainability. The experience of the last two years has shown that, on the contrary, a pattern of public expenditure and economic expectations has been set in motion that cannot possibly be sustained and that the pace and focus of institutional reforms, especially as they refer to setting conditions for diversification, have been dimmed. Today, the government's broad regulatory reform efforts appear to be dispersed and open-ended, therefore reducing their effectiveness. A greater sharpness of regulatory reform on diversification is much needed.

8. **Azerbaijan needs to be strategic in navigating a way out of the global crisis**. **Preparing the groundwork for attracting non-oil investment and expanding non-oil exports will be critical, particularly given the challenging global environment and the lag time needed to implement reforms. In the short term, the government will have to look for domestic sources of stimulating demand, both private investment and government spending (which should be put on a more sustainable path)**. Today, as a result of the crisis, capital is less easily attracted by any country (investors the world over are weary and interest rates for developing countries have skyrocketed), demand for Azerbaijan's non-oil exports may well be dampened in the short term as the growth prospects for Russia and Turkey –both important trading partners-- are significantly reduced from a year ago, and the world price of oil may remain low and volatile. During the crisis, Azerbaijan may wish to focus on sustaining domestic demand and making prudent plans for public spending based on lower oil prices in the medium term. At the same time, the crisis provides Azerbaijan with an opportunity to strengthen

the institutional environment pertaining to private sector development, and to diversification. When the world exits the economic crisis, the surviving enterprises (in Azerbaijan's trading partner economies) are likely to be stronger and more competitive, both globally and regionally. These enterprises will pose fiercer competition to Azerbaijan. As such, the crisis provides an opportunity for Azerbaijan to improve the operating environment for the private sector.

9. **This executive summary presents 16 recommendations aimed to assist the country address its diversification challenges.** The recommendations on macroeconomic management aim to assist the country toward maintaining macroeconomic stability and minimizing the effect of fluctuations in the real exchange rate. This would help create a more stable investment environment, while at the same bring the size of public spending down to more sustainable levels. The section on utilities aims to help the government consolidate the gains made in current infrastructure projects, and to gradually make way for greater private sector involvement, which in turn, would improve efficiency and reduce the risks borne by the government. The section on the business environment aims to help create more opportunities for non-oil investment and for diversification by improving the regulatory environment. The section on the financial sector aims to support private sector activities by recommending greater access to credit on the basis of improvements in institutions that enhance credit access for micro, small and medium enterprises (MSMEs). In addition, it looks at the systemic risk of the financial sector, given the lessons of other resource-rich countries. Finally, the section on human capital recommends an education system that is more market-friendly, and a modernization of Azerbaijan's public sector employment.

I. Macroeconomic Stability and Governance of Public Finance

10. **Azerbaijan faces three macroeconomic management challenges.** First, being a resource-rich country, it intends to share its natural resource revenue of nearly $200 billion with its future generations.[5] Second, it has to manage the macroeconomic volatility created by highly unpredictable oil prices and by pro-cyclical government spending (spending more when oil prices are high). During the period of rising oil prices, domestic inflation increased significantly (aided by high oil inflows and a stable exchange rate against the U.S. dollar). At the same time, the real exchange rate appreciated by more than 19.6 percent between early 2006 and July 2008– making it difficult to diversify the economy into agriculture and manufacturing activities, something that is critical for the country, given the temporary nature of the oil boom. During the global crisis, while the nominal exchange rate has remained approximately stable, the NEER and the REER appreciated further through end December 2008 as Azerbaijan's trading partners were devaluing their currencies. Third, the precipitous global economic slowdown and the rapidly declining price of oil are likely to reduce foreign investment inflows, lower export demand over the next two years, and suppress fiscal revenues from oil for at least the medium term. Like other countries facing the global crisis, Azerbaijan needs to improve access to finance for the private sector. While credit is most efficiently provided on market terms, the government works to facilitate the availability of some funds through budgetary sources or international borrowing

[5] The estimate is in 2007 US$, based on an average nominal (real) oil price of $65 ($52) per barrel, in current (constant 2007) US$, for the 2010-30 period, and a nominal discount rate of 8.5 percent; proven oil reserves were estimated at 9 billion barrels in July 2008, while the proven reserves of gas are 1.34 trillion cubic meters; these figures have been confirmed by the State Oil Fund of Azerbaijan.

(mostly from development partners). Measures already taken by the National Bank to increase liquidity are also useful.

11. **The aforementioned challenges require a sustainable and predictable path to oil revenue spending. In preparation for the oil boom, the government established the Oil Fund as a key pillar of its sustainability policy. The government also laid the foundation for a modern budgetary framework.** The leaders of Azerbaijan had the foresight to set up an Oil Fund to safeguard a part of their oil revenues for future generations, as well as to approve a Budget Systems Law (BSL) that lays out the processes by which fiscal revenue from oil and gas are channeled to the consolidated budget. However, to be most effective, these instruments require that policy decisions on the level of public spending are based on the broad consensus, so they withstand the considerable pressures the government faces to spend more.

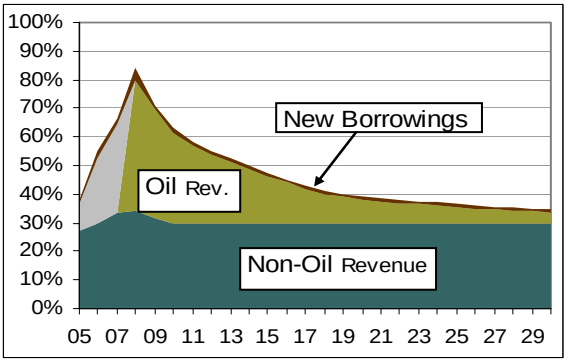
12. **In preparation for the oil boom, the government also adopted the principle of "constant real spending" out of oil revenues in its Long-term Oil Revenue Management Strategy (LTORMS) but this is yet to be operationalized and implemented.** This report proposes that the above principle be put into practice by using the permanent income (PI) approach to estimate the appropriate level of constant real spending. This would involve taking the present value of projected fiscal revenues from oil and, effectively, spending annually only the real interest earned on it. Based on the production profile as of June 2008, and the 2008 budget estimates, Azerbaijan can count on an estimated $5.9 billion per year (at 2007 prices) of fiscal revenues from oil (including oil companies' tax payments) *in perpetuity*; on this basis, the Oil Fund would accumulate about $78 billion by 2030. This figure, and the methodology behind the PI estimation, is considered quite robust for two reasons. First, it is robust to volatile short-term oil prices: oil prices are highly unpredictable in the short run, so it is difficult to match annual spending plans (be they pro cyclical or counter cyclical) with annual oil price forecasts, especially for the next two years. The best policy is to have a long-term perspective that smoothes out short-term fluctuations. Secondly, it smoothens long-term fluctuations in prices or supply: should there be changes in oil prices or production in the outer years, they would not translate into significantly higher recommended spending levels today. A simulation exercise on the permanent income for Azerbaijan demonstrated that for a specific shock to oil prices or production, Azerbaijan's public expenditure does not have to respond by a 100 percent adjustment (reduction) in spending in order to maintain fiscal sustainability, but government can respond with a smaller adjustment in spending, if that occurs consistently over a given time period after the actual shock occurs. That is, the permanent income approach also provides for stability in spending in the presence of a crisis. This report recommends that the permanent income equivalent be recalculated routinely by government, though medium-term spending plans are only adjusted over longer intervals, such as every three years.

13. **The LTORMS can also be an anchor for gradually reducing Azerbaijan's total public spending to ensure macroeconomic stability and sustainability.** In the long term, public spending will need to be consistent with the country's long-term revenues, which will increasingly come from the non-oil tax base. While Azerbaijan's non-oil tax base can be expected to stay at about 32 percent of GDP, the importance of $5.9 billion a year (in 2007 US$) from oil revenues will diminish as non-oil GDP grows over time, as shown in Figure 1 (Oil Revenue: Recommended Expenditure Rate and Financing Sources). This scenario is *largely* consistent with a real freeze in spending through 2017, and with moderate increases in real

spending thereafter.[6] It results in a gradual reduction of government spending to about 37 percent of non-oil GDP in 2024. If the country tries to spend significantly more than shown in Figure 1 (e.g., keep its public spending growth in line with nominal non-oil GDP), the report's projections suggest that it will use up its Oil Fund assets in the next 15 years and will not be able to accumulate the desired savings for future generations.[7]

14. **Implementation of a stable path for public spending would meet several of the government's objectives.** First, there will be savings out of current and future oil revenues for future generations as the LTORMS envisages. Second, it will help open up space for private economic activity (by reducing pressure on the economy's absorptive capacity). Third, it would reduce inflationary pressures, especially under the *de facto* fixed exchange rate regime which the government seems to be following. Fourth, it would not only make public spending more predictable but also limit expectations about future public spending increases, making it more necessary for agencies to pursue efficiency gains.

Fig 1: Recommended Fiscal Scenario: Expenditure Rate and Financing Sources
(as percent of non-oil GDP)



Source: Bank staff estimates

15. **The LTORMS allows for a gradual reduction in the tax burden of the non-oil sector.** The report estimates that a PI of about $5.9 billion in 2007 prices on an annual basis allows government spending to gradually drop to about 37 percent by 2024, while also allowing for a 4 percent reduction in the non-oil revenue base. As such, Azerbaijan has an excellent opportunity to reduce statutory tax rates on the non-oil economy. Such a reduction could contribute to encouraging private entrepreneurs to move into more formal operation of their businesses, and thereby minimize the role of informality and corruption in the economy. (Later discussion in section 3 argues that this opportunity should fully be taken advantage of.)

16. **The LTORMS lays the basis for a more stable macroeconomic policy and reduces the pressure on the exchange rate to appreciate, thus reducing one of the major roadblocks to the diversification of the economy.** The real currency appreciation has been significant since 2004—42 percent up to 2008—and has resulted from the tremendous pressure aggregate demand put on the domestic supply and the policy of the government to peg the manat to the dollar. The LTORMS would reduce that demand pressure and facilitate the transition from a monetary policy focused on exchange rate stabilization to one focused on inflation control. In addition, lowering the pressure on the exchange rate significantly improves the opportunities to compete abroad and makes it easier for the economy to diversify.

17. **Public spending will need to be embedded in a comprehensive MTEF, which pools all oil revenues and recognizes all fiscal risks**. The permanent income approach to spending is

[6] The scenario shown is consistent with, in real terms, a freeze in recurrent spending and a moderate reduction in capital spending through 2017.
[7] While efforts are being made by the government to increase non-oil revenues to enhance the sustainability of the budget, this report is arguing that the bulk of the adjustment should come from expenditure reduction.

sensible only if all oil-related revenues are incorporated into the net present value estimation and if all likely expenditures are included in the expenditure envelope. For instance, on the revenue side, Oil Fund revenues and taxes on AIOC and SOCAR should be included in the NPV calculation as those revenues are cyclical to the oil boom (to production levels and to price fluctuations) and need to be smoothed out. Similarly, on the expenditure side, the PI approach to spending makes little sense if looming pension liabilities or unfunded liabilities of state-owned enterprises are excluded from expenditure forecasts. As the government contemplates its response to the impact of the global crisis, any explicit or implicit commitments on Oil Fund assets need to be taken into account (and deducted from the NPV calculation) before the permanent income is estimated.

18. **In view of the above, the report recommends**:

> ***<u>Recommendation 1</u>: Translate the government's LTORMS principle of "constant real spending" into an actionable decree and then implement it; present estimates of the "constant real spending" level to the Parliament as part of the presentation of the budget and discuss how the amount of oil revenues used in the proposed budget conforms to or diverges from that estimate.***

19. **Creation of an Economic Council to the President to strengthen implementation of the above principle would formalize the current processes for high-level coordination of policies and strategies.** The government can draw on the members of the existing economic team from the Cabinet of Ministers—including the Prime Minister, the Minister of Finance, the Minister of Economic Development, the Chairman of the National Bank of Azerbaijan, the Executive Director of the Oil Fund, as well as the Economic Adviser to the President—to ensure that the Council can operate at both the Presidential and Cabinet levels. The Council would advise the President on strategic, budgetary, and implementation issues, including implementation of the LTORMS, and also track the results of the government's development strategy. While high-level consultations already exist among policy makers, the benefit of formalizing the current process of high-level coordination into the proposed Council is that it would have specific terms of reference, which could help it ensure greater consistency: (i) between the government's budget and the LTORMS principle; (ii) between policy priorities and budgetary priorities; (iii) between budgetary priorities and institutional reforms; and (iv) in the monitoring of development outcomes. The Council, as part of the terms of reference, could meet on a regular basis during the year, with some of its sessions devoted exclusively to giving strategic guidance to the implementation of the budget.

20. **A critical function of the proposed Council would be to ensure the buy-in of the macroeconomic framework and the expenditure priorities by all stakeholders, especially the line ministers early in the budget cycle**. In doing so, it could also monitor the developmental impact of public spending. While Azerbaijan has set up an expenditure management framework according to international standards (with an MTEF effectively embedded in the Budget Systems Law, maintains three inter-ministerial Commissions, on Macroeconomic Policy, one on Revenues, and one on Expenditures), the President's role as a consensus builder in the early phase of the budget process can be strengthened; the budget is the country's foremost policy instrument. In the past few years, final decisions on the consolidated budget envelope (the level of spending) have come late in the budget cycle (after September) and

through very significant mid-year revisions. Public expenditure management would be strengthened if strategic priorities that are given early in the budget cycle by the senior political leadership (a) formed part of a short strategic document that included a medium term budgetary framework, and (b) were reflected in spending ceilings for budgetary priorities. Such an approach would make the work of prioritizing and of reviewing projects and analyzing the impact of decisions more meaningful if the budget ceiling was not subject to re-negotiation. As such, greater participation of the Presidency, beyond the medium-term strategic role, is required early in the budget cycle to: (a) endorse the medium-term macro framework; (b) set annual developmental priorities as part of the medium-term budget framework; and (c) monitor the impact of spending.

21. **Apart from shouldering responsibility on budget preparation, the proposed Council could also play an advisory role to the Presidency on high-level strategic and coordination issues; its work would be aided by a five-year or ten-year strategic document**. The Council can play a leading role in ensuring that strategic objectives are prioritized, coordination bottlenecks are resolved, and institutional reform priorities are set. This applies to several settings. First, on the macro policy level, as indicated, the benefits of an accelerated pace of public sector infrastructure improvements need to be juxtaposed with the costs of a contracting non-oil private sector (when non-oil investment, or non-oil exports or non-oil FDI decline, relative to non-oil GDP). The government needs to decide when public spending is crowding out too much of the private sector. Second, regarding infrastructure investments, studies have documented that investments, especially in roads, require institutional reforms to pay off. The studies suggest that border crossings (and customs clearances) need to be made more efficient and that cargo needs to be treated equitably and with low transactions costs (few delays, no extra-legal payments) if exports are to grow. Third, on the agricultural front, while the government recognizes that the sector can be a significant source of employment and exports, the recently formulated sector strategy proposes significant incentives for Azeri self-sufficiency in several crops; the dual objectives of self-sufficiency and export-oriented agricultural production need to be reconciled, especially as incentives for self-sufficiency can lead to displacing exportable crops. Fourth, on the fiscal front, high-level leadership is needed to strengthen public sector efficiency, both on the recurrent side (hiring policies of the public sector) and on the capital side (procurement, modern appraisal standards), in a way that contributes to the diversification of the economy (creating private sector jobs and opportunities for private investment). Strengthened coordination would be especially valuable during the time of the global crisis, should prioritization of expenditures be required. The aforementioned examples suggest that high-level coordination is needed to resolve institutional bottlenecks that prevent the desired development outcomes from materializing, despite the already significant government efforts. Many European, Asian and Latin America countries have found it useful to a single issue strategic framework document that sets the medium term priorities and key polices (and sometimes financing) for the entire government. Within such a framework document, sector strategic plans (or State Programs) are developed and prioritized.

22. **In view of the above, this report recommends:**

> ***<u>Recommendation 2</u>: Formalize and strengthen current high-level policy and expenditure coordination by creating an advisory body under the President***

(e.g., Economic Council). Make decisions based on a post crisis strategic framework document (five-year or ten-year) and the MTEF.

23. **After important efforts in 2002-03, expenditure management reforms to increase the efficiency of spending have made limited progress.** While Azerbaijan has increased its public spending by four and a half times between 2005 and 2008, important components of an efficient expenditure management system have not been established. The importance of such systems will be much higher as rapid increases in total public spending levels become less feasible. Azerbaijan's Treasury Information Management System (TIMS) is in its sixth year of preparation, while its investment appraisal system is still under design. The 2008 PEFA rated Azerbaijan's system quite high in the *implementation of budgetary expenditures*, but found it wanting in the practices surrounding *prioritization and medium-term investment budgeting*. The 2008 CPAR found the public procurement system leaving too much room for discretion regarding the use of restrictive procurement practices, limitation of bidders, and inefficient centralized decision-making.

24. **There is an increasing urgency to expedite the implementation of reforms of its expenditure management systems, including TIMS, project appraisal, budgeting, and internal and external control**. In addition to completing the TIMS and the investment project appraisal system, Azerbaijan would also benefit from accelerated reforms to improve the budgetary planning process with a budgeting framework that sets the medium-term resources envelopes (ceilings) at the sectoral and agency levels (as documented in the 2008 PEFA exercise). Azerbaijan already has an advantage over some countries as it maintains functional, organizational, and economic classifications of the budget. Internal financial control and audit systems throughout the government will need to be developed to give greater assurance of efficiency and legality. There will need to be greater transparency of the Parliament's role in the budgetary process and the work of the Chamber of Accounts. An integral part of efficient public spending is adherence to modern, fair, and transparent procurement regulations, starting from the regulatory framework to implementation.

25. **Azerbaijan needs to devote special attention to strengthening procurement.** The 2008 Country Procurement Appraisal Report (CPAR) pointed out several areas in procurement that need to be strengthened; most important are the overhaul of the legal framework for public procurement, including regulations, to eliminate gaps in coverage and implementation; introduce safeguards to limit administrative discretion, and to develop standard documents. Azerbaijan can also improve the institutional management and capacity of its legal entities, including clarifying the role of the State Procurement Agency (SPA) and, at a minimum, by making it consistent with the existing legislation, building capacity, and integrating public procurement into the country's public sector governance system. The CPAR also recommended significant improvements in market practices and oversight.

26. **To further strengthen governance, there is a need for more information about the economy to be made available to policymakers and the general public**. The country provides a lot of information to the public at large about the course of the economy and the implementation of fiscal expenditures. Nonetheless, more needs to be done. For instance, the government's information strategy could be further strengthened by ensuring that certain important information is made available on a timely basis to policymakers, external analysts, and

the general public. This information should comprise detailed data on the consolidated budget (quarterly, in GFS format, and under organizational and functional breakdowns), real wages (monthly, at the sectoral level), real imports and exports (disaggregated, monthly), and non-oil private investment (disaggregated, quarterly). Making available detailed high frequency data would further strengthen the government's and the private sector's ability to monitor the economy.

27. **In order to strengthen implementation of the government's investment projects, it can issue an "Annual Report Card" on the quality of the country's infrastructure**. The government is investing substantially to improve the country's infrastructure. While the ongoing projects are a response to tangible investment needs, the government can capitalize on the improvements in the country's infrastructure by effectively advertising its completed projects. The government can issue an annual "report card" on the quality of its infrastructure. The report card can take into consideration not only outputs of investments (such as miles of highway repaved) but concrete outcomes (such as average transit times from the Iranian to the Georgian or the Russian border). The report card can track improvements in infrastructure, and progress can be highlighted to attract foreign investment.

28. **In view of the above, this report recommends:**

> ***Recommendation 3: Establish/strengthen critical expenditure management institutions (treasury management, budgeting, investment appraisal, procurement, and internal and external control) and make them functional; issue an Annual Report Card on to advertise the improved infrastructure.***

II. Public Infrastructure and Network Utilities

29. **Azerbaijan's poor quality of public infrastructure has been one of the factors impeding development since the mid-1990s, and is behind the government's push to prioritize these investments as its oil boom materialized**. The country's infrastructure capacities have been exploited beyond their useful life of 25-30 years due to a lack of financial viability (Azerbaijan's new oil resources only came on line in late 2006), and obsolete management practices. About 56 percent of the main roads remain in poor condition, and 30 percent need to be repaired immediately. Life of up to 45 percent of regional and local roads has expired, which hamper all-year links between territorial units in a number of regions. Similar problems plague the rail sector. Due to deteriorating infrastructure, Azerbaijan Railway (an important export route for oil) is unable to operate at full capacity. The reliability of public water supply, al- though has improved in recent years, especially in the capital area, remains low at 13 hours per day on average. In many parts of the country outside Baku, people receive as little as three hours of water supply.

30. **The government has taken a "short but sure" route to improving network utilities: public funding and public management.** To expedite improvements in network utilities (power, gas, water, fixed-line telecoms), Azerbaijan has sought to fund critical investments from the consolidated budget while simultaneously pursuing financial viability—through significant increases in tariffs (through the Tariff Council), and the introduction of metering and billing systems. At the same time, the government is pursuing structural reforms in all utilities—

although this report takes issue with some of the reform priorities, as discussed below. The government also is gradually moving, in some cases, to corporatization. Azerbaijan has a medium-term tariff policy, which seeks to attain financial viability of utilities by 2010; through 2008 it has been largely on track to doing so.[8]

31. **The most visible improvements thus far have occurred in electricity supply and highways—both are strategic sectors.** Electricity supply has improved along the entire grid, supporting economic activity in the process. This is especially important for Azerbaijan's burgeoning agro-processing industry, which has significant export potential. Another strategic area with visible improvements is in some of the highway portions on the North-South and East-Northwest corridor. Both corridors are important for importing products from Iran and Georgia, and exporting non-oil products, primarily to Russia and Georgia (as a transit and final destination). To continue improving and meeting the growing demand for services, the country needs to face up to several challenges.

32. **The first challenge is to strengthen the financial viability of utilities by adopting a clear pricing policy that capitalizes on the 2007 tariff adjustments**. In preceding years, utilities were subject to significant indirect subsidies. During 2006 and 2007, the implicit subsidies on utilities were estimated at 4.7 percent and 3 percent of non-oil GDP respectively. In principle, these subsidies were eliminated in 2007 with the very significant adjustment in tariffs. On the other hand, as growth statistics confirm, Azerbaijan's petrochemical sector could not manage the January 2007 tariff adjustment and had to shut down for a short while. Going forward, the Tariff Council needs to render future tariffs in a more predictable way by specifying a tariff policy that domestic and foreign investors can assess in advance. Similarly, the State Committee for the Management of State Property (SCMSP) needs to strengthen its management capacity. The SCMSP, the MOF, and the TC need to work together to ensure that the progress made in financial viability in 2007 will remain. At present, the price-setting process is unpredictable to investors, and encourages utilities to stay in the public sector. .

33. **While pricing should reflect financial viability, it should include reasonable operating costs and part of the investment (as appropriate in each sector)**. Lack of sound information about the cost structure of service delivery can make it difficult to set a credible path for tariff adjustments. Recent reforms have allowed the MOF to usually access key SOE information as part of the budget process on a timely basis. Strengthening that initiative, together with the application of International Financing Reporting Standards (IFRS) to the country's large SOEs (the cutoff date was January 1, 2008, but has been postponed), should help improve the evolving understanding of the cost structures of SOEs, which are the basis of credible planning,

[8] The amount of public resources devoted to public investment in recent years has been substantial. Capital expenditures have increased by more than 14 times in nominal terms since 2004, reaching 25.7 percent of non-oil GDP in 2007. They are estimated to have reached 37.2 percent of non-oil GDP in 2008. Over 2005–07, the government has invested significantly in administration, social services, energy, transport, and communication. As part of these investments, the government has invested AZN 420 million in Azerenerji (the electricity utility), AZN 64 million in Azeriqaz (the gas utility), AZN 125 million in Azersu (the water utility), AZN 117 billion in the State Agency for Irrigation, AZN 82 million in the Baku Metro, AZN 63 million in AZAL (the Azeri airline), and AZN 419 million in road construction through the Ministry of Transport (MoT). Spending on network utilities comprised approximately 50 percent of total capital expenditures for 2004–07.

including investment and tariff determination. In addition, the capacity of medium-term maintenance planning and budgeting of utilities needs strengthening, primarily in the road sector.

34. **In view of the above, this report recommends:**

> ***Recommendation 4: Complete pricing policies and complete institutional strengthening related to financial management and to improving maintenance; this will secure viability of investments and financial viability of state owned enterprises.***

35. **The second challenge is to improve the efficiency of the utilities and make sure that the "short but sure" route will not become financially burdensome for the state in the medium term.** An increase in SOE efficiency is needed not only to provide affordable services, but also to reduce the financing needs for new investments and the pressure on the budget. The urgency perceived by the government to address large-scale investment needs may have left little time to focus on creating incentives for improving efficiency. Nevertheless, progress has been made toward the corporatization of enterprises, in improving the billing and collections capacity of the gas and electricity utilities, in significantly adjusting tariffs in 2007, and in strengthening the exchange of information between the MOF and the utilities. In the future, tariff paths can be selected to create incentives to improve efficiency, as has been shown to be good practice in other countries. Further progress can be made by involving the private sector both in investment and management, as other countries have done with success. A first step could be selling Aztelecomm (fixed-line operator) to a reputable international investor when the global crisis dissipates, advancing the introduction of IPPs to Azerbaijan. Likewise, management contracts for water should be considered. However, a more forceful engagement requires introducing greater precision in the institutional arrangements and structural incentives in each sector.

36. **In view of the above, this report recommends:**

> ***Recommendation 5: Consider using the medium-term tariff policy to increase SOE efficiency during the global crisis, and as the crisis eases, pursue greater private sector participation to improve efficiency, lessen operational risks and create fiscal space (in particular, privatize Aztelecomm, proceed with one IPP, and consider private sector maintenance for roads).***

37. **The third challenge is to create the conditions for assuring financial sustainability, efficiency, and private sector participation through the buildup of appropriate institutions**. To begin with, the Tariff Council needs to be fully independent. However, a proper regulatory agency requires the government to have taken decisions regarding market structure and the role of the private sector. A good example of the link between market structure and regulation is provided by various strategic options facing Azerbaijan's power sector. First, it could seek to develop into a company that services the domestic economy, and, in this case, choose from a menu of sector ownership and management models, which would spell out the role of Azerenerji, and the potential role of independent power producers (IPPs), as well as the ownership and management of the distribution network. The regulator would then need to be organized around that model. Alternatively, the country could take advantage of the regional opportunities

available in the power sector. But this would imply that Azerenerji would become more of a purchasing company, and it would be more efficient if it could give up managing a distribution network. In each case, the exact role of the government is different, as are the roles of the private sector and of the regulator. But without a concrete decision on the structure of the market, the government is keeping investors at bay and delaying the development of the regulatory authority. While Azerbaijan's other utilities sectors (i.e. telecommunications, gas, and to some degree water and irrigation) appear to be more straightforward, decisions on strategic direction and market structure are likewise wanting. On the railways, the government is intending to continue further restructuring and to turn it into a commercial entity and plans to create subsidiary entities under separate lines of business (infrastructure, freight, passenger, and non-core activities).

38. **In view of the above, this report recommends:**

> ***<u>Recommendation 6</u>: Complete strategic decisions on market structure of utilities sectors (particularly regarding the power and water), to begin fine-tuning regulatory arrangements and invite private sector involvement.***

III. Private Sector Environment

39. **Private investment depends not only on infrastructure services and inter-temporally consistent macroeconomic policies but also on a climate for private sector that is very open and competitive**. Azerbaijan has been quite successful in attracting large investments into oil- and gas-related sectors, but much less so in other areas. Total private investment has averaged more than 50 percent of GDP in recent years, although private investment in the non-oil sector remains very low (it has rarely exceeded 10 percent of non-oil GDP and 5 percent of total GDP). This low share suggests that there is considerable potential for the private sector to grow and contribute to diversification.

39. **Transition countries have used competition created by new investment (including from SMEs) to improve productivity across all their enterprises, including the productivity of SOEs**. Successful economies have demonstrated the benefits of opening up, and establishing internationally competitive industries, whose exports are the cornerstone of external sustainability. Recent research by the World Bank on growth and productivity in Eastern Europe and Central Asia showed that productivity growth has been an important determinant of growth and that such increases in productivity have been possible in countries that have stepped up both domestic and external competition. Some resource-rich countries (i.e. Nigeria, Venezuela) have been less successful in increasing their productivity because they have not opened up trade and private investment in the non-oil sector sufficiently to allow such competition.

40. **The government recently stepped up its efforts to improve the regulatory environment for business**. Recent steps to relax the rules for starting small and medium businesses, including the creation of a "one-stop window" for registrations, have contributed to further "leveling of the playing field" for all sizes of businesses, including SOEs. As a result,

Azerbaijan's ranking improved from 97th to 33rd among 158 countries, between the *Doing Business 2009* and *Doing Business 2008* surveys.[9]

41. **Azerbaijan, however, has delayed accession to the WTO**. Accession could help the government to resist protectionist pressures, including pressures for sector-specific supports and tax exemptions; accelerating accession would also convey a positive signal to both domestic and external investors, as well as lock-in a stable, transparent and simplified tariff structure, modernize the legal/institutional framework for standards, and introduce important sectoral reforms in key services sectors. Azerbaijan needs to juggle the terms of accession to WTO in order to signal its desire to broaden and deepen its trade in non-oil goods and services. At the same time, this will create a conducive environment for building competitive and sustainable non-oil sectors that can spur growth and employment in the medium and long term.

42. **In addition, Azerbaijan's progress in three areas—approval of licenses, trading across borders and, to a lesser degree, payment of taxes—lags other countries**. This finding of the *Doing Business 2009* report confirms the complaints from firms about high transaction costs resulting from informal barriers to business operations in respect of licenses, customs clearances and tax inspections. The high transaction costs can serve to limit the entry of new firms and can thus limit competition from both domestic and external sources; this can result in higher market concentration in various sub-sectors of the economy. There is evidence to show that price transmission processes are weak in the agricultural sector, in part due to market concentration, and that the number of small and medium enterprises per capita is significantly lower than in comparable countries. Limited competition keeps production costs higher and productivity, making the country less competitive.

43. **The regulatory system has been biased against entry and expansion: while business registration will likely improve due to recent reforms, the lagging licensing and permit issuance regime continues burden private sector operators and impede new investment**. In the last two years, Azerbaijan brought down the number of days it takes to register a company from 115 to 16; early results from 2008 are promising and show that these reforms are having an impact, although going forward careful monitoring is advisable. On the other hand, Azerbaijan's licensing and permit regulations remain roughly unchanged. There is neither a clear definition of what constitutes a license, a permit, an authorization, or a certification, nor a review mechanism to assess the legal basis, regulatory purpose or potential impact and effectiveness of these numerous requirements. There is a need to draw on international experience to examine what may be the most effective way to regulate vulnerable sub-sectors and to move to a less interventionist approach with regard to issuance of licenses and permits. A major examination of what sectors and sub-sectors of the economy needs to be regulated should be undertaken, including what would be the goal of such regulation and how it can be done quickly and efficiently. The government indicated to will seek to streamline the construction permit requirements as its next priority; the present system is needlessly time-consuming, and lends itself easily to corruption in a sub-sector where efficient operation is key to keeping construction costs down.

[9] In the Doing Business 2010 (which ranks countries' business environments for 2009 and re-ranks the 2008 results) Azerbaijan ranks 38th globally for 2009 and 2008.

44. **In view of the above, this report recommends**:

> ***Recommendation 7: Reduce coverage of licenses and permits, and rationalize the process and speed of issuing licenses and permits.***

45. **If Azerbaijan is to be a transit hub, its trade and custom facilitation processes have to be competitive with the best**. Currently, it ranks 174th in trading across borders in the *Doing Business 2009* report. The weaknesses are many. There is differential treatment of enterprises in customs processing of imports and exports in terms of speed in clearance as well as in formal and informal charges. The scope for collusion between importers and customs officials is considerable. This is evident from the fact that similar import consignments obtain different duty rates and different regulatory treatment, which distort competition in domestic markets for the same imports. Also, the processes for clearing consignments are out-dated. There is also very little mechanization or computerization of the customs system, and, partially as a consequence, no use of more modern risk-based inspections, where only a share of consignments would be inspected depending upon their risk profile; currently all imports are inspected.

46. **In October 2008, the government adopted a State Program for Reform of the Customs that addresses three important issues**. The program has already established an integrated set-up at the border crossings under the overall control of the Customs Agency, in contrast to the current situation where crossings are staffed with representatives of various agencies (like highway safety, phyto-sanitary control, customs, etc.). However, customs clearance itself remains a distinct activity, which occurs in government-run warehouses in four locations inside the country. The number of trained customs brokers and specialists is very limited. Under the program, Azerbaijan plans to introduce a modern, harmonized system of tariffs. It also expects to move to risk-based inspections. Finally, Azerbaijan seeks to develop outcome indicators to monitor progress and the impact of changes being undertaken. There is likely to be a need for support and technical assistance to the government's ongoing reforms.

47. **In view of the above, this report recommends:**

> ***Recommendation 8: Expedite ongoing reform process in customs and trade facilitation in both land-border and sea ports crossings, and move to more open, modern, computerized and risk-based, clearing processes, which lead to lower inspections.***

48. **The government should use the fiscal space foreseen by the oil fiscal framework (LTORMS) to undertake a gradual but credible and systemic reduction in tax rates as part of a package to support private investment and government savings.** Azerbaijan has developed a reasonable tax system since independence, and its performance has improved considerably in recent years. The buoyancy of the economy and reforms in tax and customs administration have contributed to a major increase in tax revenues from the non-oil sector—the ratio of non-oil tax revenues to non-oil GDP has risen from 19.7 percent of non-oil GDP in 2003 to about 32 percent in both 2007 and 2008. Tax rates in Azerbaijan remain relatively high *vis a vis* comparators. With higher oil revenues, the government has the possibility to reduce its tax

rates; collectively, the tax rates (especially Personal Income Tax and Social Security Contributions) tend to penalize formality and discourage new private investment. [10]

49. **The current tax system (both statutory rates and administration), encourages firms to remain very small and to keep a significant part of their activities outside the formal economy.** In addition to high tax rates, tax administration practices (filing requirements, auditing practices, inspections, etc.) are too cumbersome for enterprises, which compels them either not to register, to remain within the Simplified Tax Regime, or to under-report their earnings.[11,12] The consequence is that the firms lose access to finance and technical services, and they are not encouraged either to adopt modern management and accounting practices. Therefore, it is not surprising that Azerbaijan has one of the lowest numbers of formal MSMEs per capita in the region.[13]

50. **The government has made progress on lowering tax rates and on improving administration.** Since 2003, the most important changes have been the reduction of the corporate tax rate in 2005 (from 24 percent to 22 percent) and in 2009 (from 22 to 20 percent), and the reduction of the social security contribution (from 28 to 25 percent) in 2004, reduction in the VAT (from 20 percent to 18 percent in 2005), and regular increases in excise taxes. In terms of tax administration, in the last two years, several improvements appreciably reduced the compliance burden as well as the taxpayer-tax official contact. Most notably, Azerbaijan has: (i) introduced electronic filing (96 percent of VAT payers and 35 percent of all taxpaying businesses took advantage of it in 2007); (ii) established nationwide call centers; (iii) enabled taxpayer account information on the Internet; (iv) reduced the number of forms approximately from 90 to 15, over the last several years, improving efficiency and reducing the close contact between taxpayers and tax officials; and (v) linked the tax database to those of other agencies, namely, Treasury, Customs, commercial banks, and the Ministry of Interior. Consequently, most tax functions, including desk audits, have been automated. Any mismatches in tax returns are generated without human intervention and sent to taxpayers within five days. Although initially controversial, the special deposit account for VAT seems to have been well received by the large taxpayers that form the backbone of the tax system.

51. **Nevertheless tax rates remain high and the administration burdensome; critical reforms are needed with a view to getting incentives right for enterprises to operate formally and to keep all their activities formal**. Specifically, it is important to ensure that the

[10] On May 2009 the Government decreased the maximum tax rate for corporations to 20 percent (from 22 percent) and for individuals to 30 percent (from 35 percent), making progress towards the recommendations made in this report.

[11] Currently, Azerbaijan maintains a Simplified Tax Regime (STR) of 4 percent for enterprises with turnover below either AZN 22,500 per quarter (98 percent of these enterprises are in Baku), or AZN 90,000 per year; participating enterprises pay no property tax, no VAT (18 percent), make no social security contributions (23 percent), and individuals engaged in entrepreneurial activities pay no income tax.

[12] The simplified tax regime (STR) was created to support micro and small enterprises throughout Azerbaijan; this report argues that while the enterprises do enter the simplified regime, the incentives for exiting that regime (on the side of tax rates and administration need to be strengthened substantially.

[13] It is important to note that while a number of factors, such as culture, size of markets, absence of financing or unethical behavior, may affect an entrepreneurs decision to operate informally, this report asserts that the high transactions costs imposed by the tax system (as laid out in this document) are very significant contributors to that decision.

"flow-through" of enterprises from informal entrepreneurial activity to the STR, and graduation out of the STR into the regular tax regime, is managed by the right incentives. It is also important that the burden of tax administration on enterprises be reduced. While lower tax rates serve to reduce incentives to stay within the STR, and to conceal earnings, improvements in tax and customs administrations also provide strong incentives for entrepreneurs to operate formally. On the tax administration side, Azerbaijan should strengthen its current efforts to minimize contact between tax agents and entrepreneurs.

52. **The government should not keep high tax rates with the purpose of extracting resources from the SOEs, but instead collect dividends on equity of SOEs and interest on loans extended to them.** Reportedly, the government is reluctant to lower tax rates across the board out of fear of losing significant revenues it receives from SOEs. The consequence has been to maintain high rates for private firms and agents in the non-oil economy, thus castigating entry. This report recommends that when reducing the tax rates, the government maintain the same tax burden on SOEs, but extract those revenues through regulation, or through dividends.

53. **The government could use the opportunity of the global crisis to adjust spending to a more sustainable level –but still capitalize on the relative high importance of oil revenues early in the oil boom to lower the tax burden on the private sector.** Figure 1 depicts oil revenues, relative to non-oil GDP under the current oil price scenario. A more conservative price scenario would mean a lower permanent income from oil, which necessitates a faster adjustment to the proposed government spending level of under 40 percent of non-oil GDP. Thus, oil revenues could also be used to provide a break to the private sector early in the oil boom, even under a low oil price scenario.

54. In view of the above, this report recommends:

> ***<u>Recommendation 9</u>: Reduce the tax rates, especially in direct taxation and in social contributions (once timely actuarial and strategic analysis of all pensions is completed and competitive and sustainable pension packages for contributors and non-contributors are determined), which burden the private sector and often lead to shadow employment, and continue making improvements in tax administration (particularly minimizing the contact between inspectors and enterprises).***

55. **The large size of Azerbaijan's government creates multiple additional opportunities for state actions to impinge on the private economic activity. The government needs to reverse that role and to become a problem solver for the private sector and for non-oil export development.** As noted in 2008, public spending is expected to rise to 83 percent of non-oil GDP and the government will manage around 80 percent of overall investment. The poor ratings in international surveys on corruption and transparency-- confirmed by the scores on EBRD transition indicators for second-generation reforms (intended to make markets work more efficiently)-- are reasons for serious concern when the government is so large. They call for greater transparency in public actions (awarding of licenses and permits, procurement, etc.) and an open dialogue with the private sector to better respond to the constraints that limit economic activity. Recent reforms throughout the world (e.g., Ireland, Malaysia) have shown that results-oriented partnerships with the private sector (for domestic investment, FDI, and export

development) have enabled the government to respond in a more focused manner to the needs of the private sector. While the exchanges could take place on either a regional or sectoral basis, and could include labor unions and NGOs, it is important for the government to establish its own functioning feedback loop with SMEs and large entrepreneurs.

56. In view of the above, this report recommends:

> ***<u>Recommendation 10</u>: Create the conditions for a transparent dialogue with the private sector, focusing on industries with non-oil export potential and on FDI attraction; use government facilitation to investigate actively and resolve financing, quality, standardization with government facilitation, and remove domestic market imperfections that hinder competition at the sub-sector or product category level.***

IV. Financial Sector

57. **Azerbaijan's financial sector has grown in size in recent years.** In 2008, gross domestic savings were 65 percent of GDP, one of the highest levels, regionally and internationally. The real quantity of money (including real quantity of banks' deposits) also grew considerably. Credit expanded rapidly from 2005 due to a combination of monetary and exchange rate policies (see chapter 1 and below). Nevertheless, in mid 2008, the ratio of total lending to GDP was approximately 17 percent, compared to 50 percent of GDP for EU-accession countries, suggesting financial depth remains relatively low. This is especially low, given that banks are essentially the only financial intermediaries currently existent in Azerbaijan.

58. **At the same time, the regulation of the financial sector has improved.** Azerbaijan's financial sector was the first to adopt International Financial Reporting Standards. It has also been the first to strengthen the corporate governance of its banking sector, based on extensive collaboration with IFC, EBRD, and other development partners. The National Bank of Azerbaijan has developed key legislation to improve the legal and regulatory framework in the sector and to bring it closer to international standards and strengthen its capacity as a regulator.

59. **Yet, Azerbaijan's financial sector has been playing a limited role in intermediating resources and pooling risk. It has been of generally limited consequence in diversifying the economy**. The country's nascent financial sector consists mostly of banking, with 46 banks, of which the largest bank controls 44 percent of the sector's assets; the top two control more than 50 percent of assets. At the same time, the contribution of the organized capital market to growth has been very limited. Approximately 90 percent of securities transactions take place over the counter (OTC), and are not disseminated as market information. The results are poor price discovery and little market transparency. In 2007, annual equity turnover on the organized exchange was about 1 percent of GDP, and in 2008 that ratio dropped to about half. Approximately 90 percent of the primary and secondary turnover on the organized exchange is in short-term debt instruments, that is, T-bills and National Bank of Azerbaijan (NBA) notes. Corporate bond issuance has increased rapidly over the last two years, but bond duration does not exceed 15 months.

60. **In recent years, Azerbaijan has experienced extremely rapid credit expansion, which, while welcome, calls for vigilance by the supervision authorities particularly if the global crisis begins to adversely affect Azerbaijan's economy**. From 2002 to 2008, credit from the banking sector grew more than thirteen-fold, albeit starting from a very small base. The number of non-bank credit providers also increased—from 47 to 94 over this period. This increase in credit is the other side of the coin of Azerbaijan's quest for maintaining a controlled appreciation of the manat in light of the high volumes of U.S. dollar financing of the fiscal deficit, high revenues of SOCAR, and foreign borrowing from local banks. Azerbaijan, especially since 2007, also has been the recipient of foreign lending to Azeri banks, which has further boosted pressure for local currency appreciation and simultaneously pose refinancing risks to the banking system amid tight global credit conditions. In neighboring Kazakhstan, foreign borrowing of this kind led to a financial crisis. At the same time, the quality of the loan portfolio has been improving: in 2007, the banking sector's non-performing loan to total loans was 2.9 percent, and only five banks had a ratio exceeding 5 percent; by mid 2008 it was 2.2 percent (down from 29 percent in 2001)–but caution is warranted as during a crisis economic conditions tend to deteriorate, and the is relatively a recent one. In 2008, the National Bank of Azerbaijan increased the vigilance of its supervision.

61. **In the future, the authorities need to be ever more vigilant**. As long as the economy maintains a high growth rate, most credit granted will likely continue to perform. However, the rate of growth has already slowed. It is quite possible that banks may not have exercised adequate due diligence about the creditworthiness of their borrowers in an environment of both staggering credit growth but limited human resources and weaknesses in corporate governance. Weak risk management and limited control over borrowers' background could imply that the rapid monetization of the economy has been accompanied by the rapid growth of doubtful quality loans. Given the global crisis, we would expect that some banks may find themselves in a difficult position. Furthermore, the dominance of the state-owned bank has the potential to de-stabilize the banking system and the economy in the event of serious credit and liquidity concerns. Should such situations materialize, it would be important to ensure that the authorities adopt pro–active measures to help mitigate those risks.

62. **Azerbaijan's monetary authorities have played a proactive role in the exuberant—and highly risky—period before the global crisis**. In 2005–08, the stock of domestic credit in Azerbaijan increased, on average, by 64.4 percent per annum, as part of the government's fiscal policy and its desire to maintain a *de facto* pegged exchange rate relative to the U.S. dollar. The resulting appreciation of the exchange rate may have led to excessive foreign borrowing. This is a lesson that Kazakhstan learned the hard way. The Azeri banking authorities have learned from this experience and have remained extremely vigilant to avoid overexposure to currency risk. As a result of this vigilance, by the end of 2008 the commercial banks held about $2.6 billion in foreign debt. Unfortunately, due to the global crisis this debt is not being rolled over. Although the amount should be manageable and allow banks to keep current on their obligations, it represents a challenge to the banking system's ability to extend new loans. At the end of 2008, Azerbaijan had $18 billion in the Oil Fund and in National Bank of Azerbaijan reserves, providing ample coverage of short-term debt obligations.

63. **The global crisis has required the authorities to reverse their pre-October 2008 actions, and encourage credit expansion**. In order to support economic activity during the

global crisis, the monetary authorities have taken a proactive stance, withdrawing the imposition of the 5 percent reserve requirement on foreign loans by commercial banks. They have also made available low interest loans to commercial banks. However, further discussions regarding the use of Oil Fund assets to lend to-- or invest in-- commercial banks need to be viewed with caution and with careful balancing of the potential costs and benefits (with due attention to what specific problem the action is aiming to solve), respect for the regulations of the Oil Fund, and as part of the activities of the consolidated budget.

64. **The government needs to strengthen key aspects of financial infrastructure in order to expand the market for credit: the information available to creditors and the accessibility of collateral are both critical.** To ensure the availability of *information to creditors*, Azerbaijan may wish to: (i) extend the coverage of the public registry; and (ii) broaden the registry's scope to distribute credit information from retailers, trade creditors, and utility companies as well as from financial institutions. To strengthen the *accessibility of collateral*, Azerbaijan may wish to: (i) amend legislation to allow all legal residents of the country to be party to collateral agreements; (ii) create a unified registry for all security rights in movable and immovable properties; (iii) amend legislation to allow parties to have recourse to out-of-court enforcement without restrictions; and (iv) reduce the cost of enforcing financial contracts, including permitting the seizure of collateral. The country may also wish to further the development of the leasing industry and introduce legislation on warrants. Both instruments "transform" illiquid collateral into a liquid financial instrument, readily recoverable upon borrower default.

65. **In view of the above, this report recommends:**

> ***<u>Recommendation 11</u>: Maintain and strengthen proactive banking supervision and regulation by monetary authorities.***

66. **A strong and dynamic MSME sector requires financing; as such, the multiple efforts to extend credit to MSMEs need to be expanded and should be anchored on market principles.** Azerbaijan maintains multiple credit programs for MSMEs, but they need to be expanded, broadened and anchored in market principles. The country has seen significant growth in micro-credit through a new institution and in small enterprises via the National Entrepreneurship Fund. Azerbaijan needs to expand these efforts, and, more particularly, expand access to the agricultural sector. Among several countries that have succeeded in this area, the Netherlands and France provide good examples in developing commercial lending for agriculture.

67. **Furthermore, the large share of banking system lending to state enterprises is crowding out the more efficient allocation of financial resources to private sector projects.** With a large public sector, 13.7 percent of all loans are to state enterprises at end 2008, more than two-thirds of which is concentrated in the portfolio of the state-owned bank. The lack of transparency in the allocation of credit to state enterprises distorts competition and may result in higher funding costs for the real sector.

68. **Azeri policy makers should prepare to attract foreign banks when the global crisis ends**. While Azerbaijan has a few foreign banks, it is important for the country to attract some big-name financial institutions when the crisis subsides and a clearer picture emerges regarding

the health of surviving international banks. While such banks would benefit the country by strengthening competition (despite the progress already made in Azerbaijan in reducing the market share of local banks), foreign banks can add substantial value to the banking sector, particularly given their experience in lending to the agricultural sector on commercial terms.

69. **In view of the above, this report recommends:**

> ***<u>Recommendation 12</u>: Improve access to credit for MSMEs and for larger corporations by improving the institutional environment (i.e., creditor information) and by attracting large foreign banks after the global crisis (i.e., those specialized in agriculture).***

70. **While Azerbaijan's efforts to improve access to credit should continue, they need to be based on both institution-building and fair competition**. Azerbaijan's three special funds—the National Entrepreneurship Fund, the Mortgage Fund, and the Azerbaijan Investment Company—are designed to play the role of market developer and to also expand access to credit. While international experience does exist regarding the governance of sovereign funds (referenced IMF guidelines, IFC work), it suggests that the management of these funds will have difficulty resisting political pressures. If, however, Azeri policymakers feel the need to maintain these three funds, they should: (i) develop the governance of the funds as the first priority; and (ii) consider subsidizing capital, instead of interest rates.

71. **In view of the above, this report recommends:**

> ***<u>Recommendation 13</u>: Any use of public funds in expanding access to credit should be on the basis of seed capital or subsidies to borrower's capital, rather than on the basis of subsidies on interest rates.***

V. Ensuring a Qualified Labor Force and Better Use of Human Capital

72. **Azerbaijan has fallen behind in terms of the quality and efficient use of its human capital, due primarily to the inadequacy of its education system and to labor market policies.** Azerbaijan inherited a relatively good education system from the Soviet period. However, in the transition years, the quality of education deteriorated; consequently, the supply of qualified labor has also significantly decreased. The Azeri education system suffers from corruption (which decreases the value of its diplomas), under-investment (public spending on education decreased from 3.9 percent to 2.7 percent of GDP between 2000 and 2006, well below the average of 5.2 percent of GDP for the OECD countries), and a serious mismatch between the training of graduates and the skills demanded by the economy. As a result, Azerbaijan lags behind its comparators in the quality and quantity of human capital. Even though in 2007 Azerbaijan had the fourth highest GDP per capita in the CIS, it ranked 23rd in Europe and Central Asia (ECA) in the Knowledge Economy Index of the World Bank Institute (2008), ahead of only Uzbekistan and Tajikistan.

73. **Investments in education are particularly important given that the country is going through a major demographic transition.** Due to the relatively high fertility rates of the past

and a favorable population age structure, Azerbaijan's working age population (15–64) continues to grow rapidly; it has climbed from just under 5.0 million in 1999 to 5.77 million in 2006 (a 16 percent increase). During the next decade, the number of able-bodied individuals aged 15–64 will further increase to 6.55 million in 2015 (according to the UN population forecast[14]). On one hand, this will stimulate competition for jobs. On the other, as the cohort born in the 1990s—when birthrates were low—enter the labor force, the population aged 15–24 will shrink from 1.74 million in 2006 to 1.54 million in 2015, and further drop to 1.19 million by 2020. This progressive decline will lead to the ageing of the labor force. Azerbaijan, at that point, will have to be ready to meet the development challenge with a highly educated and skilled population.

74. **There is a significant mismatch between the specialization of graduates and the demands of the economy**. In professional and higher education institutions, there is an overproduction of specialists in areas such as education, health, and manufacturing, which have relatively limited job opportunities; whereas very few graduates have been trained in agriculture and services, from where much of the new demand for employment is currently coming. This mismatch is recognized by employers. For instance, while MSMEs find it very easy to find unqualified laborers (who constitute the bulk of recruited employees), they have difficulty finding qualified crafts and related trade personnel, technicians, and managers.[15] In fact, in recent years, job fairs in Baku have had very low levels of job placement: approximately 70 percent of the jobs on offer were not filled, despite acceptable wages. The General Employment Department, under the Ministry of Labor and Social Protection of the Population (MLSPP), has determined that the reason for this failure is that many of the available jobs had high competency requirements, including computer skills and English.

75. **The government needs to invest more in education, particularly at the tertiary level.** It is essential that the government revise current public spending decisions to make education a top priority. This budget reorientation should aim to enhance quality and increase enrollment rates in higher education. Moreover, an important effort to raise teacher salaries is also essential. Salary increases might be financed through raising the existing very low student-teacher ratio in secondary education (9.4 compared to the OECD average of 14). This effort should be linked to measures that reduce corruption in the education system. In this way, Azeri diplomas will regain their value. On the other hand, public spending on higher education should gradually increase to 1.1 percent of non-oil GDP, allowing for the creation of new universities (especially outside of Baku) and higher enrollment in tertiary education institutions. Furthermore, Azerbaijan could explore the possibility of attracting foreign universities or private training companies, as has been done quite successfully in Japan, China, Korea and India.

76. **Education and training must be linked to labor market needs.** Increasing employment opportunities means intervening to end the mismatch between the specialization of graduates and the structure of the economy. Intervention should entail better cooperation between the labor and education ministries, with a view to offering useful information to students on recruiting sectors and wages through career counseling. This should include revising the curricula of public universities and professional schools, based on the government's interaction with the

[14] Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, "World Population Prospects: The 2006 Revision".

[15] See the results of the survey concerning the business environment for SMEs in Azerbaijan, conducted by the International Finance Corporation in December 2007, and Kuddo and others 2005.

private sector. In addition, there should be a comprehensive study of current and future labor market needs. Concurrently, there is also a need to develop a modern system of vocational education and training (VET), as well as adult training (lifelong learning), which will equip workers with skills currently required by the employers. To this end, the existing network of regional training centers and VET schools should be restructured and modernized. At the same time, a Common Quality Assurance Framework as well as a standardized, competence-based qualification system should be created. In the process, Azerbaijan can benefit from the recent experience of some OECD countries, such as Hungary.

77. **In view of the above, this report recommends:**

> ***Recommendation 14: Focus reforms on tertiary education and ensure the system responds to market needs.***

78. **The Azeri government (MoLSPP) could develop active labor market policies.** Strategies to "activate" the unemployed with the help of high-quality employment services can help ensure that benefit recipients and other job seekers have a better chance to find employment. In Azerbaijan, activating labor policies require improving job search and matching services, initial career and job counseling, job and vacancy fairs, training programs, and public works projects through better assessment of previous programs and better tailoring to the needs and characteristics of the beneficiaries and the labor market. It also entails networking with social and health services, housing sector, and communities.

79. **In view of the above, this report recommends:**

> ***Recommendation 15: Undertake active labor market practices to help match employment with job seekers.***

80. **Azerbaijan's public sector needs to adjust its approach to employment and compensation**. In light of the need to increase public sector efficiency (Chapter 3) and the need to ensure that it delivers higher quality services to the population (Chapters 4 and 5), the government cannot continue to be an employer of last resort. It must attract qualified and experienced people, and must retain the highly qualified individuals that it already employs. To do so, it must increase their salaries and must link pay to performance. However, linking pay to performance requires an indirect approach, as recent experience has shown. Several OECD countries have tried to improve the performance of their public services by linking the pay of their public sector employees to the performance of their organizational units. This experience has proven to be arduous because measuring performance (in terms of activities, outputs, or outcomes) has been challenging and has required a considerable gestation. Moreover, the recent empirical literature on the results of performance-based pay reforms is discouraging. An alternative for the Azeri government may be to initiate pay reform around the establishment of a competitive remuneration structure that links salary improvements primarily to promotions, rather than to annual performance-related pay bonuses or salary adjustments.

81. **In view of the above, this report recommends:**

> ***<u>Recommendation 16</u>: Improve the efficiency of the public sector by raising pay to retain and attract qualified people, and linking it to promotions- refrain from using the government as an employer of last resort.***

VI. In conclusion

82. This report recognizes that diversification is key to the sustainability of development outcomes in Azerbaijan, and presents medium-term recommendations for achieving diversification. The strategy is a response to the temporary nature of Azerbaijan's oil boom and the country's need to generate sustainable growth and employment in the medium term. The urgency stems from: (i) the unsustainable level of public spending; and (ii) the recent collapse of oil prices. The stalling of diversification efforts in recent years is also an important contributing factor to consider. The proposed set of policies would have been necessary even if oil prices had stayed high, although the government would have had more time to adjust. The diversification strategy rests on three principal recommendations**:**

- **Stabilization of the level of oil revenue spending and enhancement of efficiency.** If Azerbaijan were to stabilize its level of oil spending (through more stringent implementation of the LTROMS), it would be able to reduce pressures for appreciation of the currency and create the fiscal space necessary so as to reduce the tax burden on the private sector. By curtailing spending, the government would also be reducing the exposure of the banking sector to appreciation pressures, as more stable foreign exchange inflows would make for a more stable macroeconomic environment. To reap the benefits of fiscal expenditure rule, the government would need to formalize its high-level coordination mechanisms; the proposed Economic Council could play a leading role in this context. Adoption of a fiscal expenditure rule, within the context of a medium-term expenditure framework, would exert pressure for more public sector efficiency in the implementation of the recurrent budget and the preparation and implementation of capital expenditures.

- **Focusing deregulation on diversification**. The government's ultimate goal of sustainable private sector growth could be achieved more efficiently if its efforts to deregulate the economy were prioritized according to the greatest potential benefit to diversification. On the business regulations, reforms of border crossings and clearance procedures, reduction in tax rates, and improvements in tax administration would be important. In the broader operational environment, institutions to attract foreign investors would have to be strengthened. On the utilities front, communication and power should figure as priorities, with the intention of developing world-class support to the private sector, which would attract foreign investors. The power sector has added regional potential as well. Finally, access to credit in the financial sector also rests on institutional improvements in accessing information on loan applicants, and on the banking sector acquiring expertise on particular sectors and customer types (i.e., all categories of MSMEs). To bring these elements together,

and to ensure they all work to increase Azerbaijan's non-oil exports, significantly more high-level coordination is needed.

- **Enhancement of human capital.** Azerbaijan's labor force needs to become the basis of the country's competitiveness, and both private and public sectors must play a role in providing employment. Today, secondary education, vocational education and training, and tertiary level programs need to be more closely aligned to market needs. Again, diversification can act as a focal point, and must do so, particularly since Azerbaijan is going through a demographic transition and can expect a boom in its labor force. The currently outdated training institutions are largely unable to prepare job seekers to engage in globally competitive activities, while the public sector cannot be an employer of last resort. Focusing training around activities that will likely sustain Azerbaijan's growth will ensure a better match between supply and demand for labor. At the same time, Azerbaijan's public sector needs to become more competitive; higher skills and commensurate pay are necessary.

83. The global crisis argues for very specific short-term prioritization of Azerbaijan's reform efforts to achieve diversification. The aforementioned medium-term priorities could have been implemented with some leisure under a pre-global crisis scenario, with oil prices at high levels and demand from Azerbaijan's export markets (oil and non-oil) on the rise. But the reversal of oil prices, their volatility, and the slowdown in global markets all suggest that within the aforementioned framework, the following priorities should be set:

- **Ensuring fiscal sustainability and efficiency of public spending**. Uncertainty regarding the level of fiscal revenues from oil in 2009-10, suggests that the government needs to: (i) uphold the guidance provided by the permanent income approach to spending; (ii) maximize the impact of its investment program (by focusing on bottlenecks to diversification); and (iii) given the concerns about the efficiency of public investment and the negative impact of the crisis on the real sector and employment, shift some of the investment budget to poverty alleviation under the targeted social assistance scheme. Additionally, it must move with greater commitment on budgeting reforms and strengthen, as planned, internal and external audits, and public procurement.

- **Ensure stability of the financial sector and access to finance for MSMEs**. Azerbaijan's monetary authorities should do their due diligence to assess the stability of the financial sector. Any support to the banking sector should be done transparently on an individual bank basis, with participation of shareholders, and with a clear exit strategy in mind. In parallel, the government can seek to expand access to finance for MSMEs. Any financial support from the government to MSMEs is better allocated on a market basis (using market rates).

- **Reduce the cost of production for domestic enterprises.** The global crisis is constraining trade and growth opportunities. While Azerbaijan needs to temporarily rely more on domestic demand to support growth than in previous years, it needs to focus on reducing the direct and indirect costs to production (lower burden of tax and

customs administration, lower burden of licensing agencies, help from government to resolve sector-specific challenges in production, financing, or export development).

- **Lastly, but most importantly, economic policy coordination needs to be strengthened**. The significant tradeoffs that Azerbaijan needs to make in light of the global crisis suggest that the country's leadership will have to underwrite all short-term decisions, should the country seek to position itself as a more attractive location for FDI at the end of the global crisis. While this report clearly documents that large spending increases are no longer affordable, and strongly advocates a permanent income approach to help guide long-run spending decisions, the economic leadership team needs the active participation of the Presidency to ensure judiciousness in bringing current spending down to sustainable levels. While too slow an adjustment could risk robbing future generations of a sizeable Oil Fund, too fast an adjustment of public spending, without substantial efforts to reduce the over-regulation of the private sector could push the economy into a tailspin. In addition, Azerbaijan's macroeconomic team needs to routinely assess the course of the global economy (on a high frequency basis), as current indications suggest that duration of the crisis, and of low oil price, may be protracted. Finally, the global crisis presents an opportunity for Azerbaijan to improve the environment for the private sector and to stimulate domestic demand. The reforms in licensing, modernization of border crossings and improvements in trade facilitation, further improvements in tax administration, and reduction of tax rates are important and require high level coordination.

Roadmap to this Report

84. **This report puts current development polices into longer-term perspective and argues that Azerbaijan remains in an excellent position to achieve its medium-term diversification objectives, provided it: (i) disciplines spending as part of a long-term fiscal strategy; and (ii) rallies regulatory reforms around the expansion of non-oil exports.** Chapter 1 presents an overview of macroeconomic developments since the mid-1990s, and the challenges Azerbaijan faces in its development today. Chapter 2 illustrates, particularly for the reader less familiar with the Azeri economy, the prospects for Azerbaijan's non-oil sectors and the institutional bottlenecks sectors face, especially regarding the functioning of markets. Chapter 3 covers fiscal sustainability and the governance of public finances (covers recommendations 1-3). Chapter 4 addresses the challenges in the utilities sector (covers recommendations 4-6). Chapter 5 addresses the challenges in the business environment (covers recommendations 7-10). Chapter 6 addresses the challenges in the financial sector (covers recommendations 11-13). Finally, Chapter 7 addresses the challenges in human capital (covers recommendations 14-16).

CHAPTER 1.
INTRODUCTION

Azerbaijan successfully stabilized its economy in the decade after independence (1991) and laid the foundations for managing its oil wealth. While preparatory investments were ongoing in the oil sector, 1995-2005 saw double-digit non-oil growth, albeit partially due to the prospect of the forthcoming oil boom in the country. During that time, agriculture, non-extractive industry and services grew significantly, as did non-oil exports. Poverty reduction, which was most dramatic in 2002-2005, has been felt throughout the country. However, the austerity measures that contributed to successful stabilization left the country with significant shortfalls in investment relative to comparators, which partly explains the country's lower productivity. While market reforms have been undertaken, the quality of market institutions lags comparators.

Azerbaijan seeks to develop a sustainable, market-based economy, capable of providing growth and employment in the medium term and in the post-oil period. The country has seized the opportunity of its 20-year oil boom, which started in 2006, to launch a sizable public sector investment program and to increase wages and transfers to the population. Azerbaijan is also implementing institutional reforms aimed at modernizing the economy and strengthening the functioning of markets.

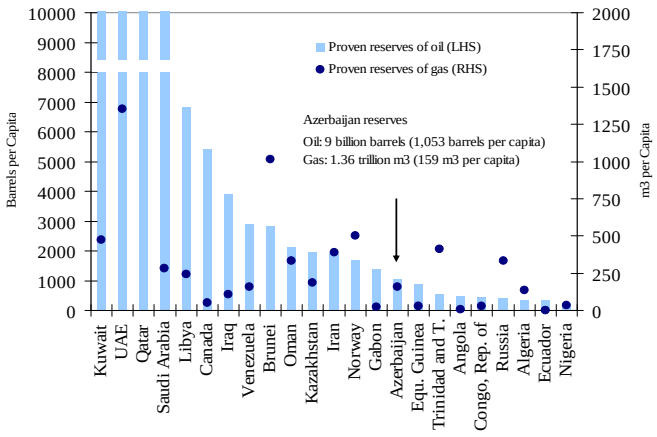
Amid Azerbaijan's ambitious development plans, the global economy experienced a crisis in the latter part of 2008, caused primarily by a year of sluggish growth in the US. Its fallout has been felt all across. GDP growth in 2009 is expected to fall in many countries, especially the high-income ones, but also in developing countries, especially in ECA and LAC. Furthermore, the crisis led to a significant drop in oil price, to which Azerbaijan needs to adjust. The crisis has also weakened global exports and is expected to reduce the volume of total international trade for 2009, while at the same time creating a dearth of private capital and raising financing needs the world over. The crisis will make the global environment less welcoming to Azerbaijan's diversification efforts, which need to be strengthened under all circumstances.

Leading up to the global crisis, the Azeri economy exhibited strong performance (including double digit GDP growth rates), although by 2007 the overly ambitious pursuit of the government's development plans had led to undesirable developments. The economy experienced high inflation and lower non-oil private investment, lower non-oil FDI and lower non-oil exports relative to non-oil GDP. The finite nature of Azerbaijan's oil boom (the oil sector will contract after 2017), the global crisis, and the already high level of public spending in 2008, all argue for a relatively smaller fiscal stimulus to the economy in the medium and long term. Azerbaijan lags comparators in first and second generation reforms in the transition to a market economy. These developments are starting to separate Azerbaijan from the diversification course taken by other successful resource-rich countries and by some small economies. This chapter reviews development trends, sets out macroeconomic and institutional challenges, compares economic performance with comparators and advocates that expansion of non-oil exports receives top priority as a means to ensure sustainability of the economy. While the global crisis is likely to delay Azerbaijan's ability to make significant gains in non-oil diversification in 2009, it provides an opportunity to advance improvements in the business environment that will enhance Azerbaijan's competitiveness after the global crisis.

A. INTRODUCTION

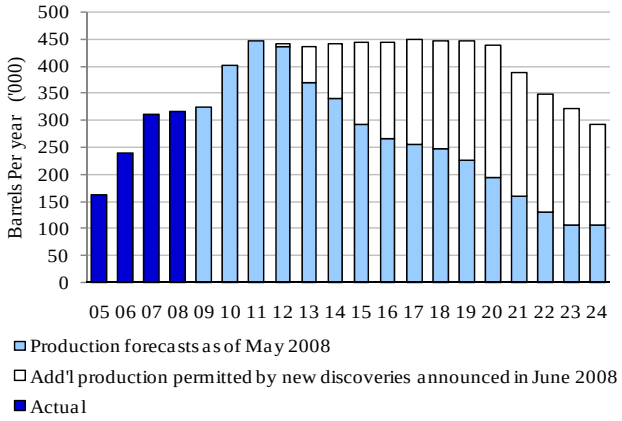
1.1. **Azerbaijan had a broad economic base before gaining independence in 1991. Yet, most of its economic life since the mid-1990s has evolved around the anticipation of oil and gas revenues. In one way or another, that has energized all sectors of the economy and supported high growth rates for the non-oil sector.**[16] During the Soviet-era, Azerbaijan had burgeoning industrial as well as dynamic agricultural and service sectors. Like all the CIS economies, it was integrated economically and socially into the Soviet Union. After independence, and following the conflict with Armenia over Nagorno-Karabakh, Azerbaijan's economy collapsed much more than the average CIS economy. Fortunately, in the mid-1990s, foundations were laid for the extraction of new oil and gas resources from the Caspian Sea. This endeavor required enormous economic resources but, once secured, brought with it foreign investment (albeit predominantly in the oil sector) and confidence in the entire economy. Confidence was further buoyed by the rising oil prices, which made Azerbaijan's "old" oil all the more profitable. By 2005, the bulk of Soviet-era industries and exports had declined, and new ones were taking their place. In that year, more than one-third of employment in Azerbaijan was in agriculture and food processing (both of which were linked to economies in the region), and a growing share of GDP was coming from services. Between 2001 and 2005, total GDP growth averaged 13 percent, while non-oil growth averaged 11 percent. In 2005, Azerbaijan's per capita income was $1,260 (Atlas method) and $4,010 (in purchasing power parity) terms.

Figure 1.1: Oil and Gas-Proven Reserves Per Capita, International Comparison



Source: Oil & Gas Journal, Vol. 104.47

Figure 1.2: Indicative Oil Production Profile for Azerbaijan, World Bank Projections (2005-2024) Based on Production Profile of June 2008



Source: Azerbaijan authorities and World Bank Staff estimates

1.2. **Azerbaijan's "new" oil and gas era began in late 2006 as the first "new oil" was produced; it is expected to last 20-25 years.** Proven reserves are approximately 9 billion barrels of oil[17] (mainly in the Azeri-Chirag-Guneshli field) and 1.34 trillion cubic meters of

[16] Given the short-term nature of Azerbaijan's oil boom, the report analyzes developments with reference to the non-oil economy. In fact, the term consists of total GDP less the extraction of oil and gas. It includes transportation of oil and gas products, and construction of oil and gas installations, including pipelines. A narrower definition of the non-oil economy is not readily available from national statistical sources.

[17] New discoveries announced in June 2008 raised the level of oil reserves from 7 billion to 9 billion barrels.

natural gas (Figures 1.1 and 1.2). Overall, fiscal revenues from existing oil and gas reserves, and based on the June 2008 profile, are estimated at $198 billion (net present value), or approximately $1,000 per capita per year through 2024.[18] At the level of production in the profile used, oil reserves are likely to be exhausted in 20-25 years. However, from approximately 2011, oil sector's growth rate is expected to be about nil, and to turn negative from about 2021.

1.3. **The country sees the new fiscal revenues from oil as an opportunity to lay the foundation for a sustainable, market-based economy, capable of generating growth and employment.** The sources of growth for this development model are discussed in this report but require further definition by the authorities. Undoubtedly, diversification away from oil and gas production as well as greater regional and global integration form parts of these plans. During 2006–08, Azerbaijan initiated a very significant increase of its public spending to address the *first-order, critical infrastructure problems,* which deterred broad-based development. They ranged from electricity shortages to the absence of water and sanitation facilities. Azerbaijan also significantly increased its social spending to alleviate the sufferings of nearly one-fourth of its 8.6 million people, who lived in "relative" poverty prior to the boom.

1.4. **However, the world is in the midst of an economic crisis and, as a result, Azerbaijan will have to rely much less, than previously envisioned, on the outside world to achieve its diversification objectives in the short term.** The latter half of 2008 saw the world economy descend into a global crisis, which (optimistically) is expected to take two years to subside. Most recently (according to Global Development Finance report, issued in September 2009), the Bank expects global GDP growth to slip from 1.9 percent in 2008 to -2.9 percent in 2009; developing country growth is expected to decline from 5.9 percent in 2008 to 1.2 percent in 2009; growth in high income countries in 2009 will likely be -4.2 percent. World trade volume is expected to contract by 12 percent, from 3.7 percent in 2008 to -9.7 percent in 2009. In the Europe and Central Asia region, prospects for 2009 and 2010 growth are also dim: growth has been expected to be -4.7 and 1.6 percent respectively for 2009 and 2010, down from the 2006-7 average of 7.3 percent. The GDP growth prospects for Russia and Turkey, two important trading partners for Azerbaijan, are -7.5 and -5.5 percent respectively for 2009. The financial meltdown, which precipitated the global crisis, and the anticipated poor performance of rich countries as well as of Azerbaijan's regional trading partners, are expected to reduce the availability of short-term financing of FDI and the potential for non-oil export growth for Azerbaijan. At the same time, it could see a significant contraction in non-oil exports, although that itself is not expected to have a very significant impact on aggregate demand. The crisis has also created uncertainty around the short-term price of oil, and Azerbaijan's fiscal revenues.

B. Economic Background

1.5. **Following independence in 1991, Azerbaijan experienced massive terms of trade shocks, a disintegration of its marketing and trading systems, and an end to Soviet-era fiscal transfers and subsidies**. The economy was riddled with distorted relative prices, multiple exchange rates and black markets for foreign exchange, as well as widespread supply shortages.

[18] This estimate is based on an average price of oil of $66 per barrel in current U.S. dollars or US$52 per barrel in 2007 prices for 2010-2030, taking into account an 8 percent discount rate, and a 3 percent rate of return on Oil Fund assets. The 30-year historical average for 1978-2007was $33 per barrel in 2007 prices.

The armed conflict with Armenia and the associated influx of approximately 1 million Azeri refugees further aggravated the economic problems. As a result, Azerbaijan suffered an output collapse and entered the post-independence transition period considerably poorer than many other former Soviet republics. Azerbaijan's real GDP dropped by 63 percent between 1989 and 1995, compared with an average of 42 percent in the CIS over the same period (Figure 1.3). [19] Growth came from both the oil sector and the non-oil sector (Figure 1.4), although it will be argued later that the latter depends on the former significantly.

Box 1.1: GDP vs. Non-oil GDP; What Metric to Measure Economic Performance in Azerbaijan?

Azerbaijan's hump-shaped oil revenue profile is expected to span about 20 years, ending in 2024. Gross Domestic Product is the sum of all final goods and services produced in an economy in a given year. Near peak production, around 2011, the oil extraction sector may produce about two thirds of the country's GDP which will then drop to about 10 percent by 2024. During the entire 20-year production cycle, the oil sector is not expected to employ more than 1 percent of the country's labor force. Planned oil extraction during the production cycle does not require large amounts of new investment—in a purely illustrative sense, the oil sector is on "autopilot" running mainly on investment made before production began.

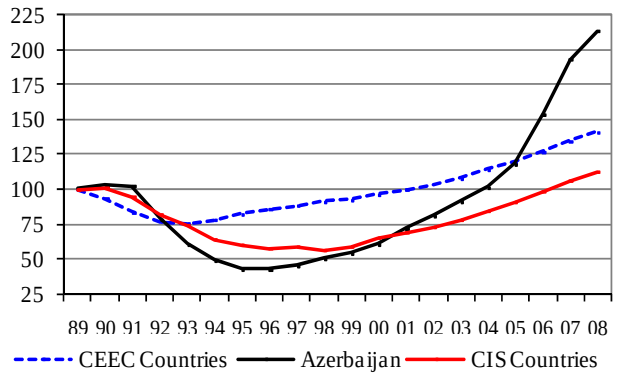
Diversification of the economy, away from oil extraction, is meaningful to the degree it creates sustainable jobs. Investment-- domestic and foreign-- in sectors other than oil extraction is critical to that diversification; therefore, it is more relevant to look at those variables relative to non-oil GDP, than to GDP, as the former will be less skewed by the temporary budge in oil production than total GDP. For a "small" economy that needs to capture export markets in order to expand its output, non-extractive exports are crucial.

What is the link to GDP? While for most economies GDP is an adequate metric to assess the importance of economy-wide flows (i.e., by comparing exports or investment to GDP), in the case of Azerbaijan, given the relatively short period of the oil production cycle (20-25 years), oil distorts the GDP (by first expanding it during the expansion of oil production, and then shrinking it during the period of oil contraction). Hence, when looking to assess the adequacy of some flows (such as fiscal flows, non-oil exports, and non-oil investment) that pertain to the long-term sustainability of the economy, the metric or denominator needs to be less sensitive to the oil production cycle. In that case, non-oil GDP is a more appropriate metric (denominator) –despite the fact that it too suffers from some distortion from the oil sector.

In looking at the value of the economy's production in Azerbaijan, for the boom years, it is also useful to look at GNP and GNP per capita, in order to take into account the large amounts of capital repatriation that took place by the oil consortium in the early parts of the production boom.

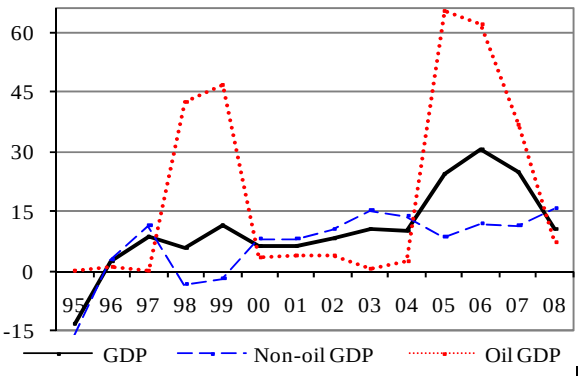
[19] For Figure 1.3, CEEC Countries calculated from Size weighted $PPP GDP, includes countries from IMF definition of CEEC Countries except Turkey. Georgia and Mongolia, which are not members of the CIS, are included in CIS for reasons of geography and similarities in economic structure.

Figure 1.3: Index of Real GDP (1989=100)



Source: EBRD Transition Report 2000 and 2001; authors' calculations.
Notes: CIS = Commonwealth of Independent States;
CEEC = Central and Eastern European Countries.

Figure 1.4: Real GDP Growth

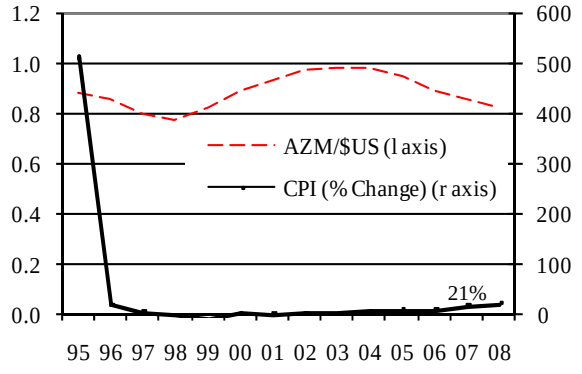


Source: Azerbaijan authorities and World Bank staff estimates

1.6. **Azerbaijan started its transition to a market economy in early 1992**. At that time, most prices were liberalized; a new currency (the manat) was introduced; a foreign direct investment (FDI) law was adopted; and a central bank law was enacted. These steps insulated the economy from FSU-wide economic instability and made it easier to leave the *ruble* zone and introduce an exchange rate policy that would ease the adjustment of domestic prices to world levels. After price liberalization in January 1992, inflation soared to triple digits, but was managed efficiently thereafter. Similarly, massive exchange rate depreciation was required to eliminate the black market for foreign currency and multiple exchange rates (Figure 1.5).

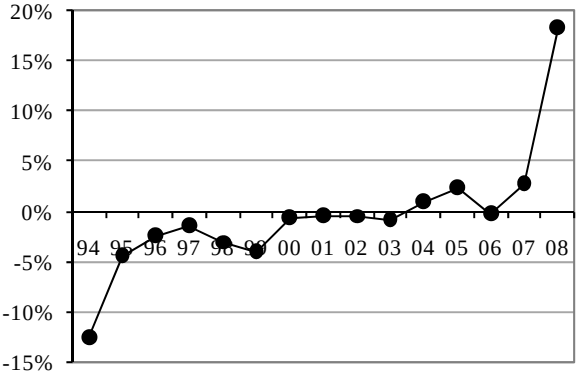
1.7. **Azerbaijan was running large fiscal deficits right after the break-up of the Soviet Union**. Following the elimination of fiscal transfers from Russia after independence, large revenue shortfalls could not be compensated overnight and required massive expenditure cuts. Coupled with less than efficient budgetary and quasi-fiscal expenditure allocations, as well as a major need to strengthen management and implementation capacity, the cuts led to both declining social outcomes and public services.

Figure 1.5: Inflation and Nominal Ex. Rates



Source: **Azerbaijan authorities and World Bank staff estimates**

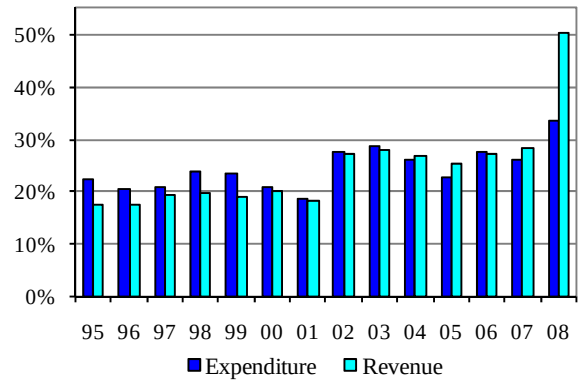
Figure 1.6: Fiscal Balance (% of GDP)



Source: **Azerbaijan authorities and World Bank staff estimates.**

1.8. **In 1995, the government embarked on a comprehensive stabilization and structural reform program.** The program was supported by the International Monetary Fund (IMF) and the International Development Association (IDA). Its key component was stringent fiscal control (Figures 1.6 and 1.7), supported by restrictive monetary policies. These efforts were complemented by a wide array of structural reforms to accelerate the transition to a market economy and to improve the environment for both foreign and domestic investment.

Figure 1.7: Government Revenue and Expenditure *(% of GDP)*



Source: Azerbaijan authorities and World Bank staff estimates.

1.9. **This reform program was remarkably successful**. Macroeconomic and financial stability was restored and maintained throughout severe external shocks, such as the Russian financial crisis in 1998 and the large drops in oil prices in 1998 and 1999. Growth recovered to more than 11 percent per year over 1996–06. This growth was aided by rapid oil and gas exploration: on average, the sector grew at 22 percent per year. The non-oil sector also grew—at more than 7 percent annually over the same period. The success in reducing inflation was also impressive. The inflation rate was reduced from triple digits in the early 1990s to single-digit level by the late 1990s. The overall fiscal deficit was greatly reduced—from 12 percent to less than 2 percent of non-oil GDP during 1994–97. The budget even registered a small surplus for the first time in 2000, due largely to high oil prices.

Managing the Oil Boom

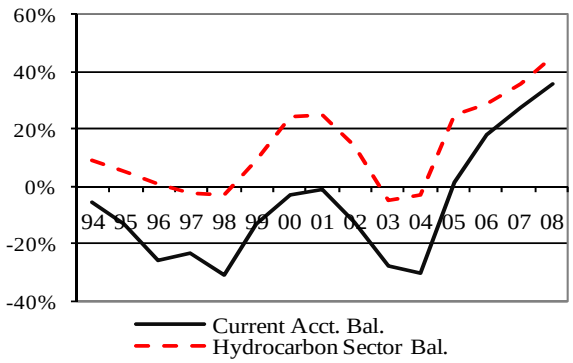
1.10. **Prospects for growth improved significantly with the beginning of the "new" oil boom**. Indeed, oil and gas both have a long history in Azerbaijan, dating back to the end of the 19th century. However, the "new" oil boom started in the mid-1990s with the signing of a number of Production Sharing Agreements (PSAs) between the State Oil Company of Azerbaijan (SOCAR) and foreign oil companies that regulated both exploration and production.

1.11. **During 1996–06, the Azeri economy grew by an average rate of 11 percent per year**. This growth was largely driven by the rapid development of the oil and gas sector. After the PSAs were signed, Azerbaijan experienced massive foreign investments in several mega-projects. As a result, the oil and gas sector registered extraordinary growth rates, which peaked at 47 percent in 1999.

1.12. **In 2005 and 2006, GDP growth continued at very high rates** (26 percent and 35 percent respectively, Figure 1.4). However, these rates were driven primarily by new oil production coming on stream, and the much higher export volumes that was made possible by increased production. Oil GDP, which includes oil and gas extraction and oil processing (but excludes oil and gas transportation, such as pipelines, and oil- and gas-related construction) grew by 67 percent and 69 percent respectively in 2005 and 2006 (Figure 1.4). As a result, the share of oil and gas sector in the economy grew from only about 10 percent of GDP in 1995 to approximately 60 percent in 2007 (Figure 1.11). Oil has also naturally driven the current

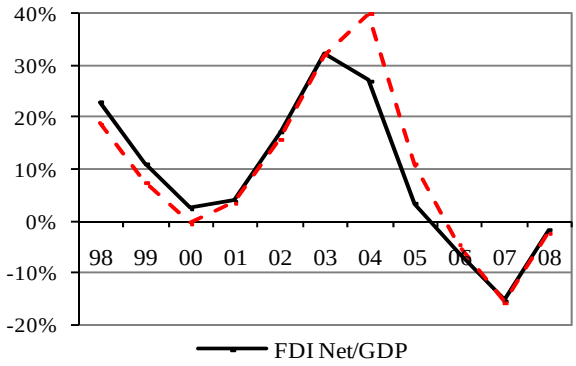
account. Large deteriorations in the current account in the late 1990s and mid-2000s (Figure 1.8) reflected large oil sector imports funded by FDI (Figure 1.9). Significant amounts of negative flows reflect capital repatriation from oil companies, given high profits due to high oil prices (Figure 1.9). Improvement in oil inflows mostly reflects increases in international prices, as Azeri production picked up noticeably in 2007 (Figure 1.12). Rising oil prices (Figure 1.11), oil sector FDI and oil sector imports have been the major drivers of Azerbaijan's external account and of the country's savings and investment balances (Figure 1.10). While non-oil investment increased in 2003-05, it has begun to drop thereafter (Figure 1.16).

Figure 1.8: Current Account Balance *(% of GDP)*



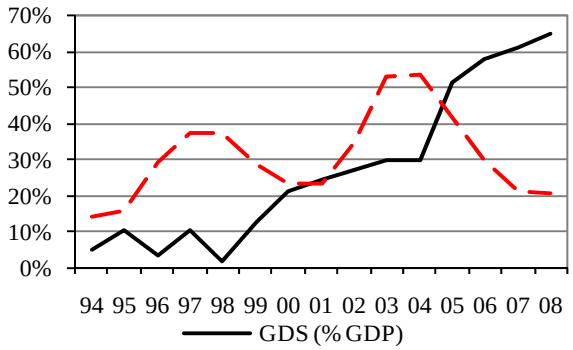
Source: Azerbaijan authorities and World Bank staff estimates.

Figure 1.9: Foreign Direct Investment *(% of GDP)*



Source: Azerbaijan authorities and World Bank staff estimates.

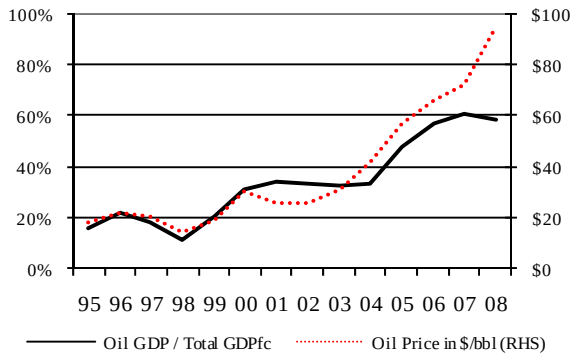
Figure 1.10: Savings and Investment *(% of GDP)*



Source: Azerbaijan authorities and World Bank staff estimates.

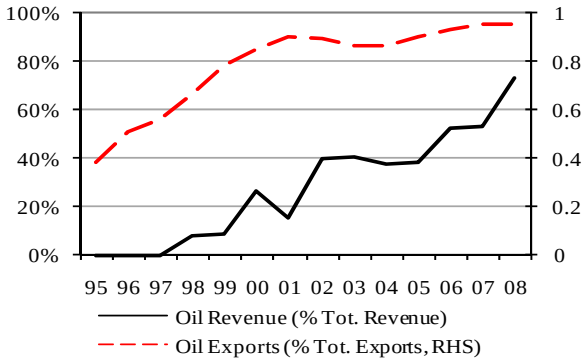
1.13. **While Azerbaijan's engagement with the world has been growing on the back of oil exports, some indicators of openness for 2008 raise concerns**. Non-oil imports have stayed under 35 percent of non-oil GDP, increasing slightly in 2006 (Figure 1.13). Non-oil exports experienced a surge in 2004 and 2005, but subsided thereafter. Since 2005, the non-oil trade balance has deteriorated (Figure 1.14), and since 2006, non-oil trade (exports plus imports) relative to non-oil GDP has deteriorated (Figure 1.15). Once Azerbaijan's structural infrastructure improvements and structural reforms are completed, its non-oil trade balance should be expected to close. (Chapter 2 discusses developments in non-oil trade and Chapter 5 the quality of trade statistics.) At the same time, non-oil FDI relative to non-oil GDP has been declining since 2006. A look at the sectoral breakdown of foreign investment suggests that declines have been registered in agriculture, manufacturing and construction; these declines have been compensated by large and growing inflows in the production and distribution of electricity and gas, as well as water. In other words, FDI in manufacturing, assembly and services is extremely weak and most FDI is going to infrastructures (supported by public spending) and extractive industries. Azerbaijan's largest non-oil foreign investor is Turkey, followed by USA and UK. Together, these three accounted for more than half of FDI in 2001-08.

Figure 1.11: Oil Share of GDP



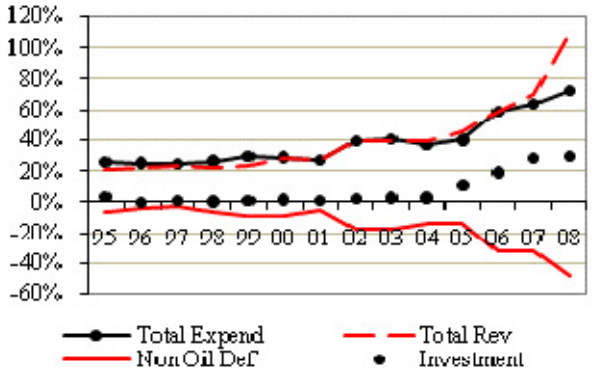
Source: Azerbaijan authorities and World Bank staff estimates.
Note: FDI is presented net of capital repatriation.

Figure 1.12: Oil Dependence



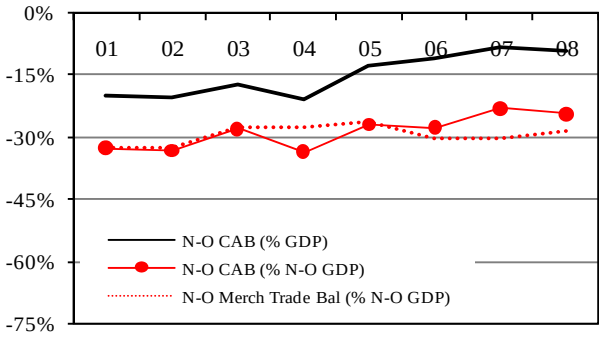
Source: Azerbaijan authorities and World Bank staff estimates

Figure 1.13: Revenue, Expenditure and Non-Oil Deficit *(% of non-oil GDP)*



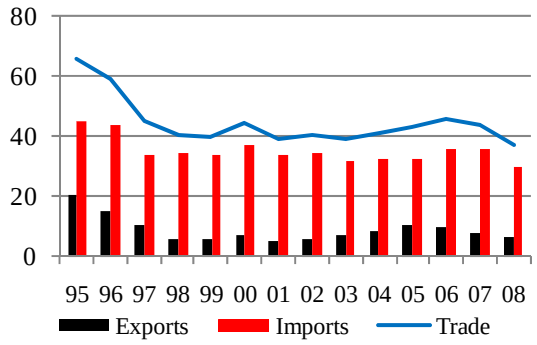
Source: Azerbaijan authorities and World Bank staff estimates.

Figure 1.14: Current Account and Trade Balances (*in percent)*



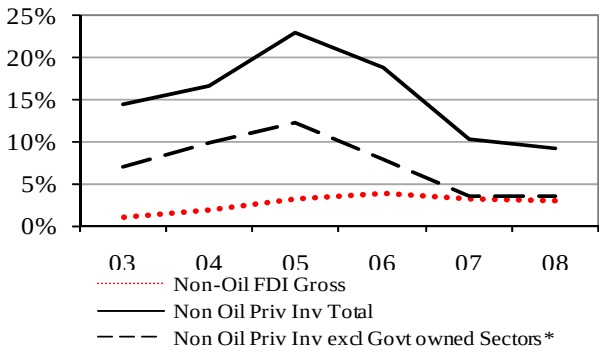
Source: Azerbaijan authorities and World Bank staff estimates.
Note: N-O: Non-Oil

Figure 1.15: Non-Oil Trade *(% of Non-Oil GDP)*



Source: Azerbaijan authorities and World Bank staff estimates.

Figure 1.16: Investment *(% of Non-Oil GDP)*

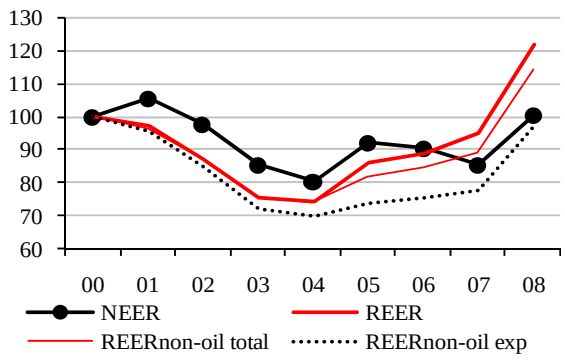


Source: Azerbaijan authorities and World Bank staff estimates.
Note: (*) Government-owned sectors are predominantly utilities and petrochemicals.

1.14. **Azeri economic dependence on oil increased gradually but consistently as commodities prices increased since the mid-1990s and as oil production came online**. By 1999, Azerbaijan's oil exports had topped 80 percent of total exports (Figure 1.12). Since 2006,

fiscal revenues from oil and gas have topped 50 percent, having increased from 8 percent of total revenues in 1998 (also Figure 1.12). The non-oil part of Azerbaijan's external account deteriorated through 2000, as global demand for its (pre-transition) exports plummeted, but again improved through 2006, as new exports and new partners emerged (Figure 1.15 in this chapter, and Chapter 2). Azerbaijan's overall real effective exchange rate appreciated by 42 percent in 2004-08 in part as a result of the increasing non-oil fiscal deficit (which was funded by US dollar inflows into the treasury. The real effective exchange rate for non-oil exports appreciated by only 11 percent in the same period, given the inflation trends by Azerbaijan's non-oil export partners (Figure 1.17).

Figure 1.17: Nominal and Real Effective Exchange Rates



Source: National Bank of Azerbaijan

Table 1.1: Azeri Economy After Independence, 1992-2008

	1992-96 (annual avg.)	1997-2000 (annual avg.)	2001	2002	2003	2004	2005	2006	2007	2008
GDP growth	-15.2	8.6	9.9	10.6	11.2	10.2	26.4	34.5	25.0	10.8
Oil GDP [1]	-10.6	23.1	7.9	3.9	0.6	2.5	66.3	63.1	36.8	7.0
Non-oil GDP [1]	-18.4	3.5	10.4	12.3	14.7	14.4	8.5	10.9	12.0	17.2
Agriculture	-19.1	4.6	11.1	6.4	5.6	4.6	7.5	0.9	4.0	6.1
Non-oil industry	-19.6	16.9	-1.5	8.9	22.2	9.9	14.8	4.1	7.9	6.4
Construction	-6.0	30.4	5.9	81.7	47.8	41.9	2.0	8.5	16.0	36.0
Services	-15.3	9.8	8.5	6.0	8.0	8.9	9.6	18.2	12.5	13.7
Tradables [1,4]	N/A	N/A	9.5	4.1	2.8	1.7	48.2	48.6	31.5	4.8
Non-oil Tradables [1,4]	N/A	N/A	8.3	4.0	1.6	0.8	21.6	19.5	18.1	-1.3
Non-Tradables [1,4]	N/A	N/A	8.1	17.6	17.4	17.2	7.0	15.0	13.6	20.8
GDP Per Capita PPP (% CIS avg) [2]	42.0	44.0	42.0	43.7	44.6	45.0	52.7	64.8	73.8	75.9
GDP Per Capita PPP (% EU 10 avg) [2]	30.3	23.6	23.4	24.4	25.9	26.8	32.5	40.8	47.3	49.0
Inflation, period avg	827.7	-1.0	1.5	2.8	2.2	6.7	9.5	8.4	16.7	20.8
Inflation, end of year [1]	808.3	-1.4	1.3	3.3	3.6	10.4	5.4	11.4	19.7	15.3
Oil Fiscal Revenues (% N O GDP)	N/A	2.9	4.1	15.9	16.2	14.8	17.4	30.8	38.2	104.2
Non-Oil Fiscal revenues (% N O GDP)	N/A	21.2	23.3	23.7	37.7	27.4	27.5	29.9	33.3	27.6
Govt Spending (% GDP) [3]	22.4	22.5	18.7	27.7	28.5	25.9	22.6	27.4	26.1	32.9
Govt Spending (% non oil GDP) [3]	32.2	27.2	27.4	40.1	40.8	37.7	47.4	67.3	70.6	84.6
Total Investment (% GDP) [3]	8.5	22.9	22.0	34.8	53.2	58.0	41.5	29.9	21.5	20.2
Non oil priv. Invest. (% non -oil GDP)	N/A	N/A	N/A	N/A	N/A	N/A	23.1	18.8	8.3	9.7
Government Invest. (% non -oil GDP)	2.0	2.6	3.4	7.6	6.8	6.0	8.0	20.1	26.1	38.2
Poverty Rate [1]	68.1	N/A	49.0	44.6	39.7	28.5	24.0	20.8	N/A	N/A
Employment mill	N/A	N/A	3.72	3.73	3.75	3.81	3.85	3.97	4.01	4.05
Share of agriculture in emp. %	32.2	38.6	40.0	40.2	40.0	39.5	39.3	39.1	38.9	38.9
GDP US$ million	$2,071	$4,724	$5,708	$6,236	$7,276	$8,681	$13,270	$20,982	$33,049	$46,257
Non Oil GDPfc US$ million	$1,662	$3,062	$3,467	$3,800	$4,505	$5,257	$6,328	$8,540	$12,189	$17,953
Population (million, mid year)	7.5	8.0	8.1	8.2	8.2	8.3	8.4	8.5	8.6	8.7

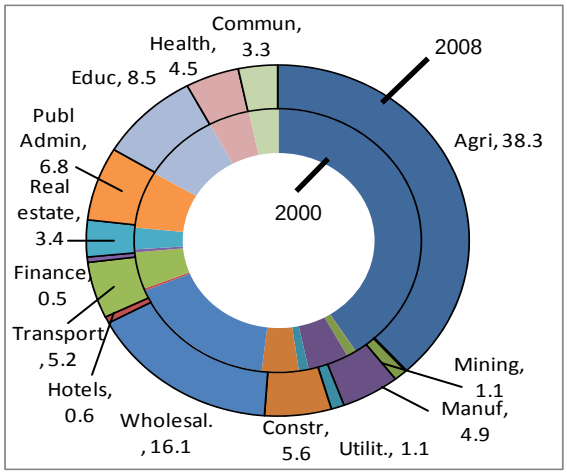
1 First column is 1993-1996. 2 Latvia, Lithuania, Estonia, Hungary, Czech Republic, Poland, Slovakia. Romania, Bulgaria.
3 First column is 1994 -1996. 4 Tradables comprise of agriculture and industry less construction; Non-oil tradables comprise Tradables less mining and quarying. Non-tradables are services and construction.
Sources: Azerbaijan authorities and World Bank staff estimates.

1.15. Table 1.1 summarizes the economic developments since independence that have been sketched above. Developments in the real sector and in poverty reduction are discussed below.

C. Employment and Poverty Reduction

1.16. **The prospects of new oil and Azerbaijan's successful macroeconomic policies have supported the broad-based development of the economy since 2000**. From the mid-1990s onward, the Azeri economy managed to move away from the industrial base inherited from the Soviet Union toward aluminum ore, crude oil, and a number of processed foods and high-value agricultural products. Azerbaijan's agricultural growth has averaged more than 5 percent per year. The industrial sector (including oil) has been subject to many fluctuations, but still managed to grow on average of over 10 percent annually for most of the review period. During the same period, the services sector has shown steady growth as well (as happened in many transition economies) of approximately 10 percent per annum and has continued to expand.

Figure 1.18: Employment Shares (%), 2000 (*Inner ring*) and 2008 *(Outer ring*)



Source: Azerbaijan authorities and World Bank staff estimates.

1.17. **Growth brought with it increases in employment, and a small adjustment in the labor force**. Azerbaijan's formal employment increased approximately 13 percent in 1995–2008, and about 80 percent of the increase occurred since 2000. Employment stood at about 4.1 million at end-2008. Azerbaijan also hosted about 15,000 immigrants employed primarily in construction (before the crisis). The years 2000–08 saw a small restructuring of the labor force. New opportunities in construction (initially in the oil sector, but also in real estate and later in the public sector) contributed to reducing the share of employment in the primary sectors (agriculture and fishing) by approximately 2.5 percentage points. During the same period, the share of employment in the industrial sector (especially construction) increased by about 1.5 percentage points. Figure 1.18 illustrates the composition of employment in 2008 (outside ring, percent shares) and compares it with 2000 (inside ring). The employment share in the service sectors increased by about 1 percentage points between 2000 and 2008; services sector accounted for approximately 49 percent of the total employment in 2008. Overall, at about 38 percent, agriculture has remained the most important employer.

1.18. **Azerbaijan's growth brought with it tremendous gains in poverty reduction.** The number of people living below the national poverty line dropped from 68.1 percent in 1995 to 24 percent in 2005 (Table 1.2).[20] The government further estimates that poverty fell to 19.6 percent in 2006. The drop in poverty is remarkable. In 2002–05, years for which the Bank has undertaken significant analysis, poverty almost halved. While the drop in poverty has been

[20] This report does not cover more recent analysis on poverty as a separate report on poverty is under preparation.

greatest in Baku, poverty fell almost equally between the other two strata, "other urban" and rural areas.

1.19. **While most improvements in welfare have been concentrated in Baku, growth was pro-poor in 2002–05** (as shown by the growth-incidence curve in Figure 1.19). Consumption growth for the poorer deciles was higher than for the richer deciles. Per capita consumption growth was positive for all percentiles of the Azeri population, with an average of 7–8 percent, while the poorest decile enjoyed an annual consumption growth of approximately 15 percent. However, poverty remains almost twice as high in rural areas as in Baku. Lack of employment, assets, and commercial opportunities, as well as weaker access to basic infrastructure, health, and education services have been major factors keeping poverty relatively high in provincial towns and rural areas. Refugees and internally displaced people (IDP) are particularly vulnerable because they not only lack assets and employment opportunities but also are heavily dependent on state transfers.[21]

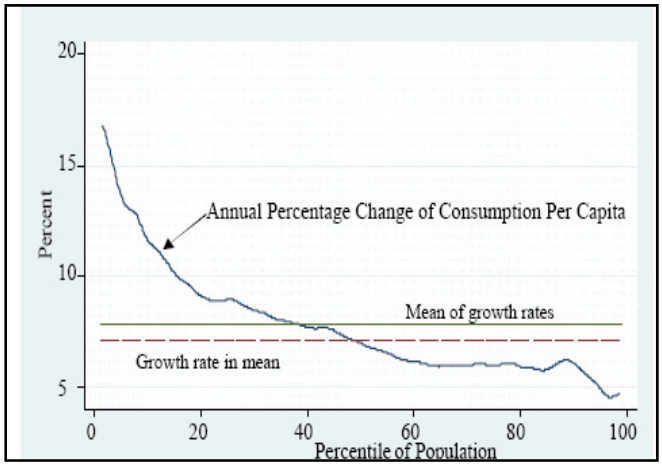
Table 1.2: Poverty 2002-2005

	Total Population	Baku		Non-Baku Urban		Rural	
		Poor	Very poor	Poor	Very poor	Poor	Very poor
2002	44.6	41.6	25.6	48.7	31.5	43.7	24.7
2003	39.7	34.8	19.3	46.0	27.9	38.4	20.0
2004	28.5	18.6	8.0	35.4	19.0	29.6	13.0
2005	24.0	14.7	6.6	27.2	11.9	26.9	8.9

Source: Azerbaijan 2002–06 HBS data.

1.20. **Poverty has fallen due to several factors**. From the analysis of poverty in 2002–05, it emerges that several factors contributed to poverty reduction: (1) the higher minimum wage, (2) higher average wages in the economy, (3) significant transfers to households based on the government's social programs, and (4) remittances from abroad, especially from Azeris living in Russia. For the purpose of this report, it is useful to look at the broader period under review, 2001–08. During that time, the government increased the minimum wage more than six-fold in real terms (albeit from a very low base) in a bid to alleviate poverty.

Figure 1.19: Azerbaijan Growth Incidence Curve, 2002–2005



Source: Household Budget Survey and staff estimates.

The minimum wage is now AZN 75 per month—equivalent to 27 percent of the average wage. In addition to the minimum wage increase, wages and salaries on average tripled in real terms since 2000,

[21] While the dynamics and magnitude of poverty reduction are not questionable, two factors may modify these results: underreporting of the poorest groups and under-evaluation of the CPI.

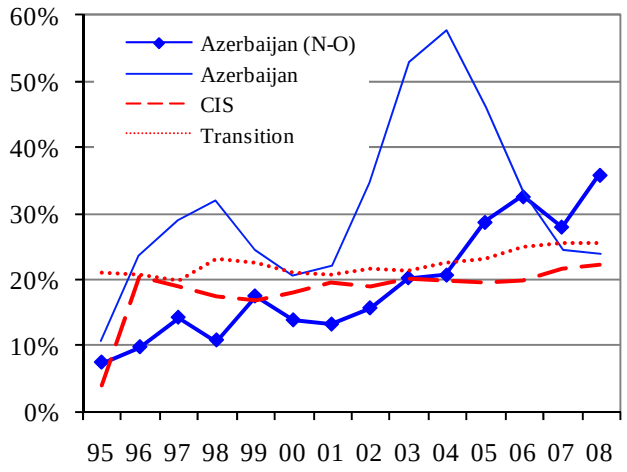
reaching AZN 274 per month in 2008. These increases are attributed partially to the government's expansive fiscal policy after 2005. From 2002 to 2008, transfers to households also increased, more than doubling in real terms. Pensions—the main component of the government's social program—increased in particular: the basic pension, which constitutes about three quarters of the average pension, increased from AZN 14 in January 2002 to AZN 75 per month in September 2008. At the same time, remittances from a significant number of Azeris working abroad increased 10-fold in nominal dollar terms since 2001, reaching approximately $1.2 billion in 2008.

D. Medium-term Challenges

1.21. **Azerbaijan's most immediate medium-term challenge is to reverse the trend of greater reliance on oil revenues**. As mentioned in the previous section, Azeri economic dependence on oil increased substantially as a result of the rapid oil sector development. This applies both to fiscal revenues and the external current account balance. The non-oil trade gap has also been increasing steadily since 2005. While over the short term, the non-oil trade gap will continue to be supported by the oil exports, in the medium or longer term (pending on the course of oil prices), the non-oil trade balance may create a financing gap, which Azerbaijan will have to overcome by either reducing imports, or increasing its non-oil exports and attracting FDI.

1.22. **Azerbaijan also faces an investment deficit, which has affected the quality of infrastructure.** Azerbaijan's investment has been skewed toward the oil sector. Figure 1.20 shows total investment relative to total GDP for Azerbaijan (dotted line), and compares that to non-oil investment (private and public) relative to non-oil GDP for Azerbaijan (solid line with markers), and the median investment rates for CIS and transition economies. The figure shows that for the 1995-2002 period, Azerbaijan invested about 4 percent of non-oil GDP a year less than the average CIS country, and about 8 percent of GDP a year less than the average transition economy. It is interesting to note that Georgia's annual investment rate for 1996–2004 (prior to the Azeri oil price boom) was about 25 percent of GDP, while Armenia's was slightly above 20 percent of GDP. Azerbaijan's annual non-oil investment, relative to non-oil GDP, averaged 11.7 percent in 1995–2004. The low investment rates prior to the oil boom have naturally had significant implications for the country's infrastructure. In general, the reliability or quality of infrastructure services in Azerbaijan remains poor. The country's infrastructure capacities have been exploited beyond their useful life of 25–30 years. Because of lack of financial viability, most infrastructures deteriorated and the quality of services has been suboptimal. About 56 percent of the main roads are in poor condition, and 30 percent

Figure 1.20: Investment *(% of GDP)*



Source: Bank staff calculations based on national statistics.
Notes: Azerbaijan, CIS, and Transition: Total Investment (public and private (including oil), GFCF) as% of GDP. Azerbaijan (N-O): Non-oil Investment (public and private, GFCF) / Non-Oil GDP; GFCF: Gross Fixed Capital Formation.

need to be repaired immediately. Up to 45 percent of regional and local roads are life-expired, which hamper all-year links between territorial units in a number of regions. Due to deteriorating rail infrastructure, Azerbaijan Railway is also unable to operate at full capacity. The reliability of public water supply, although has improved in recent years, especially in the capital area, remains low (13 hours per day on average). In many parts of the country outside Baku, people receive as little as three hours of water supply.

1.23. **Azerbaijan remains exposed to the risks associated with weak market institutions**. In contrast to the encouraging macroeconomic picture discussed above, progress on institutional development has been slow. This is a cause for concern because the economic literature has persuasively argued that good institutions are critical for sustainable economic growth and private sector development.[22] At the end of 2008, Azerbaijan ranked in the third quartile of all countries on political risk and in the fourth quartile in bureaucratic quality, corruption, and in democratic accountability, according to the International Country Risk Guide.[23] The EBRD Transition Index also shows that Azerbaijan has made less progress than CIS comparators in completing second-generation reforms relating to establishing institutional underpinnings for the allocation of resources through competition.[24] This is especially true compared to neighboring countries (Table 1.3). Concurrently, the burden of government regulation and interference remains very high for Azeri businesses. While recent studies of the informal sector are not available, one study in 2003 found that a very large share of economic activity took place in the shadow economy.[25] At the same time, Azerbaijan's official labor statistics suggest that the informal sector employment is very high (more than 65 percent of employees worked without a contract in 2008).[26]

Table 1.3: EBRD Transition Indicators, 2008

(Indicators range from 1 to 4+, where 1 represents little or no change from a rigid centrally planned economy and 4+ represents the standards of an industrialized market economy)

	Azerbaijan		Georgia		Kazakhstan		CIS	
	2001	2008	2001	2008	2001	2008	2001	2008
Large scale privatization	2.0	2.0	3.3	4.0	3.0	3.0	3.1	3.0
Banking reform & interest rate liberalisation	2.3	2.3	2.3	2.7	3.0	3.0	1.7	2.7
Securities markets & NBFI	1.7	1.7	1.7	1.7	2.7	2.7	1.8	2.3
Competition Policy	2.0	2.0	2.0	2.0	2.0	2.0	2.3	2.2
Enterprise restructuring	1.7	2.0	2.0	2.3	2.0	2.0	2.2	2.2

Note: NBFI: Non bank financial institutions.
Source: EBRD

1.24. **Azerbaijan also needs to contend with a poorly regarded business environment and some lagging reforms.** In September 2008, Azerbaijan shot up to 33 in the global *Doing*

[22] Acemoglu, and others 2005.

[23] *International Country Risk Guide Database, December 2008*.

[24] EBRD Transition Index 2007.

[25] According to a 2007 study by Friedrich Schneider, in 2002–03 the shadow economy consistently represented 61.3% of Azerbaijan's GDP.

[26] State Statistical Committee of Azerbaijan -Labor Statistics 2009.

Business 2009 rankings following several reforms in registration and labor markets.[27] These reforms are very promising. However, for most of 2005–07, Azerbaijan ranked above 90 globally, behind the bulk of its regional comparators. Azerbaijan also ranks poorly in the trade logistics index,[28] and in the *Global Competitiveness Report*. In addition, in Azerbaijan, analysis shows that the costs of corruption are significantly higher than in other countries, amounting to 6.1 percent of the value of earnings of Azeri firms against, for example, 0.5 percent in Georgia and 1.0 percent in Kyrgyzstan.

1.25. **Access to financing is an obstacle that small and medium enterprises (SMEs) face in their development** (Table 1.4). Credit supply has been increasing rapidly in Azerbaijan but from a very low base. Total credit amounted to 11 percent of GDP in 2005, and reached 18.9 percent in 2008. The bulk of the increase has gone to households and services, whereas credit in agriculture has grown very slowly. The 2008 Business Environment Enterprise Survey (BEEPS) found that access to finance was only a problem for 23 percent of firms surveyed. However, 2008 IFC survey of SMEs indicated that access to credit was one of the top three constraints to developing a business for 54 percent of SMEs (in particular, those operating in agriculture and food processing); it also showed that 95.9 percent of firms' investment funds are still coming from retained earnings.[29] Recent reforms and the development of financial infrastructure have improved access to financial services. Nevertheless, many segments of Azerbaijan's financial sector remain underdeveloped, including insurance, leasing, venture capital, stock exchange, and the banking sector.[30]

Table 1.4: Main Constraints to Businesses in Azerbaijan and Neighboring Countries, 2007–08

	Azerbaijan	Georgia	Kazakhstan	Kyrgyz Rep.
	Major or Severe constraint for doing business 2009 Business Environment and Enterprise Performance Survey (% of firms surveyed)			
Access to financing	23	35	31	28
Tax Rates	25	29	46	48
	Ranking in the 2009 Doing Business Report (out of 181 countries)			
Tax Level and Complexity of the tax system	103	112	61	156
Trading Across Borders (cost, time, procedures)	174	85	180	181
Protecting Investors	19	38	53	11
	Global Competitiveness Report 2008-09 (out of 134 countries)			
Higher education and training	80	84	59	83
Goods market efficiency	89	71	80	120
Financial market sophistication	92	79	97	115

Sources: IFC SME Survey 2008, BEEPS 2005, Doing Business 2008, Trade Logistics 2007, and Global Competitiveness Report 2007-2008.

[27] Azerbaijan's Doing Business 2009 ranking was adjusted in the Doing Business 2010 (which ranks countries' business environments for 2009 and re-ranks the 2008 results); Azerbaijan ranks 38th globally for 2009 and 2008.
[28] World Bank's new Logistics Performance Index (LPI).
[29] IFC 2008.
[30] Banking sector assets came to 27 percent of non-oil GDP in 2008.

1.26. **Employment is rising, but existing skills might fail to match market needs and thus impede productivity growth.** In 2006, approximately 64 percent of the working age population was employed, and the total unemployment rate stood at 7.1 percent; regional disparities in the labor market are significant, and undeclared work has increased. Only 41 percent of the employed had a labor contract in 2006 (down from 55 percent in 2003). Moreover, Azerbaijan faces the challenge of a mismatch between the qualifications of graduates and workers, and the changing structure of the economy. In particular, there is an excess supply of workers with general secondary education but no vocational skills.[31] On the other hand, graduates from vocational education establishment find the acquired skills irrelevant to the labor market demand. *A priority is to invest in education and training to meet future labor demand and the higher skill needs* expected in agriculture, agro-processing, oil production, oil-related industries, tourism, communication, and financial services.

1.27. **Azerbaijan's challenges have together contributed to lower productivity in the non-oil economy relative to comparators**. Azerbaijan's overall productivity growth has been high in recent years—8 percent in 2001–04 and 26 percent in 2005–07. However, most of this impressive growth has been in the oil sector.[32] Productivity growth has been more reasonable in services (4.8 percent on average), but almost zero in agriculture (0.5 percent on average from 2001–07). As discussed below, agriculture has suffered from low levels of investment, which resulted in a decline of capital per worker. In services, productivity growth accelerated in 2006–07, and it reached 11.3 percent on average. Despite the growth in services, Azerbaijan's overall productivity level is very low compared to neighboring countries, such as Georgia and Kazakhstan, where, in 2005 it was almost 200 and 300 percent higher respectively (Table 1.5).

Table 1.5: Azerbaijan and Comparators -Productivity Level (2005), and Average Annual Growth Rate (1995-2005)
(*Value added per worker in PPP, constant 2000 international dollars*)

	2005				1999-2005 average annual growth rate			
	Agriculture	Industry	Services	Total	Agriculture	Industry	Services	Total
Azerbaijan	2,349	47,451	5,251	9,217	1.3%	17.4%	1.9%	9.8%
Georgia	2,117	19,882	10,743	6,887	-1.8%	11.2%	11.3%	7.3%
Armenia	5,376	34,799	11,099	12,105	4.7%	24.0%	13.1%	13.4%
Kazakhstan	2,995	28,621	14,777	13,239	n.a.	n.a.	n.a.	n.a.
Ukraine	7,919	19,745	13,871	14,138	3.4%	9.8%	7.0%	7.2%
Turkey	8,972	21,420	31,424	22,329	0.3%	0.7%	0.6%	2.2%
Latvia	9,209	23,500	33,857	28,101	14.2%	3.8%	6.4%	7.1%

Source: World Bank Staff calculations based on *World Development Indicators*
Notes: Kazakhstan PPP figures for 2004; Ukraine average annual growth for 2000-05.

[31] To address some of those needs, the government took measures in 2007 and 2008 to increase employment by promoting SME growth and by developing infrastructure projects.
[32] See Jamet 2007.

E. AZERBAIJAN'S DEVELOPMENT STRATEGY AND RESPONSE OF THE ECONOMY

Objectives

1.28. **Azerbaijan's development objective is to become a sustainable middle-income country by the end of the oil boom**. In order for Azerbaijan to attain a per capita income of about AZN 5,000 (in 2007 manats) by 2025, its non-oil economy needs to grow at an average annual rate of 6.5 percent in 2008–25. Azerbaijan can use its oil resources and the capacities of the private sector to develop a diversified and sustainable economy that is globally and regionally integrated. Its agricultural sector can become an exporter of higher value-added food items. The country can capitalize on its refining capacity and in petroleum products. It can also capitalize on its geographic location to strengthen its position on the Silk Road, not only for oil and gas but also for merchandise trade. Finally, Azerbaijan can continue to expect a boost from its service sector as the economy develops.

Strategies and Policies[33]

1.29. **Azerbaijan's strategy is to modernize the economy using oil revenues, and to complete the transition to a market-based economy.** Azerbaijan expects to develop its economy by using a good part of its oil wealth to pay for much-needed infrastructure investments and reforms. It expects to frontload its investments in the early years of the oil boom to establish the non-oil economy, and to reap the benefits of a larger production base thereafter. Azerbaijan's Long Term Oil Revenue Management Strategy (LTROMS, 2003) speaks of that objective.[34] The government expects that frontloading investment will have some inflationary costs, but feels it is a price worth paying to jump-start the economy. As the country's infrastructure base is established, the government expects the private sector to take a leading role in development, and the economy to complete its transition. Taking a very hands-on approach, the government seems keen to manage all the infrastructure improvements, retain ownership of assets, and play a significant role in management. The government has astutely sought to improve the incomes of the poor while the revenues from the new oil are coming in and Oil Fund assets are being accumulated. To that end, public sector salaries as well as social transfers have been increased.[35]

1.30. **At the sectoral level, network utilities (mostly power and roads) have been given top priority in the short term, while agriculture and services are expected to assume more importance in the medium term**. Azerbaijan has made the development of its utilities sectors a top priority, given their poor performance and the debilitating impact they have on the rest of the economy. However, in the long term, Azerbaijan expects significant growth and employment from the agricultural sector and food processing and from services, particularly wholesale and

[33] This section and the next one are based on several World Bank and IMF documents: SAC-II ICR, PRSC ICR, and two JSANs.

[34] Within the LTORMS is embedded a very important concept, widely discussed in Chapter 3, namely that government should plan to spend an approximately constant real level of fiscal revenues from oil, in perpetuity.

[35] The government's vision has appeared in several places, over time, though it has been documented systematically only occasionally, such as the 2003 Presidential Speech, the 2003–05 State Program for Poverty Reduction and Economic Development (SPPRED), the State Program for Economic Development of the Regions 2006-08 and, most recently, the draft State Program for Poverty Reduction 2008–2012.

retail trade and transit services, but also from finance, hospitality services, and social sectors (especially education and health). All this calls for large investments at the tertiary levels in both sectors (and at the secondary levels too in health).

Institutional and Policy Reforms

1.31. **A broad policy package**. Azerbaijan's reform package is based on a macroeconomic framework that—together with improved public finance policies, regulation, and privatization—will provide the underpinnings for balanced growth. Efforts would be made to improve the investment climate, access to credit, and the quality of infrastructure. All this will be done to enable the development of the agricultural sector as part of a comprehensive rural development policy, and the tourist sector. The package anticipates modernization of the budget process (including PIP prioritization) to be completed and exchange rate appreciation to be avoided. In addition, there will be significant privatization across the economy (including utilities and the banking sector); structural reforms in the energy sector (SOCAR restructuring, etc); adoption of new curricula for general education and of a basic health care package. The Bank expects most first-generation policy reforms to be completed by 2010.

1.32. **In practice, top priority has been accorded to the social sectors, particularly social policy and assistance to the poor**. Azerbaijan established a targeted social assistance scheme that had successfully reached 165,000 households by 2008, and whose effectiveness has been documented by the 2008 Living Standards measurement Survey.[36] At the same time, Azerbaijan has raised pensions and the minimum wages of the public sector in a bid to alleviate poverty of the lowest income groups. Reforms are also underway in primary and secondary education (curriculum revision, teacher training/workload) and in the health sector (definition of basic package of services, health insurance). Finally, Azerbaijan's significant investment program initiated in 2005 may itself be viewed as a massive employment-generation program.

1.33. **In practice, Azerbaijan has accorded secondary priority to policy and institutional macroeconomic management—with the exception of the Oil Fund's stellar performance. Much lesser priority has been given to expenditure management**. Azerbaijan's macroeconomic policies have been largely consistent with macroeconomic stability – public spending has been sustainable through 2008 but inflationary pressures could have been mitigated with a more flexible exchange rate (discussed in the next section). Azerbaijan also managed the risks of the appreciating currency and the rising credit of the financial sector reasonably well. The primary challenge for macroeconomic policies has been the lack or predictability of public spending and the absence of a medium-term vision for public spending. This has led to few, if any, limitations on expenditures by budgetary agencies, and as a result, there was no pressure for sound medium-term planning and increasing efficiency. In turn, because of the lack of an articulated vision there has been very little pressure for budgetary reforms or improvements in the public investment appraisal system. However, in early 2008, a much-needed macroeconomic coordination committee was created under the leadership of the Ministry of Economic Development. The exception to Azerbaijan's modest reforms in macroeconomic management and expenditure management has been the creation of the Oil Fund, which has succeeded in credibly serving as a stabilization fund and as a fund to preserve revenues for future generations.

[36] The Living Standards Measurement Study is a World Bank study based on household surveys.

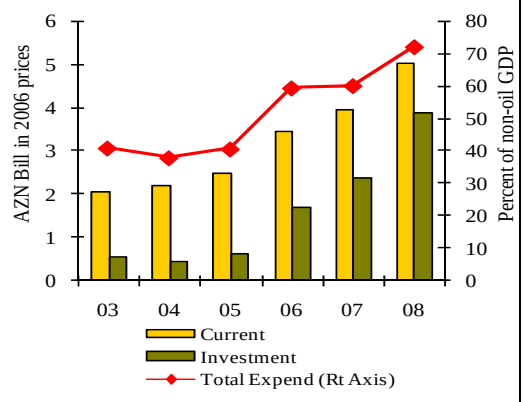
It has also spearheaded the country's participation in the Extractive Industry Transparency Initiative (EITI) and has been recognized internationally with a UNDP Excellence in Public Service Award in 2007 (Box 1.2).

Box 1.2: Azerbaijan's Oil Fund–International Role and Recognition

Azerbaijan's Oil Fund (OF) was established by a Presidential Decree on December 29, 1999; statutory regulations for the OF were approved by the President on December 29, 2000. The purpose of the OF is to serve as a stabilization fund and to safeguard oil revenues for future generations. In 2008 the Oil Fund had accumulated $11.2 billion in assets. The OF assets are managed according to investment guidelines approved (and amended) in 2001 and 2005. The Fund's revenues comprise the sale of the government's share of profit from oil and gas exploitation, BTC dividends from oil and gas projects, revenues from management of OF assets, and other smaller revenues. The Oil Fund also serves as the government's implementation agency for the EITI. Azerbaijan gained wide experience in EITI implementation and is the only country that has already submitted eight EITI reports; Azerbaijan obtained EITI Candidate status in September 2007 was the first country to complete Validation (2009).

1.34. **In practice, policies and institutional reforms in the utilities sector have been slow but sensible on the financial management front, although very much government-centered**. The government has strengthened the quality of service provision to the private sector (and to households) by retaining ownership of the country's utilities (power, gas, fixed-line telecommunications, but also road management, and rail). This has been done through heavy investment aimed at improving service quality, accelerating introduction of metering, and gradually introducing accounting standards for transparent monitoring by the central government. These efforts have produced good progress in: (i) bringing tariff rates to cost recovery levels for most utilities (latest effort in January 2007); (ii) investing in metering for power, gas, and water and commensurately raising the collection rates; and (iii) investing in International Financial Reporting Standards (expected to be operational in 2009-2011, depending on the individual state enterprise). Notwithstanding the above mentioned progress, there has been some controversy in the approach, notably the insignificant involvement of the private sector in the management of the SOEs, which entail enormous commercial risk. Challenges facing the utility sectors are discussed in Chapter 4.

Figure 1.21: Recent Expenditures (2003-2008)



Sources: IMF and World Bank Staff estimates

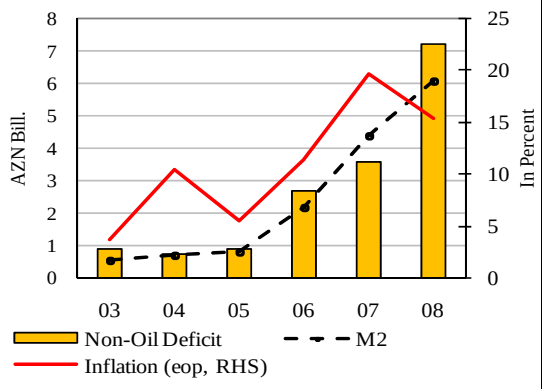
1.35. **In practice, despite recent progress highlighted in *Doing Business 2009*, Azerbaijan has accorded low priority to the improvement of the regulatory environment for the private sector**. *Doing Business 2009* notes regulatory improvements made in 2007/08 in the business environment, particularly in areas related to starting a business (Chapter 5). However, other regulatory reforms, such as passage of the Competition Law and the Investment Law, as well as modernization of licensing and of customs administration, have lagged behind. Azerbaijan ranked 97th in Doing Business 2008 survey.

Public Spending

1.36. **The development strategy translated into very large fiscal expansion from 2006 onwards—which came at a macroeconomic cost that was acceptable to the government**. The central government's expenditure doubled in real terms in 2004-08, driven by a 72 percent increase in current spending and a 226 percent increase in investment spending. As a result, the ratio of consolidated government expenditures to non-oil GDP soared from 40.5 percent in 2004 to a projected 81 percent in 2008 (Figure 1.21). However, while the burst of spending raised the non-oil fiscal deficit from 12.6 percent of non-oil GDP in 2005 to 32.1 percent in 2007, the overall fiscal balance remained positive. In the government's view, accelerating public expenditure growth for a few years would have a short-term cost of relatively higher inflation and/or currency appreciation, but it would ultimately produce a positive effect on productivity (through investment in infrastructures and capacity-building), thereby enhancing the long-term competitiveness of the non-oil economy. The structure of the budget is presented for year 2007 in this chapter and is further discussed in Chapter 2.

1.37. **The Azeri economy responded to the fiscal stimulus. It grew extremely fast during 2005-2008, at 24.2 percent on average**. Although slower than oil sector growth, non-oil GDP growth has averaged 12.1 percent in 2005-08. Services were the most dynamic component of the non-oil economy in the last four years, whose share increased to 55.1 percent of non-oil value added, while other sectors' shares declined: non-oil industry now represents 7.4 percent of non-oil GDP, construction 21.2 percent, and agriculture 16.3 percent.[37]

Figure 1.22: Non-oil Primary Deficit, Money Growth, and Inflation (2003-2008)



Source: National Bank of Azerbaijan

1.38. **The combination of the large fiscal stimulus and a policy of managed float against the U.S. dollar, as well as monetary expansion and the credit boom, fueled inflation in 2006-2008.** The annual appreciation of the manat against the U.S. dollar was 6.7 percent for 2005, 4.9 percent for 2006, 3 percent for 2007, and 4.3 percent for 2008. As a consequence, the National Bank followed an expansionary monetary policy to counter the rising need for manats. Annual inflation rose from 5.4 percent in December 2006 to 15.3 percent in December 2008 (Figure 1.22). While the jump in inflation can be explained partly by the administrative price adjustment in early 2007 (adjustment of gasoline and utility tariffs as well as regulated prices), most of it is due to the monetary expansion—broad money (M2) increased by 622 percent between January 2006 and December 2008. In this period, Central Bank's international reserves tripled, as it sought to accommodate the government's fiscal policy and at the same time maintain a nominal appreciation rate of 4-5 percent per year. Concurrently, credit growth, mainly directed at households, was as high as 203 percent in 2006-2008, which fueled a real estate boom. In the face of inflationary pressures, the National Bank of Azerbaijan (NBA) was

[37] In contrast to the changes in the structure of the economy, official statistics report few changes in the structure of employment (see figure 1.18).

relatively slow to respond, waiting until March 2007 to raise the refinancing rate, which rose from 9.5 percent in March 2007 to 15 percent as of July 2008, and down to 8 percent by December 2008 (as the crisis picked up, the Central Bank eased its monetary policy).[38]

1.39. **The fiscal expansion has started crowding out non-oil private investment**. While public investment and public expenditure are on the rise, non-oil private investment decreased in 2006–2008 in its share of GDP (Table 1.6). This trend raises concern that the public spending boom might have a relatively large crowding-out effect.

Table 1.6: Estimated Non-oil Private Investment Breakdown, 2003–08

	2005	2006	2007	2008
Total Investments	96.4	81.7	71.4	61.5
Government Sector	13.3	21.6	34.1	38.5
Private Sector	83.1	60.2	37.4	23.0
o/w Oil	60.0	41.3	27.2	13.4
o/w Non-oil	23.1	18.8	10.2	9.7
o/w construction	..	5.9	4.2	4.5
o/w other	..	12.9	6.0	5.1

Sources: Statistical Committee and World Bank staff estimates.
Note: Corresponds to Figure 1.16.

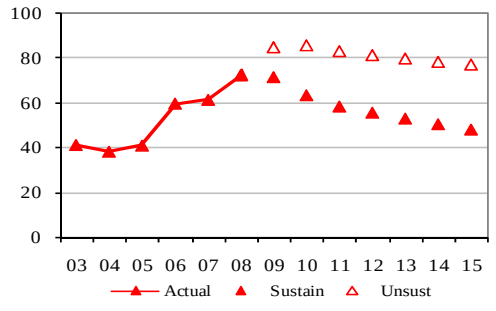
1.40. **The overall trade surplus and rapid growth, as well as devaluations from trading partners as a result of the crisis, has led to appreciation of the REER.** The CPI-based non-oil REER appreciated in 2005–2008 after depreciating in 2001–2004. The rate was below its 2001 level through 2007. While the manat appreciated against the U.S. dollar by 2.9 percent in 2007, it depreciated against the currencies of its main trading partners (respectively by 7.5, 16.4, 1.4 and 4.2 percent against the *euro*, the Turkish *lira*, the Kazakh *tenge* and the Russian *ruble;* however, in 2008, many of Azerbaijan's trading partners devalued their currencies (See Figure 1.17).

1.41. **The global crisis "put the brakes" on the overheated Azeri economy**. While heading into 2008, the Azeri policymakers had to subdue an overheating economy (rising prices, appreciating currency and suffering non-oil sector). In late 2008, oil prices dropped to less than $50 per barrel and international credit to the Azeri economy was drying up. Azerbaijan runs moderate risks of having lower remittances (from Russia) in 2009, and lower than expected oil revenues. The conservative 2009 budget proposes a modest 15 percent nominal increase of the consolidated budget (perhaps resulting in a real contraction of the budget). All together, these are reasons for depreciation of the currency that, however, risk provoking a banking crisis.

[38] In early 2008, the CBA adopted a dual currency basket containing dollars and euros to allow for more exchange rate flexibility and reduce imported inflation. The policy was abandoned as the global crisis deepened later in the year.

1.42. **In the post-2008 period, Azerbaijan will have to contend with lower fiscal revenues relative to the size of the non-oil economy.** Sustainability requires Azerbaijan to moderate its fiscal expenditures in the short and medium term (Figure 1.23). This moderation will minimize the fiscal stimulus to the Azeri economy, relative to 2005-2008, necessary if Azerbaijan wishes to set aside some oil revenues for the next generation. Azerbaijan will have to increasingly rely on the private sector and non-oil exports to generate domestic demand.

Figure 1.23: Fiscal Scenarios–Expenditures as Percent of Non-Oil GDP

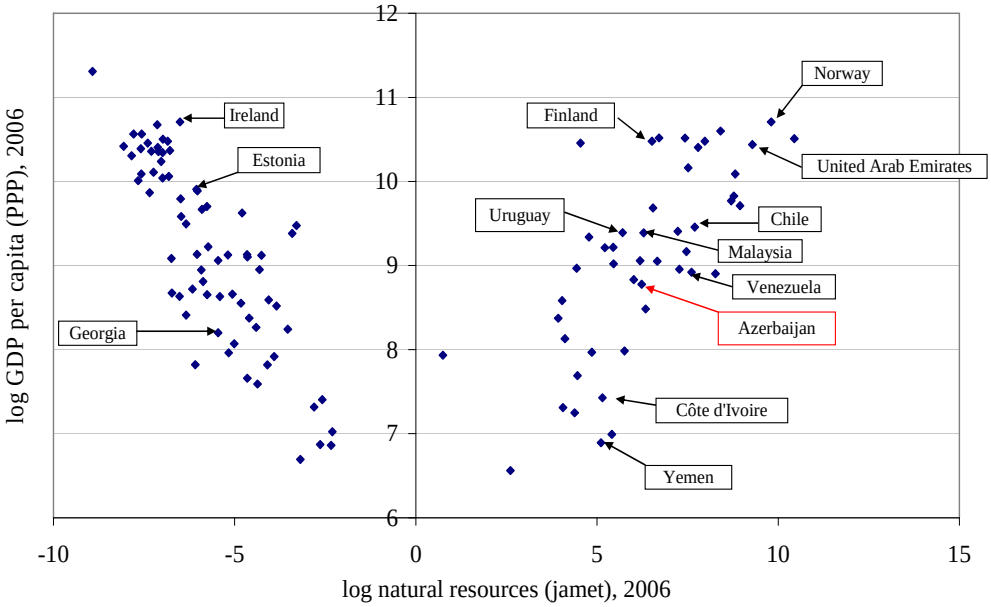


Sources: World Bank staff estimates

F. Successful Development in Resource-Rich and Small Economies

1.43. **International evidence suggests that natural resources are neither a curse nor a blessing; the ability of the each country's political system to reach an agreement on the creation of sound institutions is behind the natural resource success stories**. Figure 1.24 shows that the number of countries that have resource endowments is almost equal to the number of countries with high per capita incomes. The figure has a notional "V" shape: along the left side of the "V" are countries with no natural resource endowments, while on the right side of the V are countries with natural resource endowments–there is a large number of countries on the right side. Both sides of the V have high- and low-income countries, and confirm that Azerbaijan has the ability to choose the group it will belong to in the future. Box 1.3 highlights the example of Malaysia, which has pursued successful social policies and diversified its economy.

Figure 1.24: Natural Resource Endowments and Level of Development



Source: Maloney 2007 and Bank estimates using IMF and UN Comtrade data.

1.44. **Successful development results from better market institutions**. Success comes when countries diversify their exports, improve public finance management, and build on the accumulation of knowledge and infrastructure. Successful countries that have natural riches—Botswana, Chile, Norway, Malaysia, and the United Arab Emirates—have taken into account the importance of institutional capacities in their strategic priority-setting by ensuring that these capacities are sufficient before considering using resource revenues to stimulate growth. It is important to note that these countries score much better than Azerbaijan on governance indicators such as control of corruption, rule of law, government effectiveness, political stability, regulatory quality, and accountability.[39] An objective measure of the broad quality of economic institutions, abstract from views of analysts or survey respondents, can be found in the proxy Contract-Intensive Money (CIM), which measures the degree to which individuals are willing to hold a larger proportion of their financial assets in the form of currency as protection in environments where third-party enforcement of contracts is unreliable.[40] Figure 1.25 compares broad institutional quality for Azerbaijan in the beginning of its oil boom, with that of well performing resource-rich and small economies. The figure shows that 30–40 years ago, most of the comparators were little different from where Azerbaijan was in 2008. In fact, in the 1960s, Chile's per capita income, CIM and non-commodity exports were somewhat comparable to those of Azerbaijan today. However, by 2008, Chile's non-commodity exports had more than tripled (as a share of non-commodity GDP), its CIM was identical to that of Norway and, most importantly, its per capita income had also more than tripled.

Box 1.3: Malaysia's Successful Diversification

The example of Malaysia illustrates that the presence of large natural resources is not perforce a curse. It demonstrates that a strong political will and commitment to sound economic policies, sustained over many years, can avoid the "resource curse." As recently as 1980, 32% of Malaysia's total exports of goods and services were from oil and natural gas. From 1980-2006, there were wild gyrations in the price of oil. However, by 2006, oil and natural gas comprised only 13% of total exports while Malaysia's real per capita GDP grew at an average annual rate of 3.6% from 1980 to 2006, reaching over 150% to $12,536 (in current $PPP) in 2006.

A critical element of success was the high savings rate that made capital available for investment. Households were required to contribute to a compulsory savings scheme. Government expenditures favored education, housing, and health, and achieved a geographically balanced distribution. Moreover, good governance enabled Malaysia to sustain these high growth rates. In the 2005 Transparency International Corruption Perception Index, Malaysia ranked 39th, far above Nigeria (159th), which failed to emulate Malaysia's diversification model. For example, it currently takes only one day to either Stamp the Company Documents or to register with the Income tax Department in Malaysia. Not surprisingly, Malaysia ranked 20th globally in the World Bank 2009 Doing Business Survey. (Azerbaijan's recent graduation to 33rd is encouraging).

Although Malaysia promoted export-oriented manufacturing from the early 1970s, it also tried, unsuccessfully, in the early 1980s, to use its oil income to start heavy and chemical industries in the public sector with government protection. Moreover, the size of the public sector doubled between 1966 and 1981. This too was abandoned due to the recession of the mid-1980's. Thereafter, Malaysia pursued economic and export diversification.

Sensible economic policies were formulated and implemented by professional civil servants, academics, and technocrats. At that relatively early stage of economic development, the government focused on labor-intensive industrialization utilizing workers from rural areas. Recognizing that at this time multinational companies (MNCs)

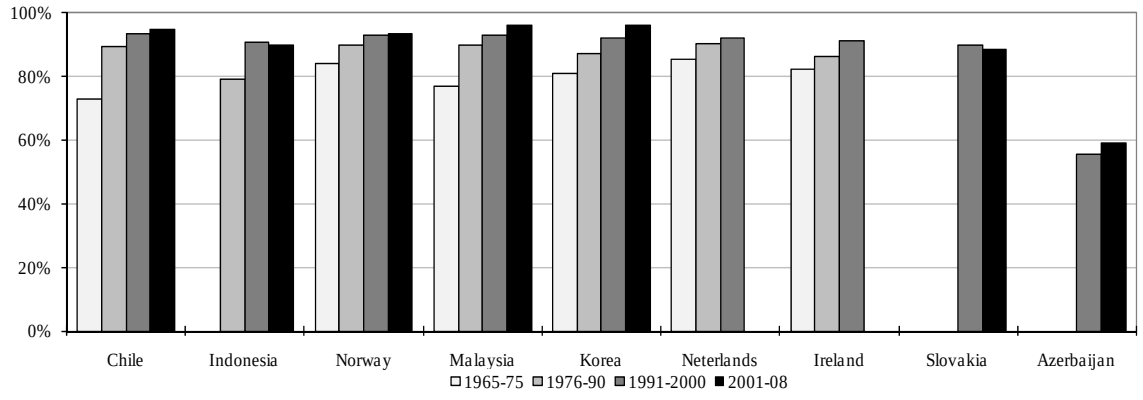
[39] See Kaufmann and others 2007.

[40] CIM is measured as (M2-Currency)/M2. It is based on citizens' decisions regarding the form in which they choose to hold their financial assets and is positively related to investment and growth rates, and to the relative size of contract-dependent sectors of the economy. Clague, Christopher; Philip Keefer, Stephen Knack, and Mancur Olson (1999), "Contract-Intensive Money." Journal of Economic Growth, 4, 185-209.

were relocating manufacturing to developing countries to take advantage of lower wages, the government increased the supply of skilled workers to the rapidly expanding manufacturing sector by allocating a substantial portion of the budget to education. Moreover, even within manufacturing, Malaysia diversified from resource-based to technology-intensive products. In particular, since 1987 the electronics industry has been the leading export earner in Malaysia. This industry developed with the arrival of MNCs in two waves, the first in 1972-75 and the second in 1985-90, lured by Malaysia's educated work-force and business-friendly environment. Exports of these high value-added products have grown rapidly and have provided Malaysia with a cushion against terms of trade shocks and led to the aforementioned sustained growth.

1.45. **Good market institutions imply a good degree of global integration—this has been a lesson for small countries as well, and will be important for post-oil Azerbaijan**. Success has come to resource-rich countries that diversified their exports and improved public finance management. Successful resource-rich countries—Chile, Malaysia and Indonesia—improved their institutional capacities and then used resource revenues to stimulate growth. Similarly, several small economies—the Czech Republic, Ireland, South Korea and Taiwan—rapidly became high-income countries by competing in global markets and improving their institutional capacities. While for small economies the need to be open may be obvious (i.e., the need to expand markets, and to be competitive), it is important to note that successful resource-rich countries diversified their exports by gathering critical inputs through imports and FDI. For instance, Chile and Malaysia managed to increase the technological content of resource-based clusters and developed new areas of competitive advantage.[41] Common features include policies to improve business environment and attract FDI (including trade facilitation, competition policy, and a qualified labor force), a diversification strategy that built on existing strengths (horizontal and vertical diversification through clusters based on natural resources) before moving to higher skill-content specializations, and efforts to coordinate public and private actors. Figure 1.26 presents the export performance of selected small economies that Azerbaijan is urged to emulate, while Figure 1.27 presents non-commodity exports of selected resource-rich countries that have successfully diversified.

Figure 1.25: Long-term Measure of Institutional Quality
(*Contract-Intensive Money[M2-Currency] as Percent of M2)*

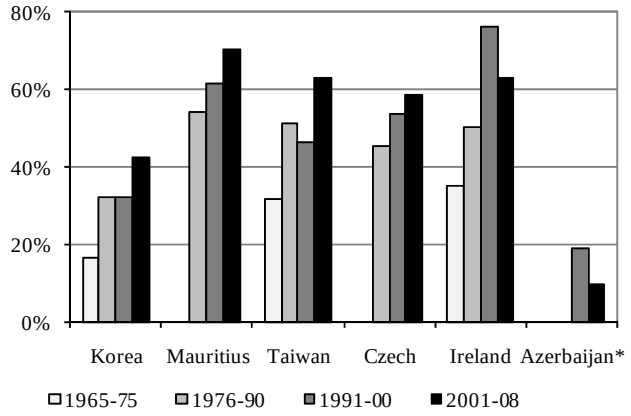


Source: Bank staff estimates based on Clague, Keefer, Knack, and Olson (1999).
Notes: (a) No data for Ireland and Netherlands after 1998 because they adopted the euro; (b) no data for Azerbaijan and Slovak before 1992; (c) data for Georgia, Kazakhstan and Armenia average of 2006-07; and (d) no data for Indonesia before 1979.

[41] See J-F Jamet, "What can Azerbaijan learn from successful diversification strategies abroad?" *CEM Background Paper*, 2007.

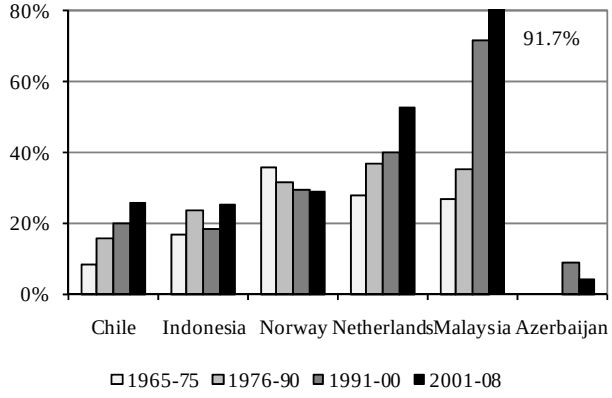
1.46. **Good market institutions have been complemented by focused public-private partnerships aimed at facilitating exports of specific sectors of products with demonstrated market opportunities**. Focused partnerships between the public and private sectors have aimed to strengthen access to foreign markets, standardize quality, and reduce transportation costs. Box 1.4 provides examples from Malaysia and Chile.

Figure 1.26: Exports of Selected Small Economies *(% of GDP)*



Source: Comtrade
Note: (*) Non-oil exports as percent of non-oil GDP.

Figure 1.27: Non-Commodity Exports of Selected Natural Resource Economies *(% of GDP)*



Source: Comtrade

1.47. **While the government can play a very significant role in diversification, it should not compromise competition**. A study of 10 cases of successful diversification in some resource-rich and some non-resource-rich countries has revealed a common set of actions that governments could take to support the private sector, and create incentives for diversification.[42] The following industries/countries were studied: software in India; electronics in Taiwan and Malaysia; palm oil and related products in Malaysia; salmon farming and wine production in Chile; grapes and maize in India; fisheries in Uganda; floriculture in Kenya. The common actions of governments in these successful cases of diversification were:

- Governments set up goals to support non-traditional or nascent industries because they were valuable sources of export-led growth, foreign exchange, and/or fulfilled employment objectives.
- Governments did not necessarily pick winners (except for electronics, palm oil, and salmon –the cautious development of the salmon industry in Chile is documented in this chapter, Box 1.4), but instead supported industries that were growing faster than others. They pursued private sector-driven export-led growth by facilitating the private sector's ability to adapt and master new technologies and sharpen export competiveness.
- The governments rewarded winners and dropped losers by conditioning public support on export performance.

[42] Chandra, Vandana (ed.) Technology, adaptation, and exports: how some developing countries got it right. World Bank 2006. Adapted from Box 1.2, page 40.

- Competition between domestic firms, and between domestic and foreign firms, was generally unrestricted.
- Rule of law, including observance of international property rights, applied in all cases.
- Political commitment, sometimes in the form of a national vision, was a significant contributor to the success of the industries.

Box 1.4: Examples of Diversification in Resource-rich Countries: Malaysia and Chile

The Palm Oil Diversification Program in Malaysia

After its independence in 1957, the Malaysian economy was dependent on tin and rubber, which accounted for 50% of GDP at the time and whose development was supported by the government. However, the advent of synthetic rubber led to the fall of rubber prices, which triggered an economic and social crisis in the 60s. The government was forced to recognize the necessity of expanding the economy's narrow base to generate growth. It adopted a diversification strategy based on the development of palm oil exports and on the establishment of industrial estates aimed at growing the manufacturing sector. The promotion of the palm oil industry proved to be a success story and the emphasis on rural and agricultural development provided employment and income-earning opportunities to the rural poor. This came mainly from a policy that allowed for an increase in palm oil production and greater sophistication of exports, based on initiatives in penetrating and deepening markets, R&D and a conducive regulatory framework:

- The *Federal Land Development Authority* opened new lands for resettlement of the rural landless, seizing the opportunity to promote oil palm smallholdings. It also helped to convert large areas of rubber land to palm oil.
- The *Palm Oil Registration and Licensing Authority* ensured the orderly development of the palm oil industry by issuing license to the businesses involved in production, transportation, storage, exports and sale of palm oil, and by controlling quality of the products, and registering trade contracts.
- The *Palm Oil Research Institute of Malaysia* was in charge of improving productivity, value added, quality and other aspects of the industry's performance. In particular, it provided the bulk of R&D about palm oil.
- The *Malaysian Palm Oil Promotion Council* was responsible for public relations and market promotion in international markets through trade missions, exhibitions and distribution of information on nutritional aspects of palm oil. It made special efforts to increase consumer knowledge on palm oil products and provided technical support to develop the utilization of palm oil.

Diversification from Copper in Chile

Chile offers a good example of how a country can successfully diversify into agricultural products and processed food exports by combining horizontal and vertical integration. The world food industry is concentrated and internationalized, and "retail distribution has become a key component of the food chain, with monopsony power reinforced by buying alliances".[43] In this context, competitiveness of the agro-food sector on world markets is particularly dependent on low logistics and transport costs and performance of the whole food chain. It also requires increasing productivity by investing in agronomic R&D, permitting technology transfers, training workers, upgrading quality standards and facilitating access to credit.

Chile was also particularly successful in differentiating primary agricutural production as well as food products (for instance wine, organic cultures, fresh fruits or high quality cereals) and developing the service content of its exports (thanks to good logistics and branding). These actions were important on top of the improvement of the economic environment the country displayed: stable macroeconomic fundamentals, upgraded infrastructure, integrated commercial networks (including small farmers), competition in the non-tradable sector and better access to credit, education and R&D. Finally, FDI played an important role as it facilitated participation in international production and distribution networks.

The development of the salmon industry is in particular very instructive of how the government and the private

[43] OECD, *Trade and Competitiveness in Argentina, Brazil and Chile: not as easy as A-B-C*, 2004

sector can cooperate to achieve international success. Early on, the government created opportunities for fish farming in the country (by seeking assistance from donors and co-funding), and funded agencies that gradually worked to develop the sector. The Chilean government first looked into salmon and trout farming in the 1960s, developing the Institute for Fishery Development (IFOP) and the Agricultural and Live Stock Service (SAG) to explore the feasibility for fish farming and to identify locations and to work with donors (Japanese International Agency for Cooperation) to establish some local expertise. A Japanese firm was the first to invest in Chile's salmon sector. The Chilean Economic Development Agency (CORFO) made its first loan for trout farming in 1974. As demand for trout and salmon increased, not only did production increase, but enterprises became self-sufficient in producing most inputs needed for fish farming (netting, pens, etc.), except eggs. Eventually in the 1980s, as the industry grew, the government structure evolved, separating the strategy and policy from the implementation and enforcement tasks.

Over the years, the government developed numerous agencies, and enabled the engagement of donors in various stages of development of the industry: CORFO for lending, Canadian International Development Agency funded a project to co-manage local firms, local partnerships emerged with Norwegian and Japanese firms; Fundacion Chile (private non-profit) did a lot of experimentation, and disseminated knowledge. In the 1980s, as a critical mass of producers was formed, an association was established for: (a) marketing research; and (b) establishment of standards (INTESAL -Institute for Salmon and Trout). The government focused on rationalizing regulation (across jurisdictions). In the 1990s, Salmocorp, a joint venture, was created to look for new markets.

1.48. **Non–reformers pay a price.** On the other hand, it is widely known that resource-rich countries can be underachievers in development. Failures are found when incentives for rent-seeking and corruption are unmitigated, and when there is a lack of spillover from the resource sector to the rest of the economy, low value-added of exports, and low efficiency of public spending.[44] Such incentives generally proliferate in an environment of weak institutions[45] and poor public finance governance.[46] Figure 1.25 showed a generic measure of institutional strength in Azerbaijan, relative to other resource-rich countries at the time when they experienced resource booms and relative to small open economies. While it suggests that—as can be seen from other countries—the institutions that support exchanges (and in fact the functioning of markets) are weak in Azerbaijan, it also shows that progress for Azerbaijan is within reach, and that it can work to close the gap.

1.49. These resource-rich countries attained higher incomes by adopting deficit/debt rules aimed at stabilizing spending, promoting public spending transparency and anticorruption initiatives as well as the removal of trade barriers, streamlining business regulations, and developing public-private partnerships. It is also recognized that resource-rich countries are often unable to sustain high economic growth due to their inherent incentives for rent-seeking and corruption. Furthermore, because of the lack of spillover from the resource sector to the rest of the economy, there is low value-added to exports and little employment. All of these problems are exacerbated by weak institutions and poor public finance governance.

1.50. **The examples of successfully diversified resource-rich countries suggest that the best employment of oil resources by the government is one that leads to reduced costs for the private sector**. This applies to the deployment of macroeconomic policies that reduce volatility in the economy (such as the course of the exchange rate or inflation). It also applies to reducing

[44] See Sachs and Warner 2001.
[45] See Lane and Tornell 1995.
[46] See Manzano and Rigobom 2007.

transport and operating costs, whether they originate from economic, institutional, or administrative barriers.

G. Overcoming the Hurdles Caused by the Global Crisis

1.51. **Amidst Azerbaijan's ambitious development plans, the global economy descended into a crisis. While ECA is hard hit by the crisis, Azerbaijan, to date, seems to have escaped relatively unscathed but still has suffered some minor shocks.** The ECA and LAC regions seem to be the second hardest hit by the crisis after the high-income countries –they are the only regions whose 2009 GDP growth is expected to be less than half the 2006-2007 average. The ECA region seems to have had little direct exposure to the U.S. financial crisis, but was hit by indirect spillovers. Slow demand in the Euro zone has dampened the export performance of ECA countries. Already, the performance of the Baltic countries has stalled; the CIS countries are also experiencing a decline because of the drop in oil revenues, and as a consequence of the impact of the banking crisis on the Russian economy. For 2009, the Azeri economy is expected to hold up better than the average country in ECA because: (a) the country was less integrated regionally and previous years' performance relied significantly on oil revenues (see earlier discussion), the reliance of the banking sector on foreign credit had been relatively small and external borrowings could be covered by national reserves, the reliance of aggregate demand on non-oil exports was low; and (b) oil production is currently expected to increase further in 2009-2010 before gradually tapering off. With anticipated higher oil production, a significant financing source for the economy is currently expected to remain intact, even if oil prices remain suppressed. Nevertheless, amid the global crisis, vigilant monitoring of global developments, oil production plans, non-oil sector performance, and prices, is required.

1.52. **During the crisis Azerbaijan should ensure that domestic demand is sustained**. In the absence of the crisis, Azerbaijan might have continued to rely on the public sector to expand aggregate demand, simultaneously pursuing the development of non-oil exports. As a result of the crisis, however, Azerbaijan needs to rethink its growth strategy. One approach is to use public spending to support aggregate demand, as before. However, Azerbaijan's public spending is already quite high, as this chapter and Chapter 3 suggest. Under current circumstances, the downward trend in public spending (relative to non-oil GDP) should be sustained, although there is leeway regarding the pace of the decline. Should the domestic economy weaken as a result of the crisis, the pace of adjustment could be slower in the short term. Another approach is to accelerate reforms that encourage non-oil private investment. In Azerbaijan, the private sector operates with significant administrative hurdles (Chapter 5 discusses licensing, tax and customs administrations placing significant costs on the economy). During 2009, Azerbaijan should focus on reducing those hurdles following the recommendations in Chapter 5.

1.53. **To support domestic demand, and to ensure financial stability, Azerbaijan can strengthen its vigilant supervision of the financial sector, and ensure that access to credit for the private sector does not decline significantly as a result of the crisis**. The inadequacy of financing created by the global crisis will likely have an impact on Azerbaijan. The direct impact relates to short-term foreign debt that is not rolled over and the financing shortages that would be created for some commercial banks, which will affect the private sector. These short-term obligations are anticipated to be in the order of $1-2 billion in 2009, significantly smaller than the Oil Fund assets and the country's foreign currency reserves at end-2008 (about $15

billion). The indirect impact of the global crisis on the financial sector (and more broadly in financing of domestic investment) will be from the lower availability of private foreign financing, either in the form of foreign lending to Azeri banks, or FDI, especially to the non-oil sector.[47] To mitigate the risk of adverse developments in the banking sector, Azerbaijan's monetary authorities should enhance the supervision of the financial sector. If government support of the financial sector is required, such support should be channeled through the consolidated budget. In order to enhance the ability of the financial sector to support investment, especially in 2009, Azerbaijan may wish to accelerate reforms in formalizing the operations of the private sector (discussed in Chapter 5) and ensure hassle-free access to credit (Chapter 6).

1.54. **While in the absence of the crisis Azerbaijan could have acted early (in 2009) and aggressively to expand export markets (as has been done in earlier decades by Asian countries), the crisis forces policy makers to look to 2010 or 2011 for gains in non-oil exports**. The relatively poor prospects for Azerbaijan's trading partners as a result of the crisis suggests that gains in diversification, and especially in expanding non-oil exports, may take a little longer to achieve. Azerbaijan can use the 'down time' in the global economy to: (a) strengthen the efficacy of its public sector interventions; and (b) reduce operating costs for it private sector.

1.55. **Azerbaijan must exercise exceptional caution as the depth and the duration of the global crisis are yet to be determined, as is the trough and duration of low oil prices**. This section demonstrates the high degree of oil dependence of Azerbaijan's economy, and the need to reduce public spending (relative to non-oil GDP) in the presence of high oil prices (in a pre-crisis scenario). As a result of the global crisis, however, Azerbaijan faces significantly more pressure to reduce public spending. The country may find it beneficial to adopt a long-term approach to estimating fiscal revenues from oil (as proposed in Chapter 3), and to base short-term expenditure plans on permanent income estimates. At the same time, it is very important that accurate forecasts of oil production for the short term are used, incorporating margins for error in oil and gas extraction and transportation, and also, for lowering the pace of production, should that be necessary for the short term. Separately, Azerbaijan's foreign currency reserves (at the National Bank and the Oil Fund), and its untapped oil reserves give it ample room to gradually adjust its public spending (i.e., soft landing) to a new expenditure level based on lower oil prices than expected in 2008.

H. CONCLUSION

1.56. Oil undoubtedly buoyed the Azeri economy for the whole of 1994–2005. Today, Azerbaijan's strategies and policies are pointing in the right direction-- toward greater regional and global integration. The importance given to infrastructure and institutional reform aimed at improving the business climate for the private sector, and social policies to help the needy are also appropriate. Both private sector growth and social policies target poverty reduction in the long and short run. Early in the oil boom, the government needs to take concentrated action to reverse the unfavorable trends in non-oil private investment, non-oil exports, and non-oil FDI.

[47] In order to strengthen the management of state guaranteed debt, in 2008 the government created the Security Fund for Debt Under State Guarantee, and included provisions for it under the budget. The main purpose of the fund is the timely repayment of state guaranteed debt.

The action is even more urgent given the global financial crisis and the need to reduce public spending in order to ensure sustainability and leave some oil revenues for future generations. The lessons from resource-rich and small economies show that a strategic focus on global integration needs to be maintained and strengthened, even during the global turmoil that the world is currently facing. This report is about strengthening fiscal policies and economic management institutions that can help Azerbaijan meet its medium- and long-term development objectives. Prior to embarking on that task, the next chapter looks more closely at sectoral developments of the Azeri economy.

CHAPTER 2.
THE ECONOMY AND ITS PROSPECTS

Azerbaijan's current output structure provides significant opportunities for the private sector to grow in the medium term. The country can capitalize on existing activities in agriculture, agri-business and the service sectors. Its economy often operates below its production frontier, sometimes for lack of inputs (scarce or poor-quality inputs, high cost of imports or lack of know-how) and sometimes because of institutional shortcomings (poorly functioning markets). These constraints have neither prevented Azerbaijan from attaining double-digit growth in recent years, nor from gradually expanding its non-oil exports. But, since they do add to the cost of production, they may have hindered non-oil private investment and FDI. Identifying and addressing the challenges will allow Azerbaijan to be more competitive when the buoyancy of high oil spending subsides, or if the country faces unforeseen challenges in the global downturn.

Removing the constraints that hinder the operation of markets would allow Azerbaijan to make progress across its entire economy. First, agriculture could move into higher value-added products and greater commercialization, and it could prepare agro-products for the more lucrative, but demanding, upper middle-income markets; second, investment in commercially viable downstream oil and gas activities could be stimulated; third, the cost of construction for all types of investments could be reduced; and fourth, it could improve the quality and scope of the service sectors, possibly transforming Azerbaijan from a transit route into a location for processing and value added. All of these activities would generate employment, which must be a high priority for Azerbaijan.

This chapter provides the reader who is less familiar with Azerbaijan with a micro context for the macro level development dialogue that follows in other chapters of the report, and a basis for assessing the economy's prospects.

A. AZERBAIJAN'S FUTURE: BROAD STROKES FOR THE MEDIUM TERM

2.1. **In the medium term, Azerbaijan's sustainability and growth as a small economy (given its size and market power) depend on its ability to integrate itself into the regional and global economies**. For integration to be sustainable, it must be based on efficient participation in global markets in the non-extraction industries; being regionally and globally competitive in non-extraction industries will secure jobs. To that end, building infrastructure and undertaking a broad reform program to improve productivity and competitiveness, is strategically sensible. This parallel initiative will serve Azerbaijan well in the future.

2.2. Azerbaijan's ***agricultural and agri-business sectors*** hold significant potential. Most immediately, given its existing knowledge and export base, and its climatic and geographic advantages (spring in Azerbaijan arrives one month before Russia's, providing opportunities for exports) the agricultural and agri-business sectors have significant scope for growth This is especially true in the south and east of the country, since Azerbaijan already has an important presence in Russia's food market. It exports a range of unprocessed products to Russia (fruits, vegetables, nuts, edible oils and fats, cotton, tea, and sugar). There is an opportunity to move up

the value chain on these products by producing canned goods and processed nuts. Azerbaijan also exports sugar, animal feed, and wheat flour to Georgia. Improvements in the country's electricity and transport sectors will help in this respect.

2.3. There is also no reason why Azerbaijan's engagement in ***natural resources*** should be limited to upstream activities only. Given the country's improving knowledge base, Azerbaijan should reevaluate the potential of these sectors, both commercially and competitively. First, it has been shown that resource-rich countries that managed to diversify, also managed to broaden their activities in resource-rich sectors (such as Norway in paper products).[48] Second, regarding the chemical and agri-business sectors, research suggests that one approach to diversification is to capitalize on existing exporting industries and move up the value chain.[49] Azerbaijan should also not neglect the regional opportunities in power and gas. There is potential for a regional power market covering the South Caucasus, Russia, Iran, and Turkey, where Azerbaijan can have an important position. .

2.4. Azerbaijan's ***trade and transport sectors*** also offer many opportunities. Azerbaijan already is a regional trade center. It imports products from China (light manufacturing), Iran (carpets, fruits, vegetables, food stuffs), and Turkey (carpets, clothing), and exports to Georgia and Russia. Improved road infrastructure will reduce transportation costs. However, studies on other continents suggest that institutional barriers, particularly costs related to border crossings and road transport (i.e., cost of security, police protection, etc.) can be higher than costs stemming from poor infrastructure. Preliminary evidence emerging from the Central Asia Regional Economic Cooperation Forum (CAREC) countries supports this conclusion.

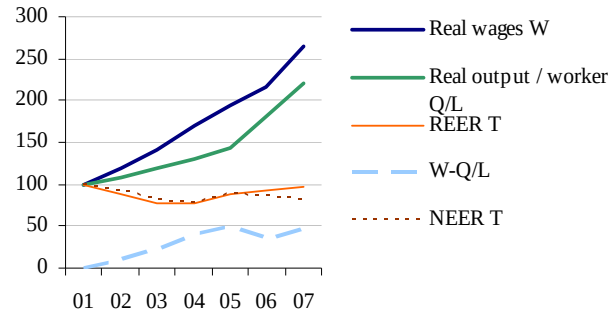
2.5. Azerbaijan's ***other service sectors*** also hold strong potential, particularly *banking*. While credit has rapidly risen in recent years, it has been directed primarily to households. As the number of formal SMEs grows, thanks to recent improvements in business registration, but hopefully also thanks to lower tax rates (as proposed in Chapter 5), the banking sector should be able to respond to the growing demand for credit. Also promising is *tourism*, which showed progress in 2007 and 2008. Due to the country's natural beauty, especially in the west and north, Azerbaijan has local and regional potential in tourism and hospitality services. However, it would have to offer better quality services in order to turn tourism into a major source for employment.

2.6. **Increasing competitiveness will be critical to Azerbaijan's future**. Looking forward, the key challenge for Azerbaijan comes not from a lack of non-oil economic activities, but from the need to ensure the competitiveness of the non-oil economy, as that is the key to employment generation in the future. Today, Azerbaijan's wages for the non-oil sector have been outpacing productivity. The REER for non-oil exports and imports has been appreciating modestly during the oil boom, due primarily to the inflation experienced by its trading partners (Iran, Russia). The rising gap between real wages and output per worker suggests that, for the non-oil economy, the exchange rate may be under-valued. Figures 2.1 and 2.2 show largely similar increases in the gap between real wages and labor productivity pointing to the need for Azerbaijan to better coordinate its public expenditure policy with its macroeconomic policy. The shortages of inputs

[48] Lederman and Maloney 2007.
[49] Ibid.

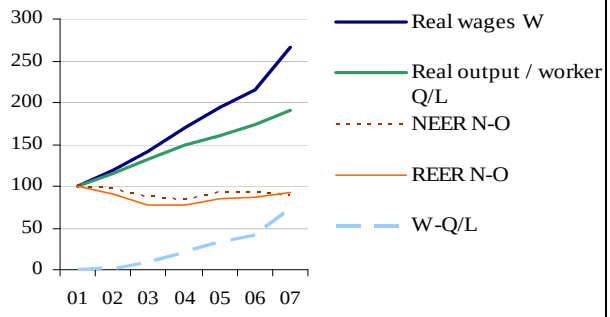
created by the build-up of public investment affected competitiveness in 2005-07 (discussed in Chapter. 5). In turn, public investments and institutional reforms will have to contribute to increasing productivity in 2008 and beyond, so that the gap between productivity and real wage increases begins to contract.

Figure 2.1: Real Wages, Output per Worker, NEER, and REER: Total GDP



Source: Statistical Commission, National Bank of Azerbaijan and Bank staff estimates.
Notes: REER T: Real effective exchange rate for the whole economy; NEER T: Nominal Effective Exchange Rate for the whole economy; W-Q/L: Difference between real wage and output per worker.

Figure 2.2: Real Wages, Output per Worker, NEER, and REER: Non-Oil Economy



Source: Statistical Commission, National Bank of Azerbaijan and Bank staff estimates.
Notes: REER N-O: Real effective exchange rate for the non-oil economy; NEER N-O: Nominal Effective Exchange Rate for the non-oil economy; W-Q/L: Difference between real wage and output per worker.

2.7. **Azerbaijan should be wary of the Dutch Disease, which could affect its economy in the medium term**. Many resource-rich countries suffer from an appreciation of the real exchange rate stemming from sudden influx of foreign currencies and rising domestic prices for the non-traded sectors. In turn, this has detrimental effects on a country's non-commodity exports. The negative aspect of Dutch Disease that threatens policymakers is the temporary nature of real exchange rate appreciation. By the end of a resource boom, the real exchange rate reverts (depreciates) to the pre-boom level. But then the real danger is that the country would be left with no natural resources and an economy that had lost skills and competitiveness in the non-commodity sector. This is especially true of Azerbaijan, where oil production will end in 20 years. The only sure way for a country to "beat" Dutch Disease is to: (a) keep all foreign currency revenues outside the country; or (b) bring them into the country at a predetermined and sustainable rate. While Azerbaijan's domestic prices increased in 2005-08, two factors argue against declaration of a Dutch Disease calamity. First, Azerbaijan's non-oil trading partners also suffered from currency appreciation; Figure 1.17 shows that the REER for non-oil exports appreciated modestly in 2006-07, and is at the 2002 level. Second, the rate at which Azerbaijan has been "importing" its foreign currency has generally been considered sustainable in that it is roughly on par with the permanent income equivalent discussed in Chapter 3. Should oil prices stay low, Azerbaijan will have to adjust downwards the level of its oil spending permanently, then a case might be made for Dutch disease should the economy not adjust. Chapter 1 discussed the trends in the REER of Azerbaijan; Chapter 4 discusses policies that will contribute to Azerbaijan smoothening its REER appreciation (which also depends on its trading partners).

B. Sectoral Developments and Impediments

2.8. This section looks at recent developments and challenges to Azerbaijan's economic sectors. Although an image of segmented sectors and markets emerges from this section, it also suggests that the recommendations made to improve the business environment (Chapter 5) may be necessary but not sufficient to ensure that Azerbaijan's non-oil economic base obtains a sustainable footing; the government will also need to look at independent reforms in these sectors.

Agriculture: Potential yet to be tapped

2.9. **Azerbaijan's agricultural sector has been growing at reasonable rates in recent years**. Since the trough of transition, around 1995, its agricultural sector has been growing at an average annual rate of more than 5 percent, which means production will have doubled from this trough by 2009 (Table 2.1). Today, a dynamic rural commercialization process is beginning to accelerate in many parts of the country. In primary production, a progressive commercialization of farming has stimulated some land consolidation under lease-holding and purchase. This is required to achieve larger-sized holdings, which are better able to support specialization and investment in structures and machinery. In the agri-food industries and inputs distribution enterprises, investment and modernization are being encouraged. It is being done by expanded rural lending facilities from commercial banks and by the initial capitalization of enterprise development funds being administered by commercial banks from budgetary sources. In terms of products, although production of some crops has slowed (tea leaves, tobacco, sunflowers, cotton), production of most others has increased manifold: cereals have doubled production since 1995, potato production increased more than five-fold, vegetable production by almost two-fold, and production of fruits and berries almost doubled. At the same time, Azerbaijan's livestock sector has been doing very well; the various livestock products grew at an average annual rate of 4 percent to 6 percent in 1996–2007.

Table 2.1: Agriculture: Recent Developments

	2005	2006	2007
Production growth rates by sector			
Agriculture	**7.5**	**0.9**	**4.0**
Cereals	-1.5	-2.2	-3.6
Cotton	44.9	-33.8	-23.1
Fruits (incl. grapes)	47.1	7.2	3.2
Vegetables	4.7	5.2	3.4
Meat	3.3	4.1	7.5
Milk	3.1	3.8	3.2
Eggs	5.4	-13.0	14.5
Profitability for farmers (production cost less farm gate price; AZN per 100 Kg.)			
Cereals	4.1	3.2	5.5
Fruits and berries	16.4	11.7	16.2
Grapes	23.7	16.9	16.2
Vegetables	1.0	5.4	9.8
Potatoes	0.5	16.0	22.3

Source: Statistical Committee of Azerbaijan.
Note: Production costs include labor, fertilizers, energy, and other inputs.

2.10. **Surprisingly, the agricultural growth has come despite very low investment rates in 2001–07 and labor-shifting from agriculture to higher-paying construction jobs**. From 2001 to 2007, labor moved away from agriculture to the thriving construction sectors, initially to pipelines, and subsequently to residential construction and public infrastructure build-up. While the number of people employed in agriculture increased by 5 percent in 2001-2007, the share of total employment in agriculture fell from 41 percent in 2001 to 38.8 percent in 2007 (Chapter 1). Given the sector's declining share of employment and low investment, its entire growth from

2001 to 2007 can be attributed largely to improvements in total factor productivity (Chapter 1). With Azerbaijan's REER appreciating only moderately, and institutional reforms in the business environment and the agricultural sector falling behind (discussed below), the sector has been operating significantly below its potential.[50]

2.11. **Institutional challenges and poor policy choices hinder agriculture's performance.** Azerbaijan's agriculture faces several obstacles: (i) weaknesses in the legal and regulatory system (quality standards, resolution of contractual disputes, monopolistic practices); (ii) pervasive administrative barriers to investment (primarily from high tax rates and monopolistic practices); (iii) weaknesses in infrastructure provision (irrigation, availability of secondary roads); and (iv) low availability of credit. At the same time, policymaking has sometimes been counter-productive (regulations biased against the use of new seeds). For instance, it has tried to make up for shortcomings by promoting inefficiencies (wheat subsidies, special tax regime with no profits or value-added taxes on agricultural production, to name just a few), or has not been proactive enough—Azerbaijan has sub-standard cultivars, and herds with low genetic potential. In addition, land reform has not come full circle yet. Plot sizes remain very small after a remarkably equitable privatization program (which ended in 2000), but the consolidation that has taken place in other ECA countries and brought with it scale economies has yet to occur. Finally, corruption has also played an important role in preventing entry of investors directly, or in contributing to limiting options in the supply chain (imports, wholesale markets, etc.).[51]

2.12. **The challenges affect the sector's products differently**. The aforementioned problems affect different products differently. For example, pomegranate juice definitely has export potential but requires modern presses, filtration equipment, acceptable preservatives and/or investments in transport, and strict food safety and quality standards. However, existing production facilities are concentrated in the hands of a few (five major producers), and existing producers reportedly discourage new entrants from entering the market. Cucumbers have weak to moderate price-transmission mechanisms between farmer and market, but the product's perishable nature makes rent-seeking at the border crossing common. While potatoes have a robust price-transmission mechanism, they have poor transit facilities, and on-farm storage creates on-farm spoilage. Moreover, communities in Azerbaijan have failed to organize in order to benefit from collective investments in machinery or storage, as have communities in other CIS countries.

2.13. **Agriculture's sector-specific challenges, together with the broader ones of the business environment, lead to the reported concentration of purchasers and suppress offers made to farmers**. Figures 2.3 and 2.4 show a large discrepancy between farm gate and retail prices through 2006 (latest available data) for agricultural products. Since 2000, the increases in farm gate retail prices have almost doubled. In Azerbaijan, the discrepancy is often attributed to the small number of wholesalers in regional markets and to local "monopolists." It is reported that farm gate prices barely cover the cost of harvesting and do not cover the cost of farm and

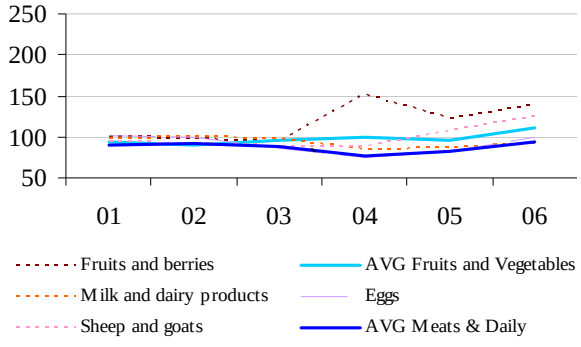
[50] Sub-sectors with export potential are pomegranate, potatoes, tomatoes, early vegetables, early fruits, greenhouse vegetables and fruits, and hazelnuts. Sub-sectors with import-substitution potential are wheat, apples, potatoes, juices and concentrates, and greenhouse tomatoes.

[51] Background paper on Primary Agriculture and the Agro-food Industries (2008); Azerbaijan Agricultural Marketing Study (World Bank 2005).

equipment maintenance or new investment.[52] For most agro-food items, the transmission of both domestic and border prices has not been very fluid.

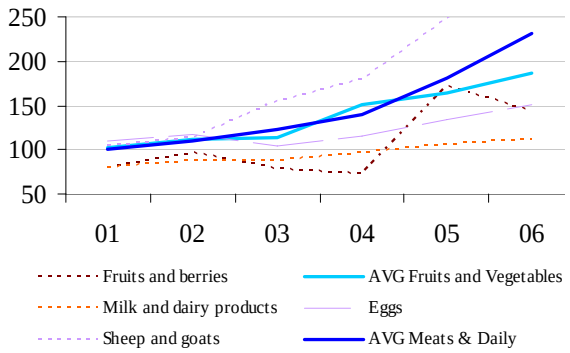
2.14. **Perceptions of "monopolization" or oligopolistic behavior can be attributed to corruption or to low market power of farmers**. The ready response obtained in Azerbaijan is that wholesalers with political connections at the rayon level dominate markets, and that farmers often are forced to sell their products to a single buyer. In Azerbaijan, the lack of community organization of farmers (either to market their products or to co-finance machinery or equipment such as refrigeration) remains a puzzle. As such, the lack of organization on the part of the farmers *makes* them weaker against the wholesalers, be they politically connected or not. Lack of marketing institutions, technical capacities, and financial services comprise the "missing middle" in the agro-food value chain.

Figure 2.3: Farm Gate Prices of Agricultural Products



Source: StatCom and Bank staff estimates.

Figure 2.4: Retail Prices of Agricultural Products



Source: StatCom and Bank staff estimates.

2.15. **Azerbaijan's recently launched State Program for Agriculture seeks to address all the aforementioned challenges but success will depend on what government chooses as a priority**.[53] The program maintains or deepens a host of relatively recent government actions, namely increased official subsidies to the agricultural sector (defraying up to 50 percent of the costs of fertilizer and fuels, and modest per-hectare payments authorized to stimulate wheat plantings), state loans to agriculture-- capitalized by budgetary transfers to participating commercial lenders-- a tax-free environment for agriculture (no profits tax and no VAT on inputs) and, of course, the establishment of Aqrolizing in 2004 to encourage the purchase of new agricultural machinery. It also introduces the restoration of intra-farming irrigation networks; seeks to expand enterprises for food processing and storage; seeks to improve the strain of cattle through imports; supports private sector activity in meat and milk processing; seeks expansion of lending resources, including Aqrolizing branches, resources through the NEF, and the establishment of a universal agrarian bank; creation of a research center for agriculture; and creation and management of a State Grain Fund. In trying to ensure that agriculture is endowed with the aforementioned services, Azerbaijan needs to ensure that excessive state management of

[52] World Bank (2006a; Swinnen, Johan, Liesbet Vranken and Victoria Stanley, "Emerging Challenges of Land Rental Markets—A Review of Available Evidence for the Europe and Central Asia Region", ECA Chief Economist's Regional Working Paper Series, Volume 1, No.4 (Washington – March 2006)

[53] State Program on the Reliable Provision of People in the Republic of Azerbaijan with Food Products from 2008–2015.

the sector is avoided and that it develops in a sustainable fashion.[54] This particularly pertains to food security, as the program seeks to significantly reduce import dependence on potatoes, vegetables, sugar beet and other products (including wheat), reversing market trends in wheat and sugar beet in recent years. Going forward, Azerbaijan should first prioritize the development of larger farming entities (through leasing of land, creation of associations, enabling the sale of land, etc.) as a means to balancing the market power of wholesalers. Improvements in licensing, business registration, and property rights should continue, with specific review of regulatory issues of specific product or geographic areas. First, the government should monitor the competitive nature of farm sales across the county and should oversee the development of the "missing middle" (of service providers for marketing, storage, technical assistance, etc,)—when that develops, farm gate prices should begin to rise. Second, related to the proposal to recreate a universal agrarian bank for action in 2009–10, Azerbaijan should review the experience of the Netherlands, where the agricultural bank is operating on commercial grounds.[55] Non-commercial approaches to operating an agricultural bank risk reversing the good progress that Azerbaijan has made with financial sector reform and saddling the government with a large contingent of liabilities, which will lay indirect claims on the Oil Fund.

Industrial Output: Robust Growth of Food Processing and Transport Equipment

2.16. **Azerbaijan's industrial output is dominated by the oil sector.** As noted above, *oil extraction accounted for 95 percent of industrial activity* in 2007, up from 76 percent in 2004, before oil prices and production increased.[56] However, the *oil sector accounts for only 1 percent of total employment*.[57] Outside oil extraction, about 86 percent of the industrial sector's value added in 2007 came from manufacturing (still oil-related), especially refining, food processing, and machinery and transport equipment) and about 14 percent came from utilities. Employment in the non-oil extractive industries was about 6 percent of total employment in 2007, largely unchanged from the employment share in 2001. Manufacturing is not only important for its role in generating employment, but also for its role in trade: plastics and chemicals are important export items to Turkey and Russia, which are Azerbaijan's most important trading partners.

2.17. **Upstream oil is largely privately managed and regulated by PSAs**. Oil production in Azerbaijan increased dramatically with the completion of the Baku-Tbilisi-Ceyhan (BTC) pipeline in 2006—from approximately 15 million tons a year from 2001–05, to 46 million tons in 2007. Production and transport of the new oil and gas is managed by the Azerbaijan International Oil Consortium. The State Oil Company of Azerbaijan (SOCAR) is the *de facto* "competent authority" dealing with the upstream oil sector on behalf of the government *vis-à-vis* the AIOC. SOCAR is also a holding company that manages Azerbaijan's other upstream oil and gas

[54] Cf. the Action Plan set forth in Section V of the Program.

[55] It is worth noting that the formation of the Netherlands' *Rabobank* and France's *Crédit Agricole* was grounded in long experience with cooperative credit organizations and societies. Thus, a local framework and clientele—spontaneously created—upon which a national structure could be erected, already existed in rural areas; such is not yet the case in Azerbaijan.

[56] In Azerbaijan's national accounts, industry comprises mining (including the extraction of oil and gas), manufacturing (including the manufacturing of oil products and chemicals), and utilities (power, gas, water), but excludes construction. The same breakdown is maintained in this report.

[57] This includes the extraction of oil and gas only.

activities.[58] These include oil and gas extraction, preparation and maintenance of wells, and a deep-water platforms plant.

2.18. **Azerbaijan's downstream activities are managed by state-owned-enterprises**. Azerbaijan maintains a full range of downstream activities, ranging from oil refining to the manufacture of plastics on the one hand, and gas storage and distribution on the other. The sector grew at about 6 percent a year since 2003, and has made up almost half of the non-oil extraction industries since 2006. In 2007, it accounted for almost 3 percent of GDP.[59] SOCAR manages the country's refining capacity and—benefiting from the recent surge in oil prices—has been expanding through investments in the region (joint-venture refineries and petrochemical facilities). It is also the wholesale supplier of oil products to the domestic market, based on its own production and on imports. The petrochemical sector is managed by Azerchemyia SOE, with about 6,600 employees and seven subsidiaries—the plant closed production in the first quarter of 2007, when its input prices were temporarily adjusted by the government. On the gas side, SOCAR is the single buyer of natural gas for domestic distribution, adding to its own production of gas from ACG, from Shah Denis, and previously imported Russian gas; it has also been investing in gas storage. Azeriqaz is the distribution company and the operator of the transmission network. Buoyed by soaring revenues in recent years, SOCAR has been modernizing by unloading non-core activities (especially social infrastructure), restructuring, and upgrading its financial reporting to IFRS. While Azeriqaz's distribution network of gas lines is being upgraded with government support, Azerchemyia is in a weak financial position and lower on the government's priority list. Both companies are facing delays in implementing IFRS and, as such, their financial positions lack transparency. "Regulation" of the large, downstream industries has largely focused on: (i) obtaining budget implementation and investment plans at the time of budget preparation (successfully since 2006); and (ii) increasing the prices of inputs to Azeriqaz and Azerchemyia (sold by SOCAR), which till 2007 was largely subsidized with offsets on SOCAR's tax obligations. The regulatory environment is managed by the Ministry of Energy and Industry on the one hand, and the Tariff Council on the other. In short, looking to Azerbaijan's future, while local and regional demand for downstream activities exists, efficiency improvements through better enterprise management and new investments are needed.

Table 2.2: Non-Oil Extractive Industries, Growth Rates

	2005	2006	2007
Non-Oil Industries[1]	**14.8**	**4.1**	**7.9**
Food processing	4.2	4.0	10.1
Metallurgy	30.2	9.1	1.7
Chemical industry	6.2	14.9	-33.6
Transport veh. & equip.	79.0	-11.1	23.3
Textiles industry	55.7	-17.1	-21.6
Production and supply of electricity, gas, and water	4.8	8.0	-7.6

Source: Statistical Committee of Azerbaijan
Note: One year-on-year change.

2.19. **Other manufacturing and utilities sectors have also shown buoyancy.** The next largest sectors—after the manufacture of coke and refined oil products—are the manufacture of food products and metallurgy, jointly accounting for 2.6 percent of industrial output in 2006. The most *dynamic* sub-sectors from 2001 to 2007 were the smaller ones—metallurgy, machinery,

[58] The policy discussion regarding Azerbaijan's oil and gas sector rests on "Azerbaijan: Issues and Options Associated with Energy Sector Reform", World Bank 2005. While important changes took place in the sector in 2005, the institutional issues raised here have not been addressed.
[59] This capacity helped Azerbaijan "export" its oil to the south, as it exchanged refined fuel with Iran in 2008, in exchange for Iranian crude delivered to Azerbaijan in the Gulf.

and electrical and transport equipments—all with average annual growth rates above 20 percent. The largest sub-sector in manufacturing-- food products-- grew very slowly from 2001 to 2007. Utilities (power, gas, and water) grew at an average annual rate of 8 percent through 2006, and contracted by 7 percent in 2007, after the adjustment in the tariffs.[60]

2.20. **Manufacturing is largely in public hands**. Although, in 2006, 72 percent of production came from the private sector, this number is deceptive as it includes the oil sector. Excluding the oil sector, private sector accounted for only 28 percent of value added, albeit up from a mere 15 percent in 2000. As much as 90 percent of Azerbaijan's refining, chemicals, and utilities production is government-owned, as is 60 percent of the metallurgy industry. Together, these sub-sectors make up two-thirds of the non-oil extraction industry.

2.21. **The first-level institutional issues in the industrial sector are how to reverse the public ownership and management structure in manufacturing**… While EBRD indicators show that other transition economies have moved to greater private management of their economies than Azerbaijan, the issue is not private management or privatization *per se.* It is rather selecting a governance structure for the management of the private sector that can deliver innovative products and generate sustainable employment.

2.22. **…and also in utilities**. In utilities, which are discussed extensively in Chapter 4, the government has taken a distinctly public sector-driven approach. While it is not wise to generalize for all utilities, the principle of a five-pronged approach has generally been sensible: (i) build up the targeted social assistance scheme; (ii) build metering/billing capacity; iii) improve service quality; (iv) strengthen internal management (introduce IFRS accounting principles and alter governance structures, where possible); and (v) adjust tariffs so that users pay more for better service, but the poor are protected through targeted social assistance. While the strategy has been sound, it is time to take the next step, i.e., to establish efficiency enhancing governance structure (see next paragraph). Azerbaijan's utilities were 99.3 percent publicly owned in 2007 (similar to 2000), up from 89.9 percent in 2004. Attempts at negotiation with regional and Asian investors regarding electricity generation have fallen through, though Azerbaijan is currently using management contracts for distribution. The government's renewed efforts at bringing in private sector management are important, as is the ongoing process for the selection of strategic investors that respect national priorities.[61]

2.23. **There are many examples of successful private participation in infrastructure**. However, should Azerbaijan find it absolutely necessary to retain government ownership, China is an interesting example (Box 2.1). Given the myriad transactions between governments and private sector the world over, the critical factor is perhaps not the *a priori* selection of a methodology for engagement, but the commitment to principles of transparency, fairness to the country and to investors, and to dealing with agencies of international repute. Most important is the commitment to seek private participation for the purpose of increasing efficiency.

[60] In January 2007, Azerbaijan adjusted utilities' rates in all sectors to nearly cost recovery levels (Chapter 4).
[61] See EBRD transition indicators on privatization progress in Chapter 5.

Box 2.1: Transformation of a Chinese SOE by Private Management

The recent construction of the Guangzhou Metro Rail project in China offers valuable lessons about the successful construction of a transportation infrastructure project wherein the government retained ownership of the SOE. This is an SOE that once performed poorly and had a bad reputation. Today, it is considered to be one of the best-run mass transit companies in China. The transformation program was put together jointly by the Guangzhou Metro Corporation and Booz, Allen, Hamilton (BAH) in 1999, with the Government of Guangzhou retaining ownership. By 2003, two of the major rail lines were fully operational, with a total length of 37 kilometers and an average daily ridership of 470,000. Subsequent construction added six more lines.

In 1999, when the metro project first began, it was plagued by fraud scandals. A new management team was appointed to transform this project into an effective company. This new team hired BAH, the renowned American management consulting firm, to help them achieve their goals. BAH and Guangzhou Metro Corporation Management first carried out a complete diagnostic examination of the project, including its organizational structure, construction management, operations, governance, human resources, financial performance, and affiliated businesses.

After consolidating all of the findings from the first phase, the strategic development plan for the next five years was formulated, and a conceptual framework for the longer term was outlined. First, the company streamlined its organizational structure. It then revamped the employee-compensation system by setting up a new incentive mechanism that would be more aligned with desired behavior and performance. Guangzhou Metro then built its core capabilities and developed a learning culture. In a few short years, as noted above, the first two lines of the Guangzhou Metro rail system were operational.

In addition, BAH also recommended that Guangzhou Metro Corporation and its owner (the Guangzhou government) adopt a new relationship, based on a clear contractual arrangement between them and a new governance model, whereby a Board of Directors would be established to protect the interests of the asset owner and to provide checks and balances on management. Moreover, the management team would be fully empowered to run the company. The Hong Kong Mass Transit Railways Corporation and the Airport Authority of Hong Kong are widely recognized success stories of well-run statutory bodies.

2.24. **For SOCAR, the challenge is greater specialization in commercial activities and elimination of "competent authority" functions**. In Azerbaijan, most oil and gas upstream activities have been structured under PSAs. However, older oil and gas upstream activities fall under the management of SOCAR. At the same time, it is the "competent authority" in the government's relations with the AIOC.[62] Given the tremendous scope of commercial activities of SOCAR, Azerbaijan's national interest could be better served by allowing it to focus on its commercial role while refraining from regulatory ones. In fact, SOCAR has already begun to streamline commercial activities. It already ended its previous social obligations (transferring the management responsibility for some social infrastructure and programs to government agencies). This transfer, plus new investment that allows the company to adopt international accounting standards and a new management organization, has made SOCAR a more efficient

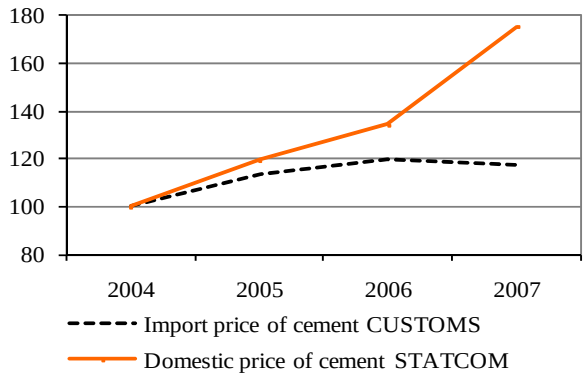
[62] The Azerbaijan International Operating Company is a consortium of currently 10 petroleum companies that have signed extraction contracts with Azerbaijan. These companies include: BP (UK), Chevron (USA), Devon Energy (USA), StatoilHydro (Norway), Türkiye Petrolleri Anonim Ortaklığı (TPAO; Turkey), Amerada Hess (USA), State Oil Company of Azerbaijan (SOCAR; Azerbaijan), ExxonMobil (USA), Inpex (Japan), and Itochu (Japan). The AIOC has made significant investments, contributing to the construction of the South Caucasus Pipeline and the Baku-Tbilisi-Ceyhan Pipeline, and is currently discussing construction of a Trans-Caspian Oil Pipeline between Kazakhstan and Azerbaijan. Extraction of oil from the Azeri-Chirag-Guneshli fields and natural gas from Shah Deniz has been made possible by FDI in this consortium.

enterprise, better positioned to focus on its core commercial objectives. However, the next critical step needs to be the separation of SOCAR's regulatory role (as the "competent authority" dealing with the upstream oil and gas sector) from its commercial role. In addition, as SOCAR is a representative of the State and in good financial health, the government can consider transferring the management of the government's minority share in the PSAs and some joint ventures to a separate holding company.

Construction: Despite Two Booms Market Constraints Prevail

2.25. **In recent years, Azerbaijan's construction sector has seen three surges in demand.** Azerbaijan's first construction boom took place in 2001–04, and was mainly the result of the construction of the BTC pipeline. The second boom was due to the rise in demand for real estate and increased confidence in the Azeri economy (because of the pipeline) and partly to developments in Russia. The third boom, especially from 2005 onwards, was fueled by increases in the national budget. These helped boost the incomes of Azeris. The latter factor, coupled with the poor quality and low supply of housing, a booming capital city, and a lack of capital market opportunities for investors, provided the boost to real estate and triggered the construction boom. After oil, construction was the highest growth sector in 2001–05 (Table 1.1).

Figure 2.5: Analysis of Cement Prices (*Index 2004=100)*



Source: Statcom, State Customs Commission, and Bank staff estimates.

2.26. **The constraints faced by the construction sector stem from the large role played by the state, the huge regulatory burden, and to the absence of competition**. The share of the state in Azerbaijan's construction sector has diminished substantially since 2001. It came down to 25 percent of the total in 2007, compared to 47 percent in 2000; and the number of state-owned construction companies has diminished by 18 percent since 2001. There are three principal barriers hindering development of the construction sector. First, *the issuance of* ***construction permits*** is a major impediment to investors (primarily because of the significant number of inspections and permits required). This has been noted in several *Doing Business* surveys, along with the issues of corruption (discussed in Chapter 5). Second is the issue of ***rising cement prices***. Only one cement producer is operating in Azerbaijan today, following the departure of a foreign investor. This has likely contributed to cement prices increasing faster in Azerbaijan than internationally. Figure 2.5 indicates that the domestic price of cement was closer aligned to international prices in 2004–06, but by 2007 was 50 percent higher than imported prices. Third, it is reported that there are only a few ***importers of construction materials*** and that officials at border crossings assist in limiting foreign competition. Taken together, the three factors suggest that monopolistic practices are prevalent, and that they translate into very direct costs to investors and to the economy.

Services

2.27. **From 2001 to 2007, Azerbaijan's service sector was the most dynamic component of the non-oil economy**. Two factors contribute to the buoyancy of the service sector. The first is the often-observed increased importance of services that accompanies development. The second is the important role that trade and transport have long played in Azerbaijan, given the country's location on the Silk Road. Of significant interest in this respect (indicative of trade not evident from the review of official statistics) is the Baku International Airport Bazaar, with its estimated 7,000 stalls (shops). It imports from China (electronics, kitchenware, clothing), Iran (carpets, textiles), and Turkey (higher-end clothing, textiles), and sells locally as well as to buyers from Georgia, Iran, and Russia (Dagestan), who export their purchases back home by air, truck, or bus daily.

2.28. **The structure of services sector has undergone significant change in the 2000s**. Transport and wholesale/retail trade were among the largest service sub-sectors (nearly 10 percent of non-oil GDP). Hotels, public administration, defense, and financial intermediation were among the most dynamic, exhibiting the highest growth. Transport sector statistics include the ramping up of the BTC and BTE pipelines, which are not separated by the State Statistical Committee for publication purposes. Nevertheless, other transportation services (all the non-oil services) remain important, particularly those related to regional and transit trade. Telecommunication services boomed in Azerbaijan in 2001–07. Especially in the last two years, cell phone companies have begun operations, whereas the fixed-line operator remains in public hands. Azerbaijan's financial sector has also seen tremendous growth, particularly from 2005 to 2007, as credit expanded due to Azerbaijan's *de facto* fixed exchange rate policy through March 2008. Part of the growth in the banking sector is due to the increase in credit to households, which in turn, supported the real estate boom. Social services and public administration have also grown, but that was due partly to the hiring policies of the public sector. Azerbaijan's tourism sector has seen resurgence, based mainly on local tourism. The health sector held its share of non-oil GDP, while other sectors—real estate, education, and community and personal services––seem to have contracted relative to non-oil GDP.

2.29. **The institutional issues facing the service sector are as varied as the sector itself**. On wholesale and retail trade, administrative barriers in tax and customs are an important issue. The success of the Airport Bazaar, with its flat rate rental/tax payment and flat rate transport costs (inclusive of import/customs duties) points to the challenges other traders face. In the transportation sector, the most important strategic route (the BTC) is managed under a long-term contract. The rail sector, another important transport conduit, is publicly run, but contractual arrangements are being revised (Chapter 4). Air and sea transport remains closed to competition. On telecommunication, there is significant competition in mobile telephony, particularly with the recent addition of a third operator. At the same time, however, the fixed-line operator is publicly owned, and presents a very good opportunity for privatization (Chapter 4). Azerbaijan's banking sector has been raising its level of competition, gradually but steadily. The market share of the two largest banks has dropped significantly in recent years. However, foreign banks have been conspicuously absent from Azerbaijan's burgeoning economy.

Summary

2.30. **Azerbaijan's economy is indeed broad-based but needs to modernize to compete regionally.** To sustain its non-oil growth rates, Azerbaijan will have to turn more to the outside world to cultivate and secure export markets and products. Global markets do not tolerate low productivity levels and inefficiencies. Azerbaijan must open up to new investment for two distinct reasons: (1) to overcome the existing deficit in productivity prior to the oil boom; and (2) to overcome the burden placed by recent real exchange rate appreciation on its competitiveness.

2.31. The existing structure of Azerbaijan's non-oil economy is not conducive to attracting know-how and new investment because it remains very closed and averse to competition. Despite its very significant potential, Azerbaijan's agricultural sector is not ready to make the productivity gains that are within its reach because there are no incentives for consolidation (through outright purchases or leases). The main reason is monopolistic or oligopolistic control of wholesale purchases at the regional level. This also has stalled the development of vertically integrated enterprises observable in other transition and developing economies, and of low levels of community organization.

2.32. At the same time, the oil and gas sector are not effectively open to new entrants for downstream activities because the utilities sectors are not open. While no legal barrier exists to entry, the absence of significant competitors in Azerbaijan's booming economy speaks volumes. Other industrial sectors, with stable levels of domestic investment and declining foreign investment (relative to GDP) also speak of an unfriendly environment. This is also true for construction. At the same time, the services sector is booming, but its two potential flagship sub-sectors—banking and fixed-line telephony—lack serious foreign competition. In addition, the domestic environment for operating in the service sector is fraught with regulatory problems. Azerbaijan's export potential is undermined by the low level of non-oil FDI.

C. Regional Integration and Trade

Recent Developments

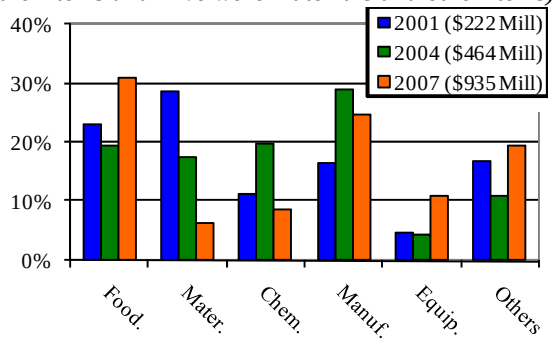
2.33. **Azerbaijan's growing economy has increasingly relied on oil exports**. Its total trade increased from 79 percent of GDP in 2001 to 102 percent in 2007. In 2007, oil accounted for over 91 percent of total exports. Depending on the outlook for oil prices, the share is expected to increase through 2010 as production peaks, and to start dropping thereafter as production flattens while the non-oil economy, along with non-oil exports, continue to grow. In 2007, Azerbaijan's total foreign trade balance was $13 billion or 42 percent of GDP, while the non-oil trade balance was -$3.8 billion, or -12.3 percent of GDP. The non-oil trade balance stayed approximately stable as a share of non-oil GDP, from -29.9 percent in 2001 to -28.9 percent in 2007, although as Figure 1.14 indicates, the balance improved through 2005 and then deteriorated till 2007. Azerbaijan's medium-term strategy for diversification needs to begin to close this gap, unless enormous amounts of FDI can support the current account.

2.34. **Although Azerbaijan's non-oil exports are small in comparison to the over $15 billion of oil exports in 2008, their value more than quadrupled in 2001–07**. The robust growth of exports of agro products (Figure 2.7) to $288 million in 2007, up over six-fold from

$51 million in 2001, was particularly noteworthy. In fact, agro-exports accounted for nearly 31 percent of all non-oil exports in 2007. This is an encouraging sign as 38 percent of the Azeri labor force was employed in agriculture in 2008. Agricultural goods were exported primarily to Russia, which included higher value-added processed foods (Figure 2.6).

Figure 2.6: Composition of Azeri Non-Oil Exports, 2001, 2004, and 2007

(example: in 2001, Azerbaijan's non-oil exports came to US$222 million, of which about 23% were food and other items and 27% were materials and other items)

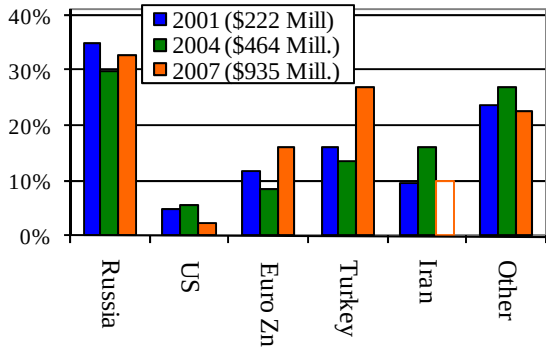


Source: Comtrade

Note : Iran reports no trade data for 2007 but Azerbaijan reported $93 million in non-oil exports to Iran.

Figure 2.7: Destination of Azeri Non-Oil Exports, 2001, 2004, and 2007

(example: in 2001, Azerbaijan's non-oil exports came to US$222 million, of which about 34% went to Russia and 14% went to Turkey)



Source: Comtrade

Note : See discussion in paragraph 2.35.

2.35. **Russia and Turkey continued to be the two largest markets for Azeri non-oil exports from 2001 to 2007, accounting for more than half of total Azeri non-oil exports** (Figure 2.7)**.** Although these two countries accounted for half of all non-oil exports in 2001, Azerbaijan's increased dependence on them is more notable, as these non-oil exports more than quadrupled between 2001 and 2007, albeit in nominal dollars.[63] Azerbaijan is still in the early stages of a transition from a system of central planning to a market-based economy and is still finding its footing in the world of non-oil trade. While Azerbaijan exported over $328 million of refined oil to Russia in 2007, it was also a market for a broad range of Azeri agricultural products during that year, totaling over $228 million (chiefly fruits, vegetables, nuts, edible oils and fats, cotton, tea, and sugar).[64] Moreover, in that same year, Azerbaijan's exports to Russia included over $105 million of manufactured goods (incl. plastics, chemicals, and textiles) and machinery.[65] In contrast, the importance of Iran as a destination for Azeri exports diminished rapidly from 2005

[63] Preliminary data from 2007 indicate that Turkey and Russia became even larger markets for Azeri goods in 2007, collectively accounting for over 80 percent of Azerbaijan's total Non-Oil Exports.

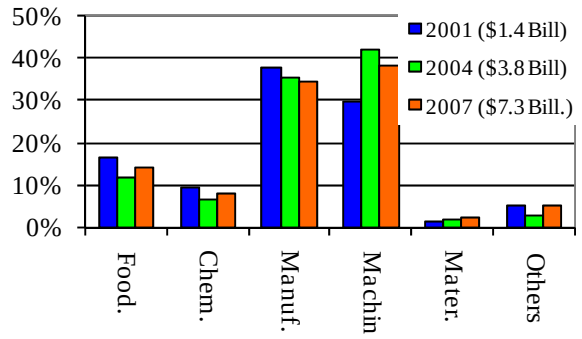
[64] In figures 2.6-2.9, both exports from and imports to Azerbaijan are calculated from the numbers reported to Comtrade by Azerbaijan's trading partners, as there was little difference between their numbers and the numbers reported by Azerbaijan from 2001-05. However, there was a non-trivial gap between their numbers in 2006, a gap that grew even larger in 2007. The likely reasons for these differences are discussed further in Chapter 5.

[65] The source of the trade data reported in figure 2.7 is Comtrade, which reports data from both the importing country and the exporting country. All the data reported in Figure 2.7 is from "mirror trade," or Azeri exports as reported by the importing country. Usually the importing country reports a higher value for imports of a particular category than the exporting country reports, primarily due to the inclusion of freight and insurance in the imports. But differences can also arise because of accounting error or even mis-reporting by either partner to benefit from export incentives, avoid import taxes, or other reasons. For 2007, the mirror trade differences between Russia and Azerbaijan are minor.

to 2007, although it was a significant export market for Azeri products from 2001 to 2004. Even though Azerbaijan had exported $135 million of a collection of goods to Iran in 2004, by 2007 non-oil Azeri exports to Iran had dropped to $93 million (of which $79 million was in manufactured goods).[66, 67] The same is true for Kazakhstan. Although there is still substantial Azeri oil exports as well as re-export of oil sector equipment to Kazakhstan, the export of all other goods to Kazakhstan has been minimal. Oil (primarily crude) is overwhelmingly the main Azeri export to the EU ($7.1 billion in 2007). Thus far, Azerbaijan has chosen not to penetrate the fast-growing markets of Asia. Exports to China have been insignificant until recently, when China began importing modest amounts of oil/oil products, and Hong Kong began importing aluminum. Azeri exports to India are also modest. They were inconsequential before 2004, when they reached $1 million of aluminum, but subsequently fell off.

Figure 2.8: Composition of Azeri Non-Oil Imports, 2001, 2004, and 2007

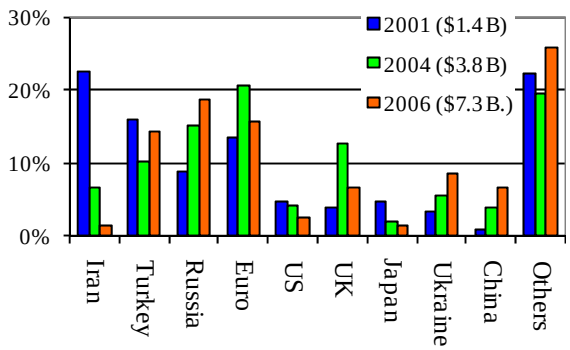
(example: in 2001, Azerbaijan's non-oil imports were US$1.4 billion, of which about 38% were manufactured goods and 30% were machinery)



Source: Comtrade

Figure 2.9: Origin of Azeri Non-Oil Imports, 2001, 2004, and 2007

(example: in 2001, Azerbaijan's non-oil imports were US$1.4 billion, of which about 23% came from Iran and 16% came from Turkey)



Source: Comtrade
Note : « B » is Billion.

2.36. **Azerbaijan is increasingly importing from industrialized countries as well as China**… Finding new sources of imports is not surprising as Azerbaijan opens up to global competition; inefficient industries have declined in relative importance and have been replaced by industries in which Azerbaijan has a comparative advantage (as evidenced by increasing non-oil exports in Figure 2.6 and 2.7). In 2001 Iran was the largest exporter to Azerbaijan of a wide variety of goods (i.e. $20 million in food products and $20 million in manufactured goods). However, between 2001 and 2007 the share of Azeri non-oil imports from Iran declined from over 22 percent to barely 1.3 percent (Figure 2.9). Even though Russia's share in Azeri imports

[66] Comtrade data for Azeri trade with Iran for 2007 come from Azeri sources. They also report non-oil exports to Iran make up 10 percent of total non-oil exports.

[67] While Figure 2.7 supports analysis based on mirror trade, it also makes an exception by including Azeri reported data in Comtrade for Iran in 2006. Azeri non-oil exports to Iran came to $74 million, or about 10 percent of non-oil exports for 2006. This information is included in Figure 2.7 to enrich the discussion and to demonstrate that Azeri exports to Iran are likely to be non-zero (as indicated in the mirror trade), but diminishing in relative importance.

increased, Azerbaijan had additional imports from China, the Euro Zone, and the UK.[68] In fact, if treated as a single entity, the Euro Zone surpassed Russia as the largest exporter to Azerbaijan in 2006, and became the largest source of Azerbaijan's imports.[69]

2.37. **… and importing a different set of products than previously.** Change in the composition of imports from Turkey provides a good illustration of processes that have been underway. A decade ago, Azerbaijan imported many of the same food products from Turkey (including sugar products and cereals) that it now exports to Russia and Georgia. Furthermore, electricity has long been a major import from Turkey (as well as from Iran). Today, major imports from Turkey are jewelry, carpets, telecommunication equipments and food-processing machinery. In 2001, Turkmenistan was a significant supplier of oil and gas, but little else. However, in 2006, oil platforms (which were originally exported to Azerbaijan from Turkmenistan) were re-exported to Azerbaijan, causing a one-time jump in Azerbaijan's imports from Turkmenistan. China has also increasingly become a supplier of a wide range of electronics, tractors, and garments (over $346 million in 2007). Japan mainly supplies motor vehicles, electrical machinery, and materials for the oil sector. The U.S. usually has supplied approximately 5 percent of Azerbaijan's imports, primarily equipment for the oil sector, pharmaceuticals, and agricultural products.

2.38. **International trade in services has represented approximately 20 percent of Azerbaijan's GDP for the past decade**. Total service exports have grown relatively slowly during this period. In contrast, service sector imports have grown rapidly since 2001, due primarily to the construction boom that is both a part of the expansion of the oil sector and a consequence of rising incomes from increasing oil revenues. A residual category of "other business services" is not further disaggregated in the available balance of payments statistics. The latter category is the second largest imported and exported service. Azerbaijan's largest service export is transportation, which is also one of its largest service inputs. Total trade in transportation services has been growing steadily in value in recent years. This is attributed to the rise in international trade, since moving more goods across borders boosts demand for transportation services. Relative to goods trade, Azerbaijan's international trade in transportation services has remained fairly constant since 1999, at 7percent to 9 percent of total merchandise imports and exports. In light of the country's desire to become a regional transportation and distribution hub, this statistic is less than encouraging for the future.

2.39. **Azerbaijan's exports show evidence of transition**. After increasing dramatically in 2001-05, the share of non-oil exports in non-oil GDP has remained constant in recent years—in the 8 percent to -9 percent range. While the share of a number of sectors (textiles, plastics, and chemicals) in exports has decreased, others are gaining more weight (Figure 2.7). The growing exports of food and beverage, as well as aluminum, are encouraging signs of ongoing diversification.

[68] The Euro Zone comprises all 12 countries that use the Euro as their currency.

[69] Preliminary data from 2007 suggest that Russia and Turkey have retained their positions as the pre-eminent sources of Azeri imports, collectively accounting for 40 per cent of Azerbaijan's non-oil imports. In fact, these data suggest that Russian non-oil exports to Azerbaijan increased more than ten-fold from 2001–07, while Turkish non-oil exports nearly quintupled in the same period.

Lessons from World Development Report (WDR) 2009

2.40. **The WDR 2009 brings important global experience to Azerbaijan, as it reviews successful diversification strategies of countries while considering their geographic location relative to potential trading partners.** The Report states that the range of goods in which a country can develop a comparative advantage has expanded along with the growth in global trade. Intermediate goods and services, more tradable nowadays, provide developing countries with a broader range of diversification opportunities than ever before. Higher exports can occur when countries *cooperate regionally* to generate scale economies, favor greater factor mobility, and lower transport costs, as well as integrate globally. *Regional cooperation* means that firms in neighboring countries can produce final goods more cheaply by building international supply chains than they can by relying on suppliers in one country alone. *Global integration* provides the demand and incentive to develop such efficient regional supply networks. This combination of regional and global integration has produced successful developers (like South East Asia, Western Europe and Coastal Chin) in today's rich neighborhoods.[70]

2.41. **Market-driven vs. institution-driven integration**. When integration is market-driven, as it was in East Asia, production factors will relocate and promote convergence in neighboring countries' per capita incomes. In contrast, when integration is institution-driven, as in most developing neighborhoods today, political economy challenges can become major concerns. This is the reason that countries far from world markets—in Central Asia, the Pacific Islands, and Sub-Saharan Africa—face the stiffest challenges to economic growth and need a strong commitment to cooperative solutions. Regional integration can occur in "natural" neighborhoods of these regions with three sets of instruments:

(i) These regions need *close institutional cooperation* and *comprehensive regional infrastructure investments*, as is the case of any other region.

(ii) They also may need *cross-country compensation mechanisms* to sustain the integration effort because deep integration is likely to lead to uneven, short-term gains and losses across countries.

(iii) The international community can support these integration efforts through *coordinated incentives.*

2.42. **Azerbaijan is located in an isolated geographic neighborhood with few large markets. It may benefit from creating centers or hubs around its border with Georgia and Iran, and also with Kazakhstan**. **The sub-region itself is on a spoke, linked to European and Asian markets.** Azerbaijan's average trade share with its neighbors was 26.7 percent during 2000–05, compared with 10.4 percent for Armenia and 39.4 percent for Georgia during the same period. The country shares two major "twin cities"—with Georgia in its northwestern region (Ganja-Rustavi) and with Iran in its Southern region (Lankaran-Astara). In the northwest, Ganja is the second largest city of the country (more than 300,000 inhabitants), located 149 km from Rustavi in Georgia along the Baku-Tbilisi corridor. In addition to the road and rail connection, Ganja has an international airport. In the south, Lankaran has 50,000 inhabitants and is located

[70] This approach is in contrast to experiences of some countries, such as Chile, Mauritius, and the well-known East Asian tigers, that have integrated globally without much cooperation from their neighbors. They enjoyed significant first-mover advantages.

36 km from the Iranian border city Astara, which is an important transit point for all kinds of goods. This geographical proximity hints that Georgia and Iran are the "natural" neighborhood of Azerbaijan, although Kazakhstan, on the other shore of the Caspian Sea, could be another option. However, effective economic cooperation will require adequate cross-country infrastructure, institutional reforms, and the help of the international community to provide coordinated incentives that can sustain this regional cooperation.

2.43. Azerbaijan could use three types of policy instruments to pursue this regional and global integration:

- ***Institutional cooperation*** to address coordination problems within neighborhoods and foster greater scale economies. *Behind-the-border reforms* (such as mutual recognition agreements on technical and business procedures, adoption of international standards, and macroeconomic convergence frameworks) could expand the size of the Azeri market by creating a more attractive business environment for domestic and foreign firms. *At-the-border policy reforms* (such as WTO compliance reforms and labor and capital mobility reforms) could facilitate the flow of capital, labor, and intermediate inputs as a precondition for cross-border production networks. *Between-the-border reforms* (such as trade and transport facilitation initiatives) could reduce transport costs and facilitate the emergence of a more reliable distribution system.
- ***Regional infrastructure*** to strategically link the neighborhood to Iran, Russia, and Turkey, as well as the EU. Productivity-enhancing regional infrastructure (such as power grid and telecommunication backbone infrastructure) could elevate the attractiveness of the Azeri market. Mobility-enhancing regional infrastructure, such as regional excellence tertiary education centers, could supply Azeri firms with a larger pool of skilled workers. Trade-enhancing regional infrastructure, such as transport hubs, could support the diversification strategy by enabling more cheap intermediate goods to be available on the Azeri market.
- ***Coordinated incentives*** involving all of the neighborhood's stakeholders and donors from the leading world markets will be necessary to compensate potential short-term losses to get the long-term efficiency gains from these institutional reforms and regional infrastructure. For instance, when a regional public good is sensitive to the performance of the weaker members, as in a hub-and-spoke airport network, the challenge for the other members is to raise the performance of the weaker links to an acceptable standard. This can be done through cross-country subsidies or through foreign aid. In a relatively poor neighborhood such as that of Azerbaijan and its neighbors, foreign aid may be the only feasible way to ensure the provision of such public goods. If the good depends on the best-performing member of the neighborhood, such as a regional tertiary education excellence center, the weaker members may be asked to contribute to stronger members, or foreign assistance can facilitate its provision. Coordinated incentives require trust among the neighboring countries. International organizations can help build such trust, as in the Aral Sea basin rehabilitation.

2.44. **Azerbaijan's development strategy seems to be very much aligned with the *WDR 2009* findings**. Azerbaijan is already investing heavily in infrastructure (in highways and rail lines) but needs to strengthen its institutional cooperation and its coordination incentives, as is suggested above and will be discussed further in the report (see also discussion in Box 1.2).

D. GOING FORWARD

2.45. **Azerbaijan's broad economic base augurs well for the country's future.** However, to sustain its non-oil growth rates, Azerbaijan will have to turn more to the outside world in the medium term. While the global crisis presents a short-term challenge to the implementation of that strategy, it also presents an opportunity to undertake the necessary sectoral reforms, and set up the market-based export-oriented institutions that will serve Azerbaijan well in the post-crisis period.

2.46. **In Azerbaijan's agricultural sector, primary production can be expected to register substantial increases through commercialization**. The fading away of small subsistence farms operated by geriatric households and poor families will accelerate. Farms will need to further consolidate into larger farming units, using modern equipment and techniques, expanded production of tradables and higher value-added crop and animal products, and much more robust levels of investment in green houses and mechanization. However, labor shedding by most of the recapitalized and commercialized farming operations is inevitable. The commercialization of primary production will be supported by an expansion of the private sector in the import and supply of modern farm inputs, including seeds, chemicals, genetic materials for herd upgrading, animals, feed supplements, veterinary supplies, and machinery and equipment. At the same time, the agricultural sector will see the rapid development of the commercial seeds industry and the availability of improved cultivars—supported by joint venturing with the major international corporations and a considerably more flexible seeds law. The domestic livestock industry will feature measurably increased reliance on private animal breeders to import and develop improved breeds.

2.47. **Agri-food industries will benefit from facilities' upgrading, modernization, and a more appealing business environment**. A host of improvements are needed in agriculture. They will be fostered by improvements in the rural business environment and a more effective tailoring of business development services to the requirements of "rural" entrepreneurs along with a slow but progressive filling-in of the absent intermediates in most agri-food marketing chains. On the investment side, there is a need for accelerated investment in modern equipment and process controls, training and automated business management systems, bulk transport, handling and storages as well as cold chains; improved grading, packaging and SPS certification procedures (not necessarily government-managed). On the institutional side, there is a need for effective de-monopolization, as Customs reform and the work of the Competition Commission could work to influence the rural business environment. This vision also features a resumed withdrawal of government agencies and SOEs from direct management and control of primary production and the food industries to a posture of setting standards, regulatory oversight, reacting to emergencies and administering (limited) public investment programs through public-private partnerships, outsourcing, and contracting—to every extent practicable. These reforms can result in higher productivity and increased employment in the sector.

2.48. **In rural financial markets, businesses and agriculturalists increasingly will benefit from the continued development and broadening of financial services and credit lines**, including savings and—perhaps—index-based insurance products, as well as from specialized credit facilities such as warehouse receipts and production advances associated with contract farming. They will also benefit from more responsive input financing and equipment leasing/purchase facilities for farms, overdraft lines of working capital credits for seasonal agro-processors and agri-food traders, and short-term trade financing facilities—whether from the financial sector or offered by foreign clients and suppliers.

2.49. **The future of Azerbaijan's industrial sector merits serious consideration**. In oil and gas, new downstream activity depends largely on the legal status of the Caspian Sea. Moreover, additional transport activities (of oil or gas from Azerbaijan's eastern neighbors) depend on geopolitical factors. However, downstream activities have potentially a more certain economic future. Currently, Azerbaijan's downstream sectors are growing but are not the most dynamic. They lack investment, which may reflect government prioritization, given the enormous demand pressure on the economy. However, prudent and sustainable exploitation of downstream opportunities would require: (i) elimination of implicit and explicit energy subsidies to the sector; (ii) a governance (and management) framework that is largely, if not entirely, in private sector; and (iii) a profit-making mandate. Research has shown that successful resource-rich countries have developed substantial downstream industries.

2.50. **The future of the construction sector remains bright** even as the country's infrastructure and housing quality (even inside Baku) remain generally poor despite significant investments. Construction has played an important role in driving up labor wages and intermediate products, such as cement, which are produced under monopolistic conditions. Substantial breathing space to the sector and to the economy could be created by allowing more competition to domestic producers, either through FDI or imports.

2.51. **Azerbaijan is counting on the potential of its service sector**. Its service sector has many opportunities to grow in the short to medium term. First, and most important, with ongoing improvement in road infrastructure, some of the country's high transportation costs will drop, improving the opportunity to transport produce, and products, from Afghanistan and Iran. Second, Azerbaijan's position as a regional trade center will improve; its wholesale, retail, and tourism sectors will be bolstered by improvements in transportation. Its banking sector has yet to open up significantly to the private sector, so ample opportunities remain. Similarly, telecommunication is still under public management. Opening up to private management should help improve service quality and demand. Other utilities (power, water, and gas) have yet to complete major investments—or undertake private management practices—that would enable them to provide quality services.

E. CONCLUSION

2.52. Azerbaijan's broad economic base and its existing level of regional integration offer significant opportunities for sustainable growth. However, existing inefficiencies place Azerbaijan behind comparators in terms of productivity. Low productivity and new terms of trade resulting from the use of oil revenues create pressure for new investments to keep Azerbaijan competitive and its growth sustainable. The government's public expenditures in

infrastructure should contribute significantly to increasing productivity.[71] However, private investment is still required for Azerbaijan to innovate and develop new products consistent with its new terms of trade. Successful resource-rich countries diversified by ensuring that their institutional capacities were adequate, before considering the use of resource revenues to stimulate growth. Possible elements of institutional capacity-building are stabilizing spending, improving the transparency of public spending, removing trade barriers, streamlining business regulations, and creating institutions that facilitate collaboration with the private sector. The latter institutions should have the objectives of encouraging technical development, promoting exports, coordinating small businesses, and developing public-private partnerships.

[71] Using an overlapping generation's model, Takizawa, Gardner, and Ueda (2007) evaluated the most appropriate use of windfall revenues from natural resources to maximize long-run macroeconomic welfare in resource-rich countries. They found that using these revenues to finance government spending on infrastructure could raise productivity and private investment. In particular, they demonstrated that the government could maintain a constant level of per capita spending by transforming oil wealth into financial assets.

CHAPTER 3.
FISCAL SUSTAINABILITY AND PUBLIC FINANCE GOVERNANCE

In planning for the oil boom, Azerbaijan's government had the foresight to set up an Oil Fund to serve as a stabilization fund and to safeguard oil revenues for future generations. Although Azerbaijan's forecasted fiscal oil revenues are considerable, they are likely to be exhausted in approximately 20 years, with an estimated net present value of $198 billion (in 2007 prices). However, although oil price forecasts for the next 20 years remain above historical averages, they are not good predictors of future prices. And the government's large spending increases in 2006-2008 have left it at a rate of public spending (82 percent relative to non-oil GDP), which is unsustainable. The spending increases have also increased volatility of the real exchange rate to the detriment of private investment and diversification.

This chapter develops a methodology for smoothening oil revenue spending with a view to maintaining macroeconomic stability and fiscal sustainability; it is based on 2008 estimates. The chapter develops an operational approach to implementing the government's existing Long Term Oil Revenue Management Strategy. The methodology produces an estimate of the 'permanent income' or 'constant real spending' from government oil revenues (in constant US$) that can be used to finance the consolidated budget, effectively, in perpetuity. The estimate is equivalent to a sustainable non-oil deficit. Naturally, this calculation needs to be conducted frequently, about every three years. The chapter's analysis is based on permanent income estimates under three long-term price scenarios that have been selected during the unfolding of the global crisis. The analysis confirms that the level of the 2008 non-oil deficit was unsustainable, and that sustainability requires a much lower non-oil deficit for 2009 and beyond (in nominal terms and relative to non-oil GDP).

This chapter argues that Azerbaijan would benefit from smoothing its spending out of oil revenues by annually spending a constant amount (the permanent income equivalent) based on the LTORMS. Smoothening oil revenue spending under the permanent income approach would gradually bring down the size of public spending to sustainable levels. However, if the government were to spend only a little more than the permanent income equivalent out of oil revenues, this would rapidly deteriorate its public finances, and would require harsh fiscal adjustments, even in the medium term.

Coordination challenges arising from the adverse developments on diversification, and prospects of a declining expenditure envelope (relative to non-oil GDP), and the prospects of low oil prices henceforth, suggest that Azerbaijan may wish to formalize its high level policy discussions with a high level advisory body to the President. This would ensure that macroeconomic and expenditure policies are consistent with diversification. Azerbaijan would also need to strengthen significantly the efficiency of its expenditures by concluding reforms in financial and expenditure management.

A. INTRODUCTION

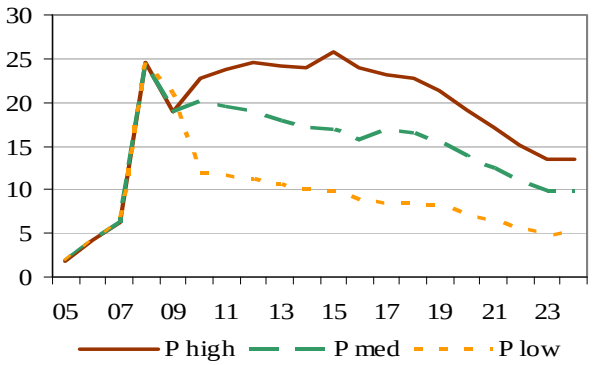
3.1. **For Azerbaijan, macroeconomic stability and governance are highly interrelated.** Development experience has demonstrated the formidable governance challenges that resource-rich countries face, given the pressures to distribute rents to stakeholders. Azerbaijan had the foresight to set up an Oil Fund (OF) to safeguard part of its oil revenues for future generations and to serve as a stabilization fund. The OF is expected to serve both as a gatekeeper to distribute oil rents in the economy and a key contributor to macroeconomic stability. Appropriately, the country's Budget System Law (BSL) stipulates that all oil revenues are to be budgeted as part of the consolidated budget. Decisions on the level of fiscal spending from oil revenues dovetail

with political decisions on the level and composition of the budget. Despite the robust double-digit growth of the non-oil economy, stimulated by large increases in government spending between 2005 and 2008, recent adverse developments involving inflation, non-oil private investment, and the tradable sector have raised questions from international observers about the level of governance. This chapter proposes a fiscal rule to stabilize oil spending, presenting the implications of this rule for medium-term budgeting, and looks at the necessary institutions to support this rule.

Forecasted Revenues

3.2. **Azerbaijan has sizable oil and gas resources that will earn large fiscal revenues in the next 20 years.** Oil reserves are estimated at 9 billion barrels and gas reserves at 1.36 TCM.[72] Figure 3.1 shows that fiscal revenues from oil have been rising since 2005; they are expected to peak in 2010–15 and then decrease gradually. Future revenues from oil production also will depend on new discoveries.[73] The revenue profile is based on projections in Figure 1.2, which has been confirmed as a reasonable estimate for production for the purpose of this report by the government. World Bank price projections estimate the net present value of Azerbaijan's oil and gas revenues for 2008–24 to be $198 billion (in 2007 prices), that is, more than six times the 2007 GDP. [74]

Figure 3.1: Azerbaijan Fiscal Revenues from Oil (AZN Bill): Actual 2005-07; Estimates for 2008, and Three Scenarios For 2009-24



Source: Azerbaijan authorities and World Bank staff estimates.

Note: For oil prices see Table 3.1

Variability and Risk to Revenues

3.3. **Azerbaijan's actual fiscal revenues from oil might be higher or lower than currently expected.** Future extraction volumes are relatively well known in the short run, although they could change, depending on new discoveries. However, volatility of revenues is probably much more influenced by price volatility. Oil prices are largely unpredictable, with major shocks and volatility spikes (Figure 3.2). After the oil shocks of 1973–79, prices returned to long-term prices close to $20 per barrel. However, beginning in 2002, the international oil price started to rise again, and in July 2008, it was near $145 per barrel. By October 2008, it was $60-70 range per barrel. The volatility of oil prices and the global financial crisis suggest forecasts need to weigh

[72] New discoveries were announced in June 2008 that raised oil reserves from 7 billion to 9 billion barrels (bl). The inclusion of these discoveries in this study has been confirmed with the Government of Azerbaijan.

[73] Based on discussions with government officials, oil production cannot be reduced in response to low oil prices due to technical reasons. Nevertheless, should the global crisis lead to a reduction in oil or gas production in 2009 or 2010, the impact on the net present value estimate would be very small.

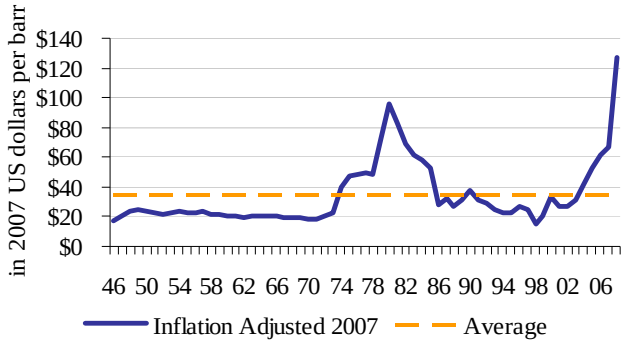
[74] This estimate is based on an average price of oil of $66 per barrel in current US$ or $52 per barrel in 2007 prices for 2010-2030, taking into account an 8 percent discount rate, and a 3 percent return on Oil Fund assets. The 30-year historical average for 1978–2007was US$33 per barrel in 2007 prices.

heavily on the side of prudence when trying to identify a medium-term oil price against which to budget.

Macroeconomic Issues and Options in Using Resource Rents

3.4. **The use of oil money inside the resource-rich economy invariably leads to real exchange rate appreciation**.[75,76] Azerbaijan's domestic prices are likely to outpace the rise in prices of its trading partners. It is because Azerbaijan is putting relatively more pressure on its domestic prices with the use of oil revenues than its trading partners are (indeed some of Azerbaijan's trading partners also have natural resources). There are two theoretically "sure"—but practically improbable—ways of avoiding real exchange rate appreciation: (i) keep the oil revenues abroad in U.S. dollars; and (ii) use oil revenues to only purchase imports. Only these two approaches would eliminate real exchange rate appreciation pressures. In practice, pressure for real exchange rate appreciation in Azerbaijan stems from: (a) OF transfers to the state treasury; (b)AIOC taxes on profits paid in U.S. dollars; (c) SOCAR foreign currency revenues; (d) foreign borrowings by SOEs under explicit or implicit state guarantee; (e) Azeri commercial bank borrowings from foreign creditors; and (f) government borrowing from foreign creditors. Azerbaijan's effective real exchange rate for non-oil exports appreciated by 26 percent from January 2005 to April 2008. However, in 2007, it depreciated by 1 percent (despite Azerbaijan's 17 percent inflation) because Azerbaijan's trading partners' currencies and prices appreciated.

Figure 3.2: Annual Average Domestic Crude Oil Prices, 1946–Jun 2008



Source: Bank staff estimates.

3.5. **Real appreciation materializes in the economy from either nominal appreciation or domestic inflation, or a combination of both. Each version has distinct implications for the domestic economy**. Resource-rich countries may prefer managed or gradual appreciation (as opposed to floating their exchange rates) in the hope that the appreciation of the exchange rate does not overshoot, which could adversely affect the tradable sector.[77] But importers effectively look at the real exchange rate of the country from which they consider importing to assess the price competitiveness of the country's goods. However, a managed appreciation policy often leads to higher domestic inflation, which is commonly viewed as a regressive tax that impacts the poor more than the rich. In Azerbaijan, which has chosen the managed appreciation route, inflation hit 19.7 percent at the end of 2007, and reached 15.3 percent in 2008. Besides the risk of creating expectations of accelerating and volatile inflation, higher inflation submits the private sector (households and entrepreneurs) to unpredictable inflation taxes, and to higher costs (and risks) associated with investments.

[75] The real exchange rate is defined as the ratio of domestic prices to foreign prices, which may be measured in the CPI or another price index.
[76] IMF 2004 discussed issues of managing Azerbaijan's oil wealth.
[77] Another reason for preferring a stable currency may be that a stable nominal exchange rate allows US$ earnings to maintain their value in foreign currency.

3.6. **To maintain competitiveness, real appreciation needs to be accompanied by higher productivity, which may be supported by public investment.** Public investment is a way to boost productivity growth, hence to relieve long-run pressures on the real exchange rate. Productive public investment includes improving and maintaining the existing infrastructure in the water, transport, telecommunication, and power sectors as well as providing better education and social services to build human capital. Nevertheless, it is important to note that, although productive public investment fosters productivity growth in the long run, in the short run, it accelerates government spending and induces upward pressures on the real exchange rate. To moderate the pace of investment, it is critical to take into account the absorptive capacity of the economy. Limits to absorptive capacity point to the need for efficient implementation of investment decisions, which requires modern and effective vetting and implementation institutions. Thus, part of public investment should be directed at the institutional infrastructure to improve its capacity aimed at evaluating and monitoring public projects.

3.7. **However, instead of exclusively using oil revenues to finance the increase in public spending, some oil money could be used to finance a reduction of the tax burden on the non-oil sector, if affordable.** This could be done as follows. First, in a—for Azerbaijan—hypothetical situation, where oil revenues are very large relative to the size of the future economy, as in the Emirates or Saudi Arabia, the tax system could be designed with low non-oil revenue objectives. Second, in the case of Azerbaijan, where a permanent stream of revenue income from oil can be estimated, the government could follow a similar but more measured approach: lower its non-oil revenues somewhat and, in doing so, could provide some relief to the private sector.

3.8. In practice, for Azerbaijan, there is a caveat. First, the bulk of the fiscal revenues outside the oil and gas profit shares to government are contributed by AIOC, SOCAR, and, to a smaller extent, by the SOEs. In most revenue categories, contributions from other tax payers amount to about 20 percent of total contributions (of which half comes from VAT, a quarter from corporate profit tax, and a quarter from personal income tax). So, at first glance, lowering statutory rates does not seem to benefit the bulk of the private sector, with the exception of two important factors. First, real exchange rate pressures coming from high oil revenue spending have negatively affected the competitiveness of non-oil businesses by raising their costs. This burden could, however, be offset by reduced tax rates on the private sector. Second, Azerbaijan's statutory rates are on the high side relative to the region, and they are likely to be significant factors pushing entrepreneurs to operate informally. Both of these factors argue for reducing the statutory tax burden on the private sector, although, of course, one would have to recognize that taxation of SOEs poses a particular challenge in Azerbaijan, which needs to be addressed head on. At the same time, the AIOC, which is a major tax revenue contributor, is governed by separate conventions (the PSAs).

3.9. **The argument for lowering the tax burden on the private sector holds even more during the global crisis**. The global crisis has played havoc with short-run oil price projections, and has even raised concerns about the short-term financing of public expenditures. However, the potential for oil revenues provides a revenue buffer for the country. It allows the government to set as a policy priority the reversal of the negative trends in non-oil private investment (or at least their arrest of the downward trends). Failure to do so would prolong the decline in private

investment and delay diversification of the economy, which is so essential for mitigating the impact of the crisis for Azerbaijan.

B. Smoothing Oil Spending: Permanent Income Approach

3.10. **Wise management of the fiscal consequences of oil revenues requires a framework to smooth public spending for at least four reasons.** First, for *intergenerational equity*. Because Azerbaijan's oil and gas resources are limited in volume, production will be limited by time. Spending too much today would entail spending less tomorrow, to the detriment of future generations. The second reason is the need to preserve *macroeconomic stability*. Oil price instability could translate to cyclical and unpredictable public spending that would raise real exchange rate and price volatility, creating uncertainty that would behave like a tax on investment decisions. Moreover, instability would create upward pressures on the real exchange rate that would harm the non-oil tradable sector and increase the risk of Dutch Disease. A third reason to smooth public expenditure is the need to maintain spending *efficiency*. This reason is reinforced by a *sustainability* imperative. Azerbaijan's resource wealth is the collateral supporting its access to capital markets. However, the value of this collateral, and thereby the ease of capital market access, will decline precisely when income flows dry up, that is, when oil prices are low or oil resources are exhausted. These would be precisely the times that access to capital markets would be most needed.

Table 3.1: Oil Price Scenarios in Current Prices, Permanent Income (*PI*) Estimates, and Average of Real Prices

Oil Price Scenarios	PI in 2007 in bill. of US$ (AZN)		2008	2009	2010	2011	2015	2020	2030	2010-30 Avg Nom'l	2010-30 Avg Real*
I. Jul 07 forecast	7.7	(6.6)	108.1	105.5	98.5	92.5	75.3	77.1	81.1	80.2	64.5
II. Pre-Oct 08 with short crisis	**7.5**	**(6.5)**	**97.5**	**70.0**	**81.3**	**82.1**	**83.7**	**85.8**	**90.2**	**85.9**	**68.8**
III. Pre-Oct 08 with delay	7.2	(6.1)	95.0	60.0	65.0	70.0	83.7	85.8	90.2	84.2	67.4
IV. Med Low	**5.9**	**(5.1)**	**95.0**	**60.0**	**61.3**	**62.0**	**63.2**	**64.8**	**68.1**	**64.5**	**51.9**
V. 30-yr hist. avg	**4.3**	**(3.4)**	**4.3**	**95.0**	**68.0**	**39.5**	**40.0**	**40.7**	**41.7**	**41.7**	**33.4**

Source: Bank staff estimates
Notes: (*) Annual average for 2010-2030 in 2007 constant US$.

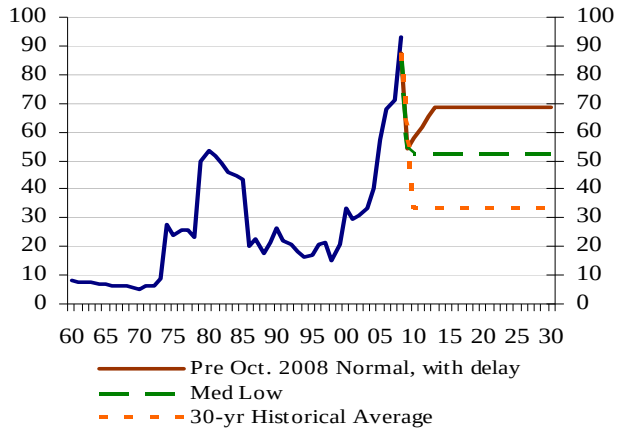
3.11. **These challenges can be overcome by a permanent income (PI) approach to spending oil revenues, as envisioned by the Long-Term Oil Revenue Management Strategy (LTORMS).** In 2004, by Presidential Decree, a LTORMS was approved that called for constant real spending fiscal revenues from oil. This is equivalent to a PI approach to spending oil revenues, which stipulates that Azerbaijan would annually spend the same real amount of expenditures in perpetuity (Box 2.1). This strategy is sustainable: first, because it proposes using only the interest portion of the anticipated fiscal revenues from oil; second, it is a flat stream of expenditure in real (foreign currency) terms. Thus, expenditure volatility is greatly reduced (although it will not disappear entirely, since PI estimates may have to be revised occasionally);

and third, spreading expenditure over time stretches out the period of real exchange rate pressure, thereby obviating Dutch Disease concerns.[78]

3.12. **An important benefit of the PI approach is that estimates of PI are not subject to extreme volatility, even in the face of extreme volatility in oil prices or production.** The benefits of the PI methodology are illustrated in Table 3.1. The PI quantifies the decision maker's forecasts about the future trend in oil prices, by smoothening the impact of price fluctuations in the forecasts. Table 3.1 suggests that if oil prices were to stay in the vicinity of *$55-60 per barrel in 2007 prices*, Azerbaijan will have about $7.5 billion per annum in 2007 prices. Historically, the price of oil in 2007 U.S. dollars was $33 per barrel for the past 30 years and $39 per barrel for the past 10 years. Today's long-term forecasts are much higher than the historical prices. They may yet change significantly, as the depth of the global crisis and the behavior of OPEC evolve. Should prices drop to about $ 52 per barrel in 2010–30, the PI will be $5.9 billion per year (in 2007 prices); should they fall to $33 per barrel in 2010–30, the PI will be $4.5 billion per year (in 2007 prices). Table 3.1 shows the PI equivalent in U.S. dollars and AZN (both in 2007 prices), selected years of the oil price forecast in current U.S. dollars, and the average oil price of the forecast period in 2007 U.S. dollars.

3.13. **The global crisis poses a challenge for medium-term budgeting. A $5.9 billion PI (in 2007 U.S. dollars) is recommended at the drafting of this report.** Figure 3.3 shows historical oil prices from 1960 and illustrates three post-October 2008 scenarios. The first assumes the same long-term global demand as before the financial crisis from 2010 onwards, but provides for a downturn in 2009, as a result of the crisis. This is scenario II in Table 3.1, and is based on Bank and U.S. Government's Energy Information Administration (EIA) projections in December 2008. The lowest scenario—scenario V in Table 3.1—is based on the 30-year historical average (1978-2007). The mid-case scenario is halfway between this report's low and high cases, scenario IV in Table 3.1. While it is not the intention of this report to recommend oil price forecasts, it needs to grapple with what is a reasonable PI on which to base fiscal expenditures. Given the unique uncertainty in the global economy at the time of preparation of this report, the "Med Low" scenario is proposed as an operational forecast. The PI equivalent of that scenario is $5.9 billion in 2007 U.S. dollars. Given the uncertainty regarding the course of the global crisis, and the recovery of oil prices, the government should undertake estimates of the PI on a routine basis.

Figure 3.3: Oil prices 1960-2030–Actual Through October 2008 and Forecasts Thereafter (in 2007 US$)



Source: Bank staff estimates

3.14. **Should the government choose to adopt a PI of $5.9 billion per annum (in 2007 U.S. Dollars), it may want to try and**

[78] The 2003 Public Expenditure Review discussed the merits of other approaches to distributing oil revenues. This report takes as its starting point the strategy that has already been selected by the government and advises on its implementation.

publicly communicate this by setting a five-year target stock of assets for the OF of *approximately* AZN 35 billion (at 2007 U.S. Dollars) through 2013, and re-evaluate the PI estimate thereafter. If Azerbaijan could draw US$5.9 billion (in constant 2007 US$) annually, the OF assets could reach approximately 40 billion manats in 2013 (under conditions described in section C below). Should the OF accumulate more (or fewer) assets than targeted, the PI level could be adjusted upward (or downward) on a 3-5 year interval. While government analysts may (and should) estimate the PI equivalent frequently, particularly during times of global uncertainty, policymakers should refrain from making large, abrupt increases in spending envelopes because that would affect macro stability and efficiency. Besides, as has been shown previously, the PI estimate is quite "inelastic" in response to future changes in revenues, and is in fact more inelastic to changes that happen even further into the future.

3.15. **The LTORMS and PI approach needs to be operationalized.** Azerbaijan issued a Presidential Decree in December 2004, which sets out the first principle for long-term use of the fiscal revenues from oil. It states:

> "When forecasting the amount of long-term expenditures from oil and gas revenues, the constant real expenditures principle shall be used as a basis and annual limits shall be set for the expenditures to be made within the period covered by the strategy."

The strategy also stipulates that the government can spend more than the real expenditure equivalent in the early phase of the oil boom, and adjust accordingly in the boom's later phase. The time before the global financial crisis demonstrated the need for a fiscal rule, as pressures for higher spending led to some unfortunate macroeconomic outcomes (discussed in Chapter 1), despite the double-digit growth rates. In the midst of the global financial crisis, the benefit of the fiscal rule would be to ensure against abrupt reductions in public spending, which could give rise to inefficiencies in public investment and possibly have negative macroeconomic consequences.

Box 3.1: Permanent Income Calculation

The permanent income calculation consists of two steps: first, it computes the discounted value of projected oil revenues, and second, it calculates which income level would give exactly the same discounted value while being constant in real terms forever. The value of parameters may be changed but a good starting point is to take a risk premium equal to 3 percent, r_S = 3 percent (equal to the US long term real interest rate (2 percent) plus a hundred basis points for Azerbaijan country risk), $\bar{p}$ = 2.5 percent (equal to the US long-term inflation rate) and thus i_R = 8.5 percent. Estimates of the World Bank consistent with forecasted revenues then shows that the level of permanent income that could be spent annually amount to 7.7 billion in constant 2007 US dollars, i.e. 31 percent of Azerbaijan's 2007 GDP or 69 percent of non-oil GDP.

Step 1:

$$NPV_0 = \sum_{t=0}^{T} \frac{P_t^{oil} O_t}{(1+i_R)^t}$$

Step 2:

$$PI_0 = r_S * NPV_0$$

$$PI_t = r_S * NPV_0 * (1+\bar{p})^t$$

with

$$r_S = i_S - \bar{p}$$

$$i_R = r_S + \bar{p} + risk\ premium$$

Where:
NPV_o = net present value from future oil revenues,
P_t^{oil} = price of oil in current dollars per barrel
O_t = production volume in year t
i_R = discount rate integrating a risk premium
$\bar{p}$ = long term inflation rate
r_S = real interest rate in the absence of uncertainty
T is the year in which oil reserves are exhausted.

In both cases, it is important for the government to operationalize the strategy to ensure that budgeting decisions are consistent with long-term fiscal sustainability and macroeconomic stability. The PI should be calculated on the basis of all resource inflows that have a cyclical

component, including OF and other oil revenues used in the state budget.[79] From the operational aspect, the estimated PI should be compared to the non-oil deficit of the consolidated budget. For the technical readers, Box 3.1 provides an overview of the PI calculation. During the crisis, the PI provides good guidance as to the sustainable level of spending.

C. Strategy for Azerbaijan's Public Finances

A Long-term Objective

3.16. **A long-term fiscal strategy can serve the vision of a moderate-sized government and mandates a small but consistent adjustment in the consolidated budget**. While the government of Azerbaijan has indicated on various occasions its desire to develop a sustainable, market-based, non-oil economy, no clear guidance has been offered as to the size of government it seeks to develop. Azerbaijan has the opportunity to develop a limited government that is still capable of delivering defense and other critical services. Unfortunately, European countries with large governments are typically shouldering large pension systems, civil services, and public service systems that Azerbaijan has largely managed to avoid thus far. This report posits that Azerbaijan should develop a medium-sized government—consistent with its wish to develop a flexible market-driven economy—of approximately 35 percent of total GDP by 2024, or 37 percent of non-oil GDP. The starting point would be the pre-oil-boom size of government (specifically from 2002–04), in which the consolidated budget was approximately 27 percent of GDP (or 40 percent of non-oil GDP) and economic stability was heralded as a critical trait of Azerbaijan. The country thus could use the bulk of its fiscal revenues from oil to build a more modern and competitive economy, and gradually return to a moderate and manageable government by the end of the oil boom. By 2016, Azerbaijan could have a per capita income of $5,700 (in 2007 US$, Atlas method), akin to that of Malaysia, Turkey, or South Africa today. The government expenditures of these countries are 29 percent, 26 percent, and 27 percent of GDP respectively.[80] Adopting such a strategy would require Azerbaijan to undertake a small and gradual *but consistent* adjustment in the consolidated budget. In 2008, Azerbaijan's consolidated budget is expected to reach 84 percent of non-oil GDP. The goal of a medium-sized government necessitates a definitive change of course from the country's current expenditure trajectory.

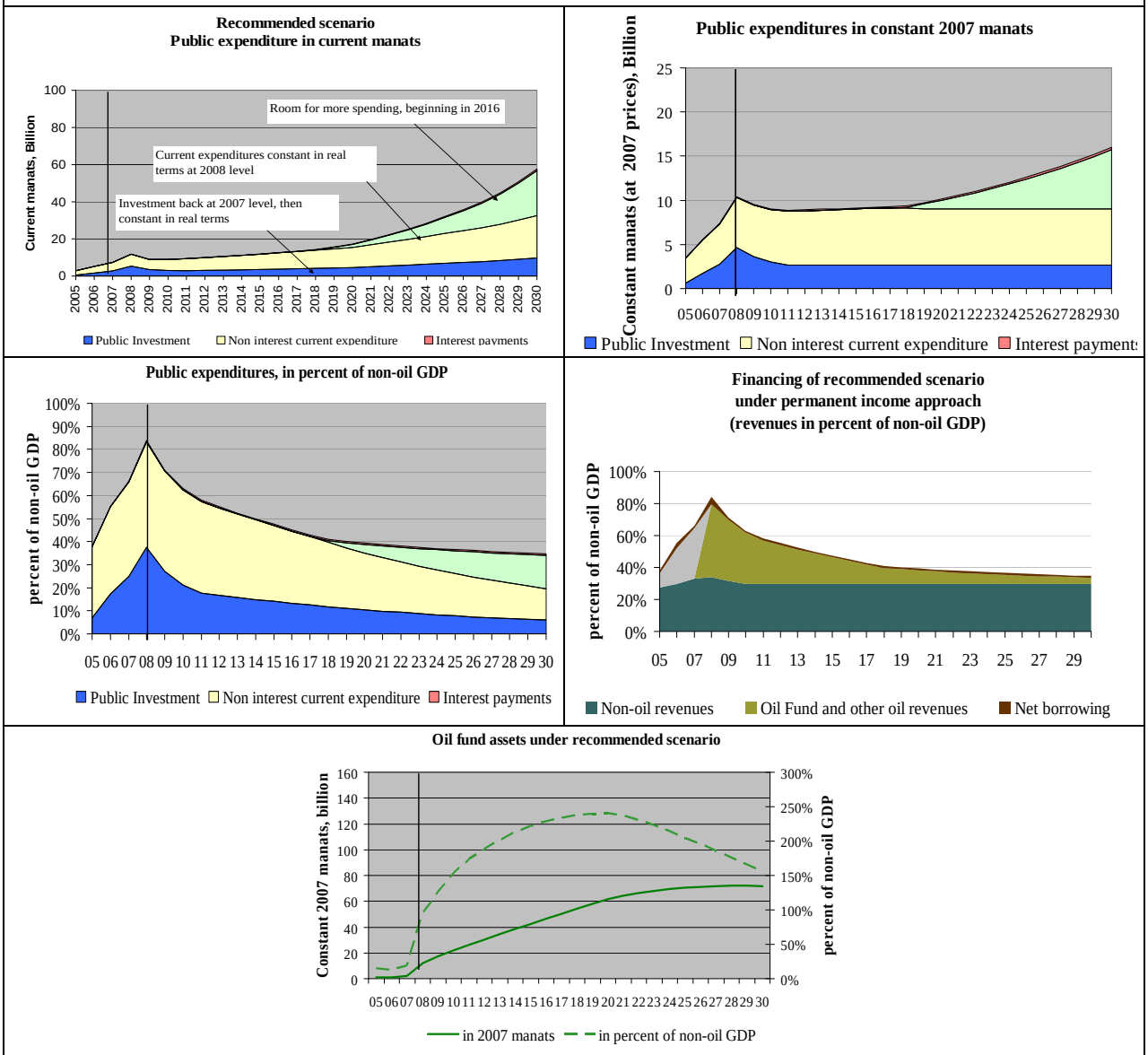
3.17. **Azerbaijan's 2008 budget estimates place oil revenue spending somewhat above the proposed PI of $5.9 billion**. Azerbaijan's non-oil deficit for 2008 is estimated at around AZN 7 billion in current prices, or about AZN 5.5 billion in 2007 prices, or about AZN 0.5 billion mantas in 2007 prices. This is based on the PI $5.9 billion in 2007 prices, which is equivalent to AZN 5.1 billion in 2007 prices.

3.18. **Azerbaijan can use the proposed PI level of $5.9 billion in its drive toward a sustainable moderate-sized government. Based on the 2008 budget estimates, is can do so by maintaining: (a) recurrent real spending at 2008 estimate levels, and (b) by reducing real investment spending to 2007 levels gradually by 2012, with a moderate non-oil tax**

[79] Cyclicality here refers to all dimensions of volatile revenues, including cyclicality in volumes and in prices.
[80] In the OECD, the top three fiscal revenue earners of 2007are France, Hungary, and Sweden with average revenue of 51.6% of GDP.

burden and low debt. Azerbaijan could attain a moderate-sized government (37 percent of non-oil GDP) (Box 3.2) by 2024, if it allowed the totality of wages,

Box 3.2: Recommended Spending Scenario, $52 per Barrel in 2007 US$ (*2005-30*)



Notes: (1) In Box 3.2 simulations, permanent income is calculated based on the net present value of oil revenues for 2008 estimates–2024 and phasing out AIOC from 2025–29. (2) In the Public Debt figure, the green line represents both the "Recommended scenario $59" per barrel, and the "Scenario $33", while the red line represents the "Very high spending with $59 per barrel"

transfers, subsidies, and goods/services expenditures to remain constant in real terms at 2008 levels, and returned the investment budget to its 2007 level.[81] Maintenance costs and interest

[81] In 2007 (constant) *manat*, investment expenditures amounted to AZN 2.8 bn in 2007 and were expected to reach AZN 4.6 bn in 2008. To be consistent with the PI approach, investment expenditures would need to gradually go back to AZN 2.8 bn (in 2007 manat) in 2012 (AZN 3.6 bn in 2009, AZN 3 bn in 2010, AZN 2.9 bn in 2011, and AZN 2.8 bn in 2012, at constant 2007 prices). The proposed trend for investment is consistent with early discussion

payments vary according to the stock of public investment and public debt. Taking these actions implies that the government needs to engage in significant inter-sectoral allocations and efficiency gains. While for some years the adjustment would involve overspending oil revenues with respect to the PI of $5.9 billion (in 2007 U.S. Dollars), it would still allow the country to accumulate about $100 billion (or AZN 72 billion in 2007 prices) in the Oil Fund by 2030.

3.19. This scenario assumes that Azerbaijan follows a reasoned approach to accumulating debt, so we assume that government debt stays at 2008 levels as a share of non-oil GDP, namely, 20.6 percent. The scenario also assumes that the tax burden will be alleviated by decreasing non-oil revenues—from 34 percent in 2008 to 31.5 percent in 2009, and to 30 percent in 2010. In this scenario, Oil Fund assets would amount to AZN 72 billion at 2007 prices in 2024 (Box 3.2), and Azerbaijan would still be able to get $5.9 billion (in 2007 U.S. Dollars) of PI from the Oil Fund, without decreasing the real value of the Oil Fund assets.

3.20. **Two plausible counterfactuals are presented for illustration**. First, oil prices drop back to their historical average ($33 per barrel, in 2007 prices) for 2010-2030, but Azerbaijan does not adjust expenditures from the aforementioned spending scenario (Annex 1, Scenario of $33 per barrel). The result, all else equal, is that the OF assets would drop from $100 billion in 2030 under the previous scenario to $40 billion in the current one. Along the lines of this scenario, it is very important for the government to consider whether it would choose a gradual adjustment (which was illustrated here purely for the purpose of illustration), or a more rapid adjustment, say over a period of 1-2 years, to bring public spending down so that the OF might still accumulate more than $40 billion. The rapid adjustment appears to be more costly in the short-term, but of lower risk for the medium term, as it helps build up the Oil Fund.

3.21. A second counterfactual is that Azerbaijan continues to increase spending at about the rate of non-oil GDP (Annex 1, Very high spending scenario). This would yield a larger government, which would be unsustainable and inconsistent with a moderate tax burden and low debt. This hypothesis under this scenario is plausible, as many countries increase wages, transfers, subsidies, and goods/services expenditures at the pace of non-oil GDP growth. In this scenario, public investment increases at the pace of non-oil GDP until 2012, and is then kept constant in real terms (that is, nominal public investment increases at the pace of inflation). Increasing current spending at the pace of non-oil growth appears unsustainable because, by 2026, the OF would be left with no assets and by 2030 public debt would be as high as 128 percent of non-oil GDP. In this very high-spending scenario, the size of government would be 67 percent of non-oil GDP in 2024—an extremely high level by today's standards—which no longer would be sustainable, as Azerbaijan would no longer be a resource-rich country by that time.

3.22. **The commitment to reduce public expenditures as a percentage of non-oil GDP requires the government to prioritize public spending**. In particular, the government must resolve some long-term strategic issues, medium-term fiscal management issues, and shorter-term macroeconomic issues:

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with authorities in 2006, at which point it was recognized that after the expenditure spike needed to implement critical investment projects, the level would have to be adjusted downwards.

(a) ***Some long-term strategic issues***: Existing implicit claims on government resources comprise several large-scale ticket times. First, large tax expenditures on energy, which stem the current from below (world) market prices to domestic producers and consumers. While social considerations are certainly important in setting domestic utility rates and gasoline prices, including affordability for poor citizens and employment in inefficient SOEs or private enterprises, Azerbaijan needs to also consider that it has to build up the non-oil economy on a sustainable footing: this applies to private enterprises and SOEs alike, some of which are in the petroleum sector but cannot yet afford to operate on international prices. A gradual policy to bridge the gap between domestic and international prices is necessary for the longer term. The alternative is that fiscal revenues forgone as a result of tax expenditures from domestic oil and gas prices are not available for other, more efficient, use of public resources. A second set of strategic issues that needs to be addressed relates to tertiary services in health and education. Azerbaijan need not maintain all tertiary services in health and education in public hands. Azerbaijan is at a fortunate moment when long-term strategic visions for both sectors are being developed. It is of critical importance that costing and financing plans at the strategic level be developed at an early phase of the public debate. It is also important to draw in the public's mind the difference between public provision and public financing of services: tertiary health and education services may be offered by the private sector but financed by the government for those in need. Again, planning to take on too much of the financial burden on the part of government will hit against the strategy of gradually reducing the size of government.

(b) ***Some medium-term fiscal issues***. It is important for the government to recognize implicit claims on itself, and potentially on the OF assets. These can be liabilities that may arise from the pension system, state enterprise debt (as is, in fact, being done), or financial sector risks (see discussion on Kazakhstan in Chapter 6). Appropriate provisions need to be made in fiscal expenditure projections, alongside all other claims on consolidated budget revenues. It is also important for the government to review the efficiency of some large economic and social programs, such as energy subsidies, minimum salaries, and pensions. The government needs to consider the necessity of these programs in light of the continued improvement of the targeted social assistance scheme. In addition, a closer look needs to be taken at the recurrent-capital budget split of the spending envelope, particularly as Azerbaijan does not budget in terms of programs (which cover both recurrent and capital budgets). The implementation of the 2007 investment program suggested that AZN 2.8 billion were difficult to implement—as can be attested by the challenges faced by the Bank's and other development partners' projects. We consider gradually returning to the 2007 level of investment as an envelope to strive for.

(c) ***Shorter-term macroeconomic management issues***. Finally, while in the pre-crisis period, the government had to decide whether spending the full PI amount ran the risk of overheating the economy, during the crisis, it now needs to decide if spending the full amount of PI is not sufficient to maintain aggregate demand. Similarly, on exchange rate and monetary policy, in the pre-crisis period, there was a need to decide how to manage the real appreciation of the currency, which

stemmed from financing of the non-oil deficit in U.S. dollar. During the crisis, the pressure for appreciation is likely to lessen, and the currency may in fact depreciate.

A Medium-term Objective

3.23. **Necessity to strengthen non-oil private investment…** A medium-term fiscal strategy would count for naught if it did not contribute to economic growth. The above discussion proposes a target fiscal policy that would result in a medium-sized government by 2024 and identified critical fiscal issues that need to be addressed in the process. While Azerbaijan may choose a larger government than proposed above, recent macroeconomic developments (Chapters 1, 2 and 5) suggest the need to: (a) curtail the growth of expenditures to alleviate pressure on domestic absorption; and (b) reduce the tax burden on the non-oil economy. The most immediate policy objectives need to be aimed at increasing the non-oil private investment rate relative to non-oil GDP and curtail the inflation rate. A third priority should be the growth of non-oil exports.

3.24. **...through reduced taxation**. As mentioned above, lower taxation would permit offsetting the burden placed by the real exchange rate appreciation on the tradable sector. The scenario envisaged in Box 3.2 proposes that the government reduce expenditures by alleviating the burden of non-oil taxation on the private sector. Non-oil revenues will decrease from 33 percent of non-oil GDP in 2008 to 31.5 percent in 2009 and to 30 percent in 2010. Azerbaijan can alleviate these taxes over two years with phased reduction of direct tax rates (see analysis in Chapter 4). Additionally, although it does not spend much on pensions currently –only about 3 percent of GDP for 1.2 million pensioners, Azerbaijan needs to urgently review the commitments under the social insurance and in particular pension system, as the current 25 percent contribution rate is relatively high and might be discouraging investment and employment generation in the formal sector.

D. Budget Increases and Constraints on Future Spending (2005-2008)

3.25. **The scale-up in Azerbaijan's budgetary expenditures through 2007 was approximately consistent with the PI approach to spending, before the global financial crisis, though estimated the non-oil deficit of the 2008 budget had surpassed the sustainable PI according to the estimates of this report**. While Azerbaijan's PI level of spending was estimated at $5.9 billion in 2007, the country's primary non-oil deficit reached AZN 3.6 billion, or $4.2 billion (Table 3.1). According to the 2008 budget estimates, the non-oil deficit in 2008 was estimated to be AZN 7 billion in current prices, or about AZN 0.5 billion in above the PI in 2007 prices (as discussed in paragraph 3.17).

3.26. **The global financial crisis placed a dilemma before policymakers: refrain from large expenditure increases as in the past to be safe, or stay the expenditure course at your risk.** The non-oil deficit for 2008 was estimated be AZN 5.5 billion (in 2007 prices), while the PI equivalent—with the moderate price scenario—came to AZN 5.1 billion.

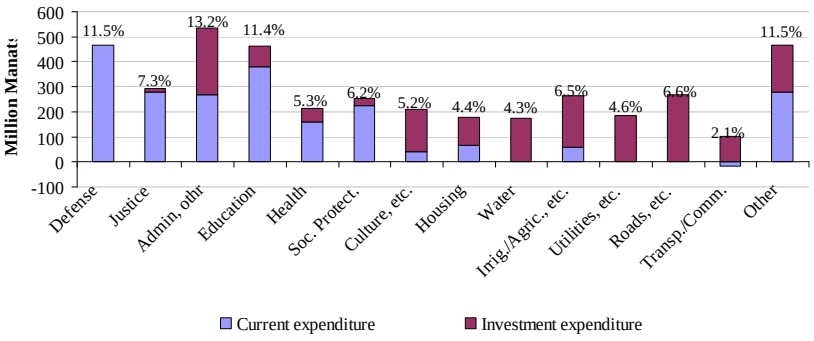
Table 3.2: Consolidated Budget, 2005-08

	In AZN 2007 Million				*As Percent of Non-Oil GDP*			
	2005	2006	2007	2008 (estim.)	2005	2006	2007	2008 (estim.)
Total revenue and grants	4190	6105	7949	22515	44.9	60.7	71.4	181.2
Oil revenue	1628	3100	4247	18414	17.4	30.8	38.2	148.2
Non-oil revenue	2562	3005	3701	4101	27.5	29.9	33.3	30.0
Total expenditure	3784	5,969	7,356	10,410	40.5	59.3	66.1	83.8
Recurrent	3040	4000	4595	5785	32.6	39.8	41.3	46.6
Investment & NL	744	1968	2761	4625	8.0	19.6	24.8	37.2
Financing	-428	43	-646	-7739	-4.6	0.4	-5.8	-62.3
Domestic (net)	-581	-259	-830	-8258	-6.2	-2.6	-7.5	-66.4
External (net)	153	303	183	519	1.6	3.0	1.6	4.2
Memo:						-	-	
Non-oil primary balance	-1178	-3128	-3571	-5874	-12.6	31.1	32.1	-47.3

Source: Ministry of Finance and Bank staff estimates

3.27. **All sectors of government activity benefited from the fiscal stimulus.** During 2005–07, administration and education—to which most current expenditures go—accounted for 43 percent of the total increase in public expenditures. Utilities, energy, and transport—in which most investments are made—benefited from 24 percent of the increase. Finally, the social sectors, excluding education, represented 25 percent of the fiscal expansion.

Figure 3.4: Prioritization: Increase in Consolidated Government Expenditures by Function, 2005–07 *(mil. manat and % of total increase)*



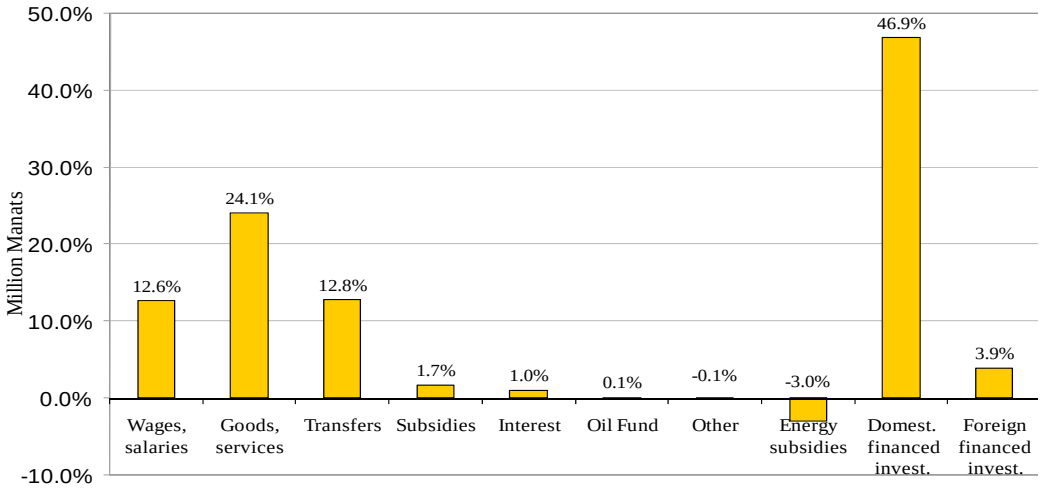
Source: Ministry of Finance and Bank staff estimates
Note: Based on available information. The height of each column measures the nominal increase in the budgetary allocation for the year. The percentage indicated on top of each column indicated the share of the particular sector in the three year increases in the budget (all percentages sum to 100%) i.e. for the first column, the defense budget increased by about 450 million manat in 2005-7, and this amounts to 11.5% of the increase in the budget over three years. The 2007 data are for the approved budget, but exclude mid-year adjustments.

3.28. **Based on available information, the composition of current expenditures has changed significantly (Figure 3.4).** Since 2006**,** defense has overtaken education as the largest budget item. The share of defense in consolidated current expenditure soared from 14.4 percent in 2005 to 17.3 percent in 2007**,** while education's share decreased slightly from 16.3 percent to 15.7 percent during the same period.. Justice and health are the only sectors, in addition to defense, whose shares in current spending increased during this period: those increases were from 7.3 percent to 9.7 percent for justice and from 4.9 percent to 5.9 percent for health. In contrast, the shares of other sectors in current expenditures, particularly social protection and transport, declined. Given the large recent increase in total spending, the shift in the composition of spending away from human capital is puzzling, and suggests human capital has not been a top priority in the budget. Separately, increases in recurrent spending in education are puzzling because the increases have funded hiring of new teachers, despite the very low salaries in the sector; earlier policy discussion had suggested that it was important to contain the number of staff, so that notable

rises would be felt in the take-home pay, thereby reducing the need for gifts and other forms of support from parents.

3.29. **From 2005 to 2008, government spending on goods and services, wages, and transfers increased dramatically** (Figure 3.5). Respectively, they account for 24.1 percent, 12.6 percent, and 12.8 percent of total expenditure expansion during these years. In 2008 estimates, the main items in total current expenditure were the purchase of goods and products (42.3 percent), social transfers (26.8 percent), wages and salaries (25.3 percent), and subsidies (2.8 percent).

Figure 3.5: Prioritization: Increase in Consolidated Government Expenditures by Economic Classification, 2005-2008 ***(Mil. Manat and % of Total Increase)***



Source: Ministry of Finance and Bank staff estimates
Note: The height of each column measures the nominal increase in the budgetary allocation for the year. The percentage indicated on top of each column indicated the share of the particular sector in the three year increases in the budget (all percentages sum to 100%) i.e. for the first column, the defense budget increased by about 450 million manat in 2005-7, and this amounts to 11.5% of the increase in the budget over three years. The 2007 data are for the approved budget, but exclude mid-year adjustments.

3.30. **From 2005 to 2008, investment expenditures to improve utilities, energy infrastructure, and social services have risen from negligible amounts to AZN 4.6 billion.** Outlays grew for all items, the composition of investment priorities changed from 2005 to 2007 (latest available year on the composition of investment). Among social sectors, the share of housing for internally displaced persons (IDPs) decreased from 18.8 percent to 7.4 percent of total investment, while the shares of culture and sports increased from 5.2 percent to 8.7 percent. The shares of other sub-sectors, such as health and education, remained constant.

3.31. **Expenditures on leisure raise questions about the process of prioritization**. Azerbaijan's emphasis on leisure infrastructure is questionable for a country in which education and health should be the top priorities. In utilities and energy, the share of water and irrigation grew significantly between 2005 and 2007, from 0 percent to 8.4 percent and from 5.3 percent to 10.4 percent respectively. The shares of other sub-sectors declined from 33.3 percent to 12.4 percent. Concurrently, investment in the road network increased substantially. This sector represented 13.5 percent of total investment in 2007, compared to 5.9 percent two years earlier. In parallel to these initiatives, investment in administration to renovate and modernize

government facilities has increased from 12.5 percent to 14.9 of total investment from 2005 to 2007. Taken together, the need for all aforementioned expenditures is difficult to question—even the ones on leisure, especially given Azerbaijan's ample fiscal resources; however, the *timing* of the expenditures raises questions about the government's priorities. This is because: (i) the large expenditure envelope has created macroeconomic pressures that the government is trying to mitigate; (ii) Azerbaijan's economy is already operating at absorption capacity, creating pressures on the private sector; and (iii) the government itself is operating at overcapacity to implement the large investment program. All these pressures could have been mitigated with a more prioritized approach to implementing the much-needed investment program.

Box 3.3: Use of SOFAZ Funds

AZN Millions	**2004**	**2005**	**2006**	**2007**	**2008**
Oil Fund Revenues	**322.8**	**660.5**	**985.9**	**1,872.3**	**11,864.7**
Oil Fund Expenditures	**163.5**	**233**	**981.3**	**1,061.2**	**4,291.8**
of which:					
Transfer to state budget	130.0	150.0	585.0	585.0	3,800.0
Financing of improvement of the social & economic conditions of refugees and IDPs	15.0	40.4	110.0	154.1	145.0
Formation of the statutory capital of the Azerbaijan Investment Company	..	..	90.0	..	..
Construction of a water pipeline from Oguz-Gabala region to Baku city	..	..	82.7	132.9	211.8
Financing of Azerbaijan Republic's share in the Baku-Tblisi-Ceyhan Pipeline project	17.8	41.0	75.4	..	..
Financing of the Samur-Absheron irrigation system reconstruction project	..	..	37.0	76.9	120.6
Baku-Tblisi-Kars railway	..	..	..	20.7	5.3
SOCAR share in exploration and development of Azeri, Chirag and Ganeshi oilfields	..	..	..	87.6	..
Ministry of Education	..	..	..	..	2.3
Fund's administration costs	0.7	1.6	1.2	4.0	6.8
Oil Fund extra-budgetary expenditures	**2.6**	**91.9**	**17.6**	**-13.9**	**678.6**
Assets Accumulation in the Oil Fund	**951.5**	**845.2**	**1,280.5**	**2,100.1**	**9,010.1**

Source: State Oil Fund of Azerbaijan (SOFAZ)

During 2004–08, the Oil Fund accumulated AZN9.1 bn in assets. Oil Fund expenditures consisted mainly of transfers to the budget (78% of total expenditures). Other expenditures were used to finance infrastructure for refugees and IDPs (6.9%), construct the Oguz-Gabala water pipeline (6.3%), finance the BTC pipeline (2.0%), and finance the Samur-Absheron irrigation project (3.5%).

3.32. **Concerning current expenditures, the government should prioritize sectors that favor human capital accumulation, in particular, education and health.** As noted above, in the last four years, defense, justice, and other administrations accounted for 46 percent of the increase in current expenditure, whereas education and health benefited from only 24 percent of this increase. In future years, the government should gradually reverse this trend by reallocating more resources to education and health, while reducing the shares of defense, justice, and other administrative expenses.

3.33. **Medium-term investment needs have been estimated at AZN 30 billion, which could be covered by annually investing an average of AZN 3 billion (at 2007 prices) over the next 10 years (2008 included).**[82] In electricity, as demand is expected to grow at roughly 4.7 percent per year, new investments of up to $4 billion annually until 2015 are required to maintain sufficient power generation capacity. Another $3 billion is expected to be spent on water projects. More investment will also be needed to improve the gas and transportation networks. In

[82] This is consistent with the fiscal scenario recommended above.

particular, from 2008, investments in transit corridors and roads around Baku, as well as regional and local roads (of which 45 percent are life-expired), will need to be increased. Many other investments are needed to develop the non-oil economy, namely, for irrigation systems, school renovation and construction, health facilities, and IDP housing.

3.34. **Implications for future budgets**. The 2005–08 budgetary increases raise a set of distinct implications for future expenditures. First, the abrupt increases in spending locked the government into a high-spending scenario early in the oil boom. This dynamic encompassed salaries; transfers, in which rudimentary budget forecasting seeks stability relative to non-oil GDP; and expenditures on goods and services, which are also needed for maintenance of the government's extensive investment program.

3.35. On the revenue side, the government may suffer a loss in purchasing power because: (a) lower inflation in the medium term would reduce inflation taxes; and (b) the tax base might erode, should Azerbaijan seek to pursue more private sector-friendly policies. One area in which the country will have savings going forward is energy subsidies—assuming improvements in metering and collections proceed as planned through 2008. Chapter 1 also suggests that Azerbaijan's economy is likely to overheat with the 2008 supplemental. If so, going forward, it needs to curtail the level of foreign currency inflows. In the absence of other policy changes that increase absorption and imports, Azerbaijan will need to significantly reduce public sector expenditure as a percentage of non-oil GDP.

E. INSTITUTIONAL STRUCTURES, BUDGET MANAGEMENT AND MAXIMIZING SPENDING IMPACT

3.36. **After important efforts in 2002-03, expenditure management reforms to increase the efficiency of spending have made limited progress.** While Azerbaijan has increased its public spending by four and a half times between 2005 and 2008, important components of an efficient expenditure management system have not been established. The importance of such systems will be much higher as rapid increases in total public spending levels become less feasible. Azerbaijan's Treasury Information Management System (TIMS) is in its sixth year of preparation, while its investment appraisal system is still under design. The 2008 PEFA rated Azerbaijan's system quite highly in the *implementation of budgetary expenditures*, but found it wanting in the practices surrounding *prioritization and medium-term investment budgeting*. The 2008 CPAR found the public procurement system to leave too much room for discretion regarding the use of restrictive procurement practices, limitation of bidders, and inefficient centralized decision-making.

3.37. **The Azeri government needs to introduce greater strategic content in the budget a five-year or ten year comprehensive strategic framework document could be useful.** Medium- and long-term visions for the country's development are plentiful in Azerbaijan, and largely consistent across sources. They can be found in the Long-Term Oil Revenue Strategy (LTORMS), the State Program for Poverty Reduction and Economic Development (SPPRED 2003-2005, and SPPRED II 2008–2015), and the State Program for the Socio-Economic Development of the Regions (SPESDR 2004-2008). The visions that emerge from these programs are reflected in Chapter 2. However, the objectives stipulated in these programs would better serve Azerbaijan if they: (i) were organized into a single strategic document (not

necessarily very detailed in projects, but in general directions of activities and financing priorities); (ii) incorporate financing objectives, including FDI, private investment, and fiscal responsibilities; and (iii) if the single document received Presidential recognition that it is "the" reference document guiding the development of State Programs (with reference to strategic priorities and financing targets). Disciplining the government's and the public's thinking by introducing financing constraints is the only way to generate governmental and public discussion about efficiency. Strengthened coordination would be especially valuable during the time of the global crisis, should prioritization of expenditures be required. The aforementioned examples suggest that high-level coordination is needed to resolve institutional bottlenecks that prevent the desired development outcomes from materializing, despite the already significant government efforts. Many European, Asian and Latin America countries have found it useful to a single issue strategic document that sets the medium term priorities and key polices (and sometimes financing) for the entire government. Within such a framework document, sector strategic plans (or State Programs) are developed and prioritized

3.38. **Azerbaijan may wish to introduce a fiscal rule to strengthen the implementation of the LTORMS, by quantifying the PI approach to spending oil revenues**. Indeed, discipline and efficiency in program development and implementation can only be introduced more efficiently with a hard budget constraint for the use of oil revenues. This could be done by amending or supplementing the Presidential Decree on the LTORMS with quantitative information about the maximum fiscal revenues from oil than can be spent for a medium-term period (once the period is over, the ceiling could be revised, based on new oil price or reserve information). Another approach to strengthen the LTORMS is to submit the new or revised version of the LTORMS Decree to parliament for discussion. Azerbaijan's Budget System's Law already provides for a four-year rolling Medium-term Budget and Expenditure Framework. The principal challenge in its implementation over the past few years has been the lack of a strategic expenditure ceiling.

3.39. **With a medium-term budgetary ceiling, strategic prioritization would become more meaningful, but would likely require more involvement from the President's Office than in the past**. The governments of resource-rich countries face especially large expenditure pressures during budgeting cycles and Azerbaijan is no exception. In order to discipline the resource allocation process, and to steer it toward strategic relevance and efficiency, it is anticipated that the highest decision-making office in the country would need to be involved in the early phase of the budget cycle. The involvement of the President's Office would be required to: (i) confirm the relevance of the medium-term expenditures ceiling (based on the LTORMS and other tax and non-tax revenues); and (ii) outline budgetary priorities at such an early stage. One way to structure the engagement of the senior political leadership of the country is through the operation of an Economic Council—headed by the President, or advising the President in a periodic and systematic way—members being the Prime Minister, the Minister of Finance, the Minister of Economic Development, the Chairman of the National Bank of Azerbaijan, and the Executive Director of the State Oil Fund of Azerbaijan. The members of the council would advise the President on strategic issues, and allow the President to make early decisions (in the budget process) on strategic priorities and expenditure trade-offs in light of the discipline imposed by the LTORMS and current macroeconomic management needs. In particular, regarding the annual budget process, after meeting with the Council early in the budget cycle, the President would be able to decide and endorse the medium-term macroeconomic framework,

including the level of oil revenue spending for the next four years and expenditure priorities, and offer guidance to the members of the Council on approximate sectoral expenditure ceilings. With the creation of the Macroeconomic Commission in early 2008, an Economic Council would be able to function very efficiently and with significant technical support.

3.40. **There is an increasing urgency to expedite the implementation of reforms of its expenditure management systems, including budget transparency, TIMS, project appraisal, budgeting, and internal and external control**. In addition to implementing completion of the TIMS and project appraisal system, Azerbaijan would also benefit from accelerated reforms to improve the budgetary planning process with a budgeting framework that sets the medium-term resources envelopes (ceilings) at the sectoral and agency levels (as documented in the 2008 PEFA exercise). Internal financial control and audit systems throughout the government will need to be developed to give greater assurance of efficiency and legality. At the same time, there will also be a need for greater transparency of the Parliament's role in the budgetary process and the work of the Chamber of Accounts. Full publication of the budget approved by the Parliament, and publication of the public investment program would strengthen government accountability and the efficiency of public spending. An integral part of efficient public spending is adherence to modern, fair, and transparent procurement regulations, starting from the regulatory framework to implementation.[83]

Box. 3.4: Examples of Coordinated Economic Management*

Even mineral rich countries with a history of instability and fractious politics can experience windows of opportunity for good management. The experiences of Chile, Malaysia and Indonesia (at least during the first decade of the Suharto government) suggest a number of common elements that can support good management: first, having twin goals—accelerating development and sustaining economic and social stability; second, a fairly broad basis of support for such goals; and third, close relationships between politicians and technocrats equipped to deal with complex problems of resource management.

In Chile, technical capacity has traditionally been strong. In the early 1970s, the country suffered both serious macroeconomic instability and social polarization. The period after the 1970 election of the Allende government and the September 1973 Pinochet coup was particularly traumatic; in 1973-75, the consumer price index rose by 3000 percent; this was followed by a deep debt crisis and economic contraction in the early 1980s. Unemployment levels reached 33 percent by 1982. Following the return of civilian rule in 1990, the traumatic experiences of the two previous decades underpinned widespread consensus around preventing further disruptive boom-bust crises and avoiding conditions that might precipitate the political instability that could lead to a return to military government. The result was a broad constituency in favor of both economic stability and public debt reduction. The strength of this consensus is demonstrated by Chile's current response to spiraling copper prices and the exceptional accumulation of surpluses in its copper stabilization fund after 2005. Net public debt fell to minus 14 percent of GDP by 2008. Nevertheless, sustaining these policies has required continuous efforts by the

[83] Ossowski, Villafuerte, Medas and Thomas (2008) in an empirical analysis show in a large sample of countries that oil funds and fiscal rules are associated with lower non-oil primary balances (contrary to what was expected), but not in a statistically significant manner. However, various indexes of broader governance indicators show that higher institutional quality is associated with higher non-oil primary balances. Similar results are obtained with regressions using public spending as the explanatory variable, in place of non-oil balances. The paper recommends the use of institutions, public financial management systems, and medium term frameworks to ensure spending quality and fiscal sustainability –within these systems, oil finds and fiscal rules can play a constructive role.

technocracy to reach out to elected officials and explain the implications of over-spending.

Indonesia, at least during the first part of the Suharto period, offers another interesting example of cautious and flexible macroeconomic management -- implemented without a dedicated fund, without transparency, and even in violation of fiscal rules. As in post-Pinochet Chile, the Suharto government came into power with a huge stake in stability. The last years of the "Guided Democracy" of the Sukarno period had been increasingly chaotic, including rice and ethnic rioting. The 1975 crisis of Pertamina, the national oil company, reinforced the caution of the government, and added to the credibility of the technocrats – a very stable team of economic advisers widely known as the "Berkeley Mafia"[84]. This team proved to have both great permanence and leeway to shape policies. Through the oil booms of 1974-81, the government formally adhered to a balanced budget law. However, without disclosure to the public or the parliament, bureaucratic controls were applied to slow actual spending, creating a *de facto* surplus and doubling reserves. Indonesia also managed its spending programs with great flexibility. As oil prices fell after 1981, the government moved aggressively with a drastic re-programming of its development spending, cancelling projects, cutting subsidies and spending, as well as stabilizing the real exchange rate through progressive devaluation.

Malaysia, another success story, has faced a threat to social stability from either of two paths: growth with Malays politically dominant yet economically disempowered, or economic collapse caused by excessively redistributive policies. Neither of these options was attractive, leaving effective economic management and reinvestment of rents to encourage growth, especially employment for Malays, as the only option. [+]

Chile, Indonesia and Malaysia are clearly very different cases, yet they have some common features, including a strong urge to maintain stability and a good appreciation of the risks in managing resources. Another common feature has been the power of constituencies rooted in non-oil tradable sectors. In Chile, they included a range of other resource-based commodity exporters developed over the years of low copper prices (see below); in Malaysia, tin and rubber producers were influential. Agriculture played a similar strategic role in Indonesia, because of its importance in sustaining rural incomes and social stability. Aside from Chile, Indonesia, and Malaysia, in Norway, fishing and other decentralized industries supported cautious spending policies; these interests have been important forces for stability; they have helped to restrain sharp exchange rate appreciations that would damage the sectors concerned. Similarly, in Botswana, traditional chiefs and cattle owners comprised a powerful constituency in the non-tradable sectors.

[*]This section relies heavily on "Confronting the Oil Curse", Alan Gelb and Sina Grasmann. Mimeo, World Bank 2008. pp. 17-18.
[+]See also Zainal Aznam Yusof and Deepak Bhattasali (2008) on the linkages between policy-making and leadership in Malaysia.

3.41. **Azerbaijan also needs to strengthen the implementation of the Budget Systems Law and to prepare to introduce an early variant of program budgeting.** On the program development side, Azerbaijan still needs to build extensive capacity at the line (budgetary agency) and central ministries level before program budgeting is recommended. However, in the mean time, Azerbaijan can introduce Fiscal Impact Assessments as a requirement before any new State Program is adopted. At the same time, it is important for line ministries and central agencies to initiate training in programs budgeting, focusing on medium-term implementation.

[84] Pertiamina had been under the management of a military associate of the President, hence the crisis – which required a $1 billion bailout.

The training program should include training for budget managers; implement program budgeting to allocate resources to policies; identify the priority areas for spending; and provide information on efficiency. These actions would require the introduction of formal links between adopted state programs and the annual budget, including an adapted IT system and a new coding system for investment projects, as well as a comprehensive methodology for policy costing. The recently completed PEFA (February 2008) for Azerbaijan provides sufficient guidance to priority reform areas.

3.42. **Of critical importance is also the much-delayed appraisal system for public investment projects**. Azerbaijan has been preparing the introduction of an appraisal system for public investment projects for some time. The current system is based on Soviet norms for construction and demand assessment. Currently, decisions are based on a light form of financial analysis, not on modern project appraisal methods. Azerbaijan's new system needs to be based on modern appraisal methods, but tailored to the existing, gradually expanding capacities of public administration. There is also an opportunity for an innovative approach of training and using the private sector for appraisal analysis. One priority for the new system should be that it has the ability to juxtapose the "development problem" in question, and private sector- and public sector-based solutions very early in the appraisal cycle. In terms of tactics, given the large number of public investment projects that have been approved through 2008, and the decision to fund mostly ongoing projects for 2009, it may be worthwhile for the government to consider: (a) emphasizing the *monitoring* of the 2006-2009 projects; and (b) approaching the 2010–13 projects as a new package to be appraised by modern methods. The year 2009 could then also be used to improve the procurement process, per the recommendations of the 2008 CPAR. Taking time to review the 2006–09 package of investment projects, in aspects of strategic relevance and public/private role, project design, and implementation quality, would allow for lessons learned to be incorporated into the 2009–13 investment package. Some of these lessons are discussed in the next chapter.

3.43. **Azerbaijan needs to devote special attention to strengthening procurement.** The 2008 Country Procurement Appraisal Report (CPAR) pointed to several areas in procurement that need to be strengthened; most important are the overhaul of the legal framework for public procurement, including regulations, to eliminate gaps in coverage and implementation; introduce safeguards to limit administrative discretion; and to develop standard documents. Azerbaijan can also improve the institutional management and capacity of its legal entities, including clarifying the role of the State Procurement Agency (SPA) and, at a minimum, make it consistent with the existing legislation, build capacity, and integrate public procurement into the country's public sector governance system. The CPAR also recommended significant improvements in market practices and oversight.

3.44. **Better monitoring of existing programs would be a second essential contribution to improve budget management.** The introduction of more strategic content in the budget will provide the foundation to monitor public policies and expenditures. As objectives are clarified and quantified, program performance assessment will be possible through internal or external audits, and conclusions should be drawn by the Parliament for the following annual budget exercises. This implies accountability and disclosure of assessment results, so that they can be debated by members of Parliament. At the aggregate level, consolidated budget figures and breakdowns should also be made public and easily accessible. Performance assessment could

start with a survey of 2005–08 PIP implementation, and a PIP appraisal. This would help tap the full potential of the PIP as an effective tool to assess and prioritize infrastructural needs.

3.45. **It is important to keep building capacity in government while the government carries out major efforts to improve the budget process and macroeconomic management**. For instance, policy costing and program budgeting will have to be simple at the beginning in order to avoid imposing too heavy a workload on public employees at all levels. As more complex and accurate methods are gradually introduced, it will be necessary to train the staff so that the program can be a first contributor to improve budgeting. It also will be necessary to use as efficiently as possible the new institutional setting, particularly by publishing a budget process manual and making use of the Economic Council.

3.46. **To further strengthen governance, there is a need for more information about the budget and about the economy to be made available to policymakers and the general public…** Azerbaijan publishes broad aggregates of its annual budget (revenues and expenditures) and provides occasional, not routine, updates of the implementation of the budget to the public. Full publication of the budget approved by the Parliament, and publication of the public investment program would strengthen government accountability and the efficiency of public spending. At the same time, the country provides a lot of information to the public about the course of the economy, although availability in electronic for is limited. Nonetheless, the government's information strategy could be further strengthened by ensuring that certain important information is made available on a timely basis to policymakers, external analysts, and the general public. This information should comprise detailed data on the consolidated budget (quarterly), real wages (monthly), real imports (monthly) and exports (monthly), and non-oil private investment (quarterly). Making available detailed high frequency data would strengthen the government's and the private sector's ability to monitor the economy.

3.47. **...and issue an "Annual Report Card" on the quality of the country's infrastructure**. The government is investing substantially to improve the country's infrastructure. While the ongoing projects are a response to tangible investment needs, the government can capitalize on the improvements in the country's infrastructure by effectively advertising its completed projects. The government can issue a "report card" on the quality of its infrastructure. The report card can take into consideration not only outputs of investments (such as miles of highway repaved) but outcomes (such as average transit times from the Iranian to the Georgian or the Russian border). The report card can track improvements in infrastructure, and progress can be touted to attract foreign investment

CHAPTER 4.
TAILORING INVESTMENT IN UTILITIES TO PRIVATE SECTOR NEEDS

As indicated in the previous chapter, Azerbaijan's government has made the improvement of infrastructure services the cornerstone of its development strategy. The country inherited an adequate infrastructure network after independence, but the poor state of the economy during the 1990s and low availability of funding before the oil boom led to its significant degradation. At the same time, the dilapidated network responded poorly to the needs of the growing economy, and was one of the factors that prevented the country from taking advantage of the transit corridor, getting agricultural products to markets, developing agro-processing industries, or other light industries, hindering the development of the service economy.

The government's decision to improve the infrastructure has accelerated investment in electricity, telecommunications, roads, railways, and water supply, as well as institutional improvements in the delivery of public infrastructure services. As a result, the *coverage and access* to such services have been greatly expanded. However, the *efficiency and quality* of infrastructure services remain less than satisfactory, and both aspects need to be improved substantially on a priority basis to enable businesses to strengthen their competitiveness. This would require: (i) completion of the financial viability agenda appropriately pursued by the government; and (ii) deepening the engagement of the private sector in infrastructure. The former requires securing financial viability with sound medium-term planning taking into consideration investment needs tariffs, input prices, and recurrent costs. The latter requires a comprehensive and sustainable solution based on strategic decisions regarding the market structure of each utility sector. This should be done to ensure the long-term role of the private sector, as well as to make sure that the appropriate regulatory framework and pricing policy are in place. The nature and modalities of such an engagement will differ across infrastructure sectors, so choices should be made based on successful experiences elsewhere, as well as on local circumstances (market size, structure, and regulatory capacity). The decisions regarding strategy are urgent, particularly since a decline in oil prices may hamper the country's ability to continue to fund infrastructure development at such a high pace.

A. INTRODUCTION

4.1. **Infrastructure is known to be among the most important factors to stimulate economic growth and reduce poverty.** Infrastructure is usually expected to help the owners and managers of enterprises reduce their costs of production, communications, and transport, and strengthen productivity and external competitiveness. A number of studies indicate a robust linkage between infrastructure stocks and economic growth.[85] Not only quantity (access) but also quality (reliability) of infrastructure is important to support continued growth.[86] As such, the immediate goal of the government to improve infrastructure has been on target.

[85] See World Bank 1994, Canning 1998, and Canning and Pedroni 1999.
[86] Calderón and Servén 2004.

4.2. **However, sustaining quality infrastructure service provision is still challenging, particularly in transition countries.** Many infrastructure services are not financially viable because facilities are often designed in a manner that exceeds usual capabilities and are exploited beyond their useful lives of 25–30 years. One vicious cycle in which transition economies tend to get trapped is that under-setting tariffs prevents infrastructure operators (public or private) from maintaining their facilities, due to a lack of financial resources. In turn, for some transition countries, the resulting poor quality of services—for instance, frequent power outages and water supply interruptions—prevents the increase in tariffs. Subsidized tariffs also convey incorrect incentives to customers, encouraging over-consumption. The latter makes it even more difficult for the operators to ensure the quality of services; it also exacerbates shortages.

4.3. **Azerbaijan's progress on infrastructure varies by sector.** Electricity services, which in the past, performed poorly, have improved dramatically. In recent years, Azerbaijan has achieved 24-hour uninterrupted service provision with a stable frequency to paying customers across most of the country. The government has invested heavily in the electricity sector to enhance generation capacity; it also invested substantial resources in highways. Investments in the water and railway sectors, although picking up lately, have been relatively slow. Importantly, it takes considerable lead-time to prepare and implement infrastructure projects with built-in risk assessments and sustainability mechanisms.

4.4. **While it has not been a fast reformer, it is noteworthy that Azerbaijan adjusted all tariffs on public infrastructure services across the board in January 2007, bringing most utility sectors to cost recovery levels (detailed below).** The adjustments in tariffs, together with improvements in metering, billing, and collections, were significant enough to *eliminate energy subsidies from the consolidated budget in 2008*. However, the tariff adjustments themselves were based on domestic wholesale prices of AZN 47.2 per thousand cubic meters (TCM) for gas and AZN 100 per ton for oil to generate electricity. Water utilities also rely greatly on that electricity generation. Azerbaijan's domestic energy prices are far below current international prices. To illustrate, based on its fuel expense data for 2006, the opportunity cost or total implicit economic subsidy was estimated at $2.4 billion, or approximately 10 percent of GDP (Table 4.1). This estimate excludes negative social and economic consequences from an abrupt shift to international prices.

Table 4.1: Implicit Subsidies, 2006

	Gas		Oil	
Domestic wholesale price	47.2	manats/1000m3	100	manats/ton
Azerenerji purchase in 2006	420	million manats	89	million manats
International price	300	US$/1000m3	350	US$/ton
Exchange rate	0.86	manats/US$	0.86	manats/US$
Implicit economic costs	2,181	million US$	208	million US$

4.5. **Azerbaijan's 2004 Law on Accounting is an important component of the country's strategy to improve the governance of SOEs**. The Accounting Law, which took effect in 2008, requires all public interest entities, including SOEs, to adopt International Financial Reporting Standards. In fact, the law provides for IFRS and national accounting standards to be used by the private sector, depending on the size of the enterprise, and for International Public Sector Accounting Standards to be used by budgetary agencies. SOCAR, the largest SOE, has

invested heavily in the production of IFRS. It is currently anticipated that by 2009, Azerbaijan's utilities will be compliant with IFRS, which will allow Azerbaijan to have, for the first time, a common (across SOEs), internationally accepted measure of revenues and expenditures. The use of IFRS can make a significant contribution if the reports are publicly available, and if they are considered, together with other reporting and medium-term budget proposals, by the government at the time of budget preparation.

4.6. **Azerbaijan needs to strengthen the financial management of SOEs by pulling together the current arsenal of institutional and policy initiatives. It can also improve service quality by introducing an Annual Report Card on infrastructure quality**. Other than the relevant line ministries, SOEs are supervised by the Ministry of Finance, the State Committee for the Management of State Property (SCMSP), and the Tariff Council. Armed with the Accounting Law, the need for the Ministry of Finance to approve SOE budgets, the role of the Tariff Council in approving rates, and the oversight responsibilities of the SCMSP, the government can strengthen the oversight of SOEs by bolstering medium-term planning and ensuring financial viability. At the same time, the government can improve service quality by standardizing a subset of existing infrastructure quality indicators (from various government, Bank and donor projects) and by preparing an Annual Report Card. Annual improvements in the scores will allow the government to use the Card to lure foreign investors.

4.7. **Chapter 4 reviews the status of electricity, telecommunication, road and railway transport, and water supply.** The next sections describe the institutional and financial issues of each sector and summarize various reform options to improve service.

B. Infrastructure Readiness and Quality of Public Services

General State of Infrastructure at the Beginning of Oil Boom

4.8. **Azerbaijan's infrastructure is still a carry-over from the former Soviet Union era.** The country inherited a large amount of infrastructure facilities, which were by and large acceptable. However, most infrastructure capacities in the country have been exploited beyond their useful lives of 25–30 years. In addition, these capacities are often designed in a manner that exceeds usual capabilities and is costly to maintain. Due to lack of financial viability, and the consequent lack of investment, most infrastructure has deteriorated physically and the quality of services has become suboptimal. However, the scale of problems varies by sector. Prior to the boom, about 56 percent of Azerbaijan's main roads were in poor condition, and 30 percent needed immediate repair. Up to 45 percent of regional and local roads were life-expired, which hampered all-year links between territorial units in a number of regions. Due

Table 4.2: Total Investment Needs for Infrastructure in Azerbaijan *(US$ mil)*

	Total investment needs	Annual average
Electricity (2008-11) 1/	910.0	227.5
Gas (2004-10)	1,001.0	143.0
Water (2007-17)	2,681.1	243.7
Greater Baku area	1,208.1	109.8
Other regions	1,473.0	133.9
Roads (2005-10)	729.5	121.6
Railways (2008-11)	1,477.4	369.4

Source: Iimi 2008.
1/Estimated at US$1,950 to US$3,600 million in the longer term (up to 2015).

to deteriorating rail infrastructure, Azerbaijan Railway was also unable to operate at full capacity. The reliability of public water supply, though has improved, especially in the capital area in recent years, remains low at 13 hours per day on average. In many parts of the country outside Baku, people receive as little as three hours of water supply.

4.9. **Based on estimates from the Bank's Azerbaijan country team, the total amount of investment needed to develop infrastructure utilities (electricity, gas, water, and sewage) and other public services (such as roads and railway) is approximately $1.1 billion per annum over the next 10 years** (Table 4.2). On an annual average basis, the railway sector's financial needs will be the largest, followed by the water, gas, and road sectors, in this order. The estimates require updating in light of high inflation in 2007 and 2008, which would increase the cost at least by 50 percent. Further prioritization is required in light of this report's recommendations for fiscal sustainability, which propose a reduction in capital expenditures in the medium term (Chapter 3).

Table 4.3: Potential Productivity Growth Gains from Infrastructure Development in ECA Countries (%)

	Aggregate infrastructure stock	Aggregate infrastructure quality
Bulgaria	0.39	1.49
Croatia	0.42	1.08
Czech		0.18
Estonia	0.02	1.52
Hungary	0.05	1.01
Kazakhstan	1.53	1.52
Latvia	0.31	1.69
Lithuania	0.11	0.38
Poland	0.27	0.87
Romania	0.47	1.60
Russia	1.29	1.49
Serbia & Montenegro	0.47	1.61
Slovak	0.30	0.20
Slovenia	0.12	
Turkey	0.62	1.39
Ukraine	0.70	1.59

Source: Calderón 2007
Note: Impact of catching up on infrastructure quality and quantity with the median industrial country.

Table 4.4: Firms' Cost Elasticity to Infrastructure Quality

	w/o sector dummy	With sector dummy
Number of days with insufficient services		
Electricity	0.0083 *	0.0086
	(0.0043)	(0.0039)
Water supply	0.0127	0.0176
	(0.0146)	(0.0132)
Telecommunications	0.0148	0.0030
	(0.0160)	(0.0145)
Avg. duration of service interruptions		
Electricity	0.0093	0.0393
	(0.0185)	(0.1681)
Water supply	0.0264	0.0683
	(0.0457)	(0.0416)
Telecommunications	-0.0317	0.0173
	(0.0387)	(0.0352)

Source: Bank staff estimates

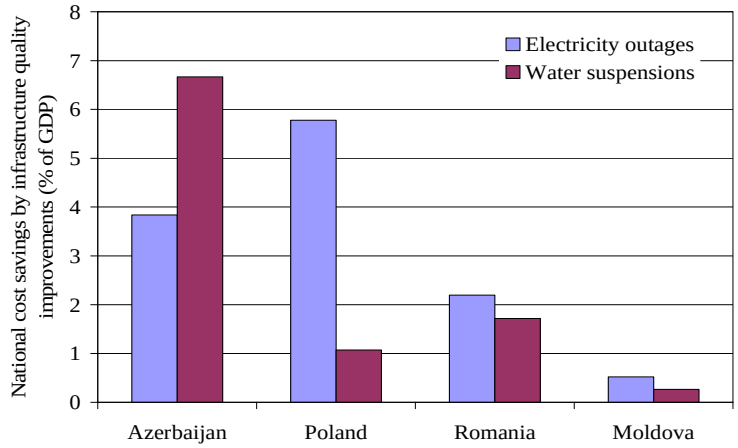
4.10. **The poor quality of utility services imposes heavy costs on the economy.** The quality of infrastructure matters to economic growth.[87] With cross-country data, empirical studies estimate the impact of infrastructure volume and quality on growth. These show that growth could be stimulated by increasing the conventional quality proxies for infrastructure, particularly in the telecommunications and road sectors. However, those quality impacts tend to be overwhelmed by the quantity effects in a statistical sense. Calderón (2007) refines the model with ECA data only, showing that the impact on potential growth of improving

[87] As per Calderón and Servén 2004. No doubt, the effect of infrastructure quantity is significant (see World Bank 1994, Démurger 2001, Fay and Yepes 2003).

infrastructure quality up to the regional top level could be 1.0–1.5 percentage points (Table 4.3).[88]

4.11. **On the micro level, the continuity of electricity and water service provision affects firms' operating costs.**[89] When estimating the cost function for enterprises with data from the 2005 BEEPS for 26 ECA countries, the elasticity of firm costs with respect to the duration of electrical outages is estimated at 0.039 (Table 4.4). Similarly, the elasticity is 0.068 for water suspensions. It means that if a country eliminates all existing electric interruptions, firms could save approximately 4 percent of operating costs. If all water suspensions were rectified, the firms' savings would amount to approximately 7 percent of operating costs.

Figure 4.1: Estimated Benefits from Improving Quality Infrastructure, 2005-07 *(% GDP)*



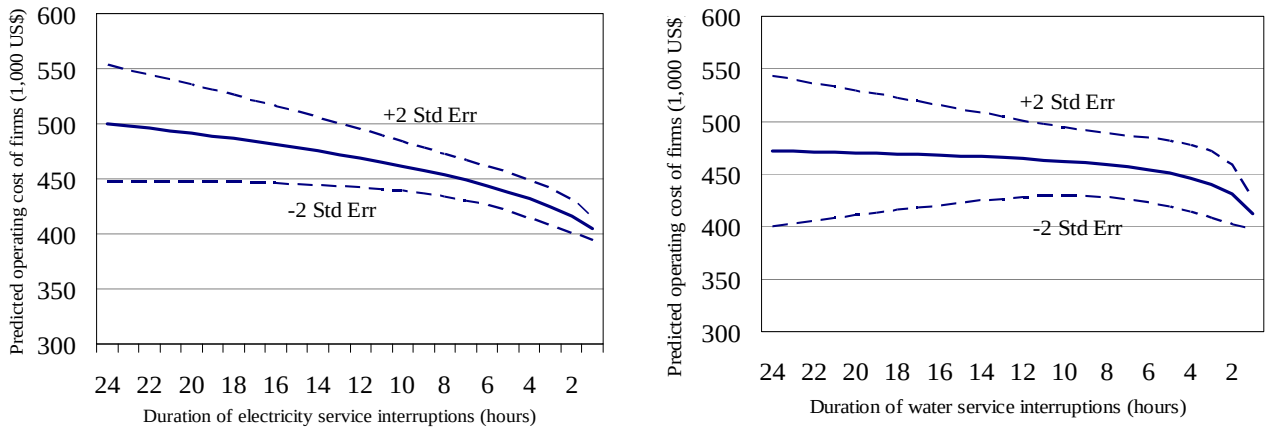
Source: Bank staff estimates.

4.12. **For the Azerbaijan economy, the predicted benefits from improving electricity and water service reliability are estimated at approximately 3.5 percent and 6.5 percent of GDP respectively (**Figure 4.1).[90] In 2004-05, the average duration of power and water supply suspensions was 3.7 hours and 3.3 hours respectively. Since electricity provision has been fully restored, the estimated result can be interpreted to mean that Azerbaijan *did* gain approximately 3.5 percent of GDP in the past three years. The results also suggest that it is essential to reduce the utility service suspensions to 0 hours, especially in the water supply sector, because the benefits from quality water services are expected to materialize only when the remaining last four-hour interruptions are eliminated (Figure 4.2). These sizable benefits can justify that the government spend several percent of GDP for investment in infrastructure.

[88] Applying this exercise to Azerbaijan shows that catching up with the median Western Europe country in infrastructures quantity would bring a permanent productivity growth gain of 1.5 percentage point. See Jamet 2008.
[89] For further details, see World Bank 2008.

[90] Since the 2005 BEEPS does not include any cost and sales information for Azerbaijan, several assumptions need to be made for inferring the impact of infrastructure quality on the Azerbaijan economy. It is assumed that the profit margin (ratio of sales to costs) for Azeri firms is the same as the regional average. Moreover, the sales information collected in the 2002 BEEPS is used with some inflationary adjustments. On the other hand, on a subjective basis, Azeri firms reported that the values lost due to electrical outages and water suspensions were estimated at 5.9 percent and 3.5 percent of total sales, respectively.

Figure 4.2: Predicted Operating Cost for "Average" Firm

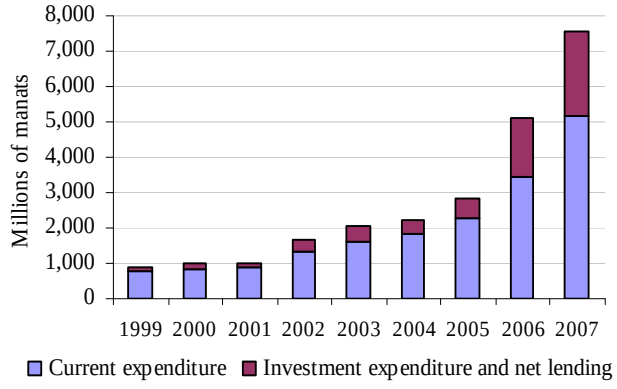


Source: Bank staff estimates.

C. DIRECTION OF PUBLIC INVESTMENT PROGRAM (PIP)

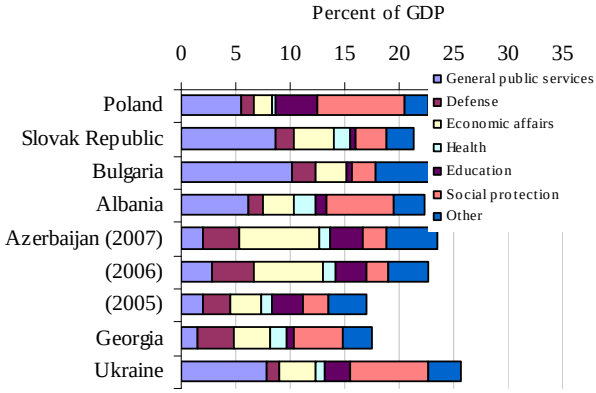
4.13. **Over the past five years, the government increased its consolidated public spending from AZN 2 billion to AZN 7 billion.** Particularly in the last two years, increases in investment expenditures were remarkable and exceeded 50 percent a year (Figure 4.3). Most of the increase was attributable to capital investment increases, the majority of which were allocated to economic affairs, primarily public construction works (including infrastructure). Azerbaijan's share of economic expenditures relative to GDP is the second highest in the region (Figure 4.4).

Figure 4.3: Azerbaijan: Consolidated Government Operations, 1999-2007



Source: IMF.

Figure 4.4: Allocation of Consolidated Budget: International



Source: IMF.

4.14. **In light of the large spending increases, it is useful to look at some specific sectoral utilities investments.** The government has invested intensively in the electricity and road sectors. From 2004 to 2007, AZN 420 million, or approximately 15 percent of the PIP, were spent in the electricity sector, especially for generation and transmission (Supervision Control and Data Acquisition/Energy Management System, or SCADA/EMS) to secure sufficient supply capacity (Table 4.5). The investments were focused on five modular power stations in Baku, Sheki, Astara, Naxchivan, and Khachmaz, at a total cost of AZN 350 million. Total installed capacity was increased from 5,140 MW to approximately 5,600 MW between 2004 and 2007.

Investment priorities in the power sector remain high to rehabilitate assets in power distribution to increase efficiency by reducing system losses.

Table 4.5: Azerbaijan: Consolidated Investment Budget2004–07 *(000 AZN)*

	2004	2005	2006	2007	Total 2004-07	Shares 2004-07
TOTAL	142.6	284.4	1,359.2	2,070.5	3,856.7	100.0
Administration	19.7	28.7	112.1	309.3	469.7	12.2
Social sectors	44.5	73.0	242.9	491.2	851.6	22.1
Education	10.9	10.4	47.3	94.0	162.6	4.2
Health	4.1	5.6	31.6	60.3	101.6	2.6
Social Prot. & Social Welf.	7.3	4.9	17.5	33.0	62.8	1.6
Culture, Art, Sports, etc.	4.2	12.1	36.5	179.9	232.6	6.0
Housing of IDPs[1]	18.0	40.0	110.0	124.0	292.0	7.6
Utilities and Energy	45.0	105.8	667.8	657.3	1,475.8	38.3
Utilities, urban amenities	15.9	49.9	352.7	257.6	676.0	17.5
Oguz-Qabala-Baku [1]	0.0	0.0	90.0	184.0	274.0	7.1
Agriculture, Forestry, & Fish.	11.1	34.9	66.1	138.7	250.8	6.5
Irrigation	9,1	13,2	71,2	148,7	242,4	6.3
Government Share in BTC [1]	18.0	21.0	110.0	0.0	149.0	3.9
Transport and Communication	25.8	72.0	181.8	419.6	699.3	18.1
Roads and bridges	12.7	12.5	113.9	279.8	418.9	10.9
AZAL	3.0	13.0	22.0	25.0	63.0	1.6
Baku subway	1.6	3.6	31.5	45.3	82.0	2.1
Baku-Tbilisi-Kars railway	0.0	0.0	0.0	50.0	50.0	1.3
Other	7.7	4.9	154.6	193.2	360.3	9.3
AIC - Statutory Capital [1]	0.0	0.0	90.0	0.0	90.0	2.3
SOCAR share in ACG[1]	0.0	0.0	0.0	89.0	89.0	2.3

Source: Azerbaijan authorities.
[1]Financed by SOFAZ

4.15. **For roads, the government has given the highest priority to major corridors, mainly the East-West and North-South corridors**. In particular, it has been emphasizing the importance of transport infrastructure to stimulate further expansion of the non-oil sector (especially agriculture, processing, and transit trade) and to improve the living standards of the poor. Road construction and rehabilitation accounted for approximately 10 percent of the consolidated government budget during 2004–07. To date, PIP has allocated approximately half of the road budget to highways (Table 4.6). Going forward, investments in other transit corridors and local roads need to be enhanced, because most of them are life-expired and require rehabilitation. The need for investment in roads and traffic management around Baku is emerging due to increasing traffic in the capital city.

Table 4.6: Azerbaijan: Public Investment Program for Transport Sector, 2004–07 ***(AZN)***

FUNCTION	2004	2005	2006	2007
Transport and Communications	17,790	29,099	181,642	369,580
o/w roads and bridges	12,740	12,513	113,917	279,750
Highways	12,740	9,147	50,604	131,294
Baku roads	0	0	55,018	146,026
Local roads	0	3,366	8,295	2,430
o/w water transport	0	0	13,800	1,043
o/w railways	450	0	400	15,350
o/w AZAL	3,000	13,000	22,000	25,000
o/w Baku subway	1,600	3,586	31,525	45,252
o/w communication	0	0	0	3,185

Source: Azerbaijan authorities.

4.16. **In the water supply and sewage sector, the highest priority is given to rehabilitation or reconstruction of water treatment plants and associated distribution facilities**, most of which have reached or are approaching the end of their economic lives. Until 2006, the government focused on improving water supply in the capital city under the Greater Baku Water Supply Project (Table 4.7). Today's focus is secondary citiessuch as Lenkoran, Shirvan, Masalli, Astara, and Mingechaur. The government is diverting a considerable amount of public resources to water supply and wastewater projects in secondary cities and rural areas, with the assistance of various foreign donors, including the World Bank. It also initiated a large-scale water resource transmission project, the Oguz-Qabala-Baku Pipeline Project, to deal with the long-run water source problem around the capital area.

Table 4.7: Azerbaijan: Public Investment Program for Water Sector, 2004–07 *(AZN)*

Water and Sewage	2004	2005	2006	2007
Counterpart share in the projects	860	1,037	10,040	12,135
Apsheron peninsula (Baku and Sumqayit)	1750	5,650	13,384	24,415
Rayons	13240	13,468	25,686	26,649
Meters installation			1,000	2,601
Oguz-Qabala-Baku pipeline			90,000	184,000
Total	15,850	20,156	140,110	249,800

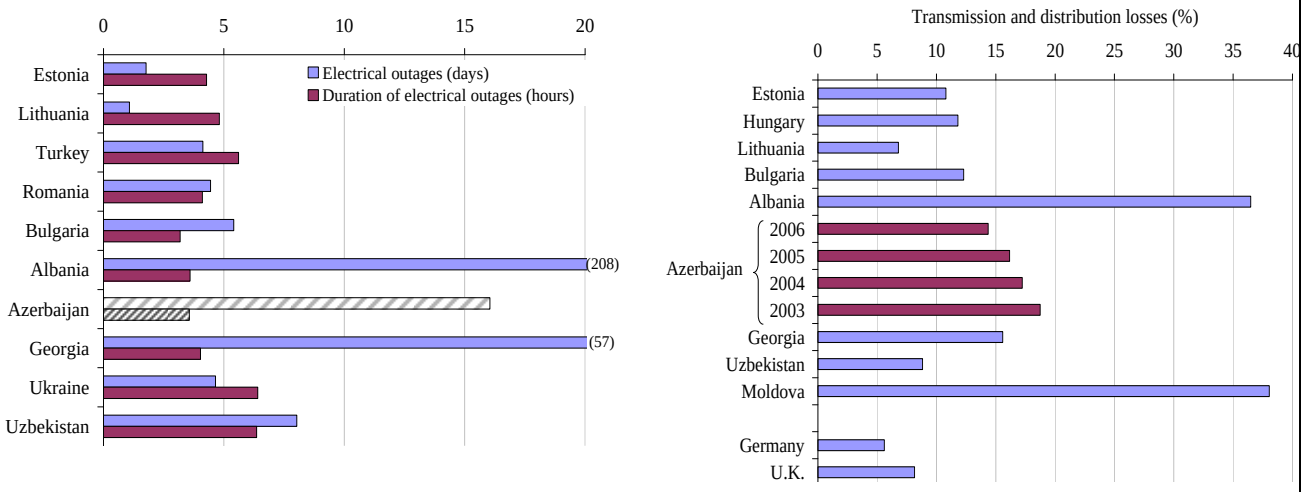
Source: Azerbaijan authorities.

4.17. **Despite heavily deteriorated railway infrastructure and locomotives, few government resources have been allocated to the railway sector** (Table 4.5). New investment is needed to fix deteriorated rail infrastructure and distressed mainline locomotives—primarily to maintain oil transport from Balajari (near Baku) through the Georgian border at Beyuk-Kasik to the Black Sea ports of Poti and Batumi. The government development program for the Azerbaijan State Railways for 2008–11 envisions substantial investments to the tune of AZN 1.2 billion (or $1.5 million) over the next five years.

D. ELECTRICITY

4.18. **Access to electricity is almost universal in Azerbaijan, and the quality of service has improved dramatically in the last two years.** Access is approximately 95 percent in the Baku area and almost 100 percent in the rest of the country—although occasional power outages still occur. The reliability of services used to be among the worst in the region, but by 2007 the country had restored a 24-hour electricity supply to most paying consumers according to Azerenrji, as a result of improvements in generation and transmission. The electricity frequency has also been improved, to achieve stability, by operating in parallel mode with Russia. However, technical efficiency in the transmission and distribution system, although improving, needs to be brought to international standards (Figure 4.5). Once a large investment in SCADA/EMS is completed (expected in 2011), Azerbaijan will be able to better manage electricity service levels and handle system emergency situations.

Figure 4.5: Electricity Service Quality And Technical Losses, 2004-05, Before Investments Initiated



Sources: BEEPS and WDI

4.19. **The market structure of the power sector in Azerbaijan is characterized as a variant between the vertical integration and single-buyer models**. The government has gradually involved the private sector in the electricity sector. The distribution segment is partially unbundled. The Baku network is served by a state-owned distribution company, while two of the three other distribution companies[91] are under a five-year private sector management contract with assets owned by Azerenerji. Nakhchivan has a separate distribution company. In the generation segment, the government is considering inviting independent power producers (IPPs) to add generation capacity.

4.20. **However, a critical strategic issue must be addressed.** Except for power distribution, the government's plans for the structure of the sector (division of labor between the public and private sector, scope to which private players could be involved, ownership, governance, and management practices) are neither clearly articulated to the participants in the sector, nor to the public. The future role of Azerenerji also is ambiguous. All options seem to be open, so it can be either a national transmission company or a generation company, or remain a national entity that generates and transmits power itself and possibly purchases additional electricity from IPPs. Azerbaijan also has the opportunity to explore its regional potential, given the possibilities for regional trade for electricity between the South Caucasus, Russia, Turkey and Iran. The government needs to make the important strategic decision for the country's role in the development of a regional power market, and if Azerenerji will be expected to contribute to that.

4.21. **The regulatory responsibilities distributed among the Ministry of Economic Development, the Tariff Council, and Azerenerji also are not clearly defined, particularly regarding the governance of power purchase agreements with potential private generators –these, in turn, will be best developed once the strategic decision is made.** At the moment, there is no independent regulatory body in Azerbaijan. There also is no consensus on who is responsible for governing power purchase agreements with potential private generators. It is generally recommended that a more market-oriented power structure be established (perhaps over the long term), linking distribution companies and power generators directly. Even though

[91] Sumgait and Sheki.

some government intervention might be needed so as to involve the private sector for augmenting capacity, it should be on an interim basis; it is recommended to return to market-based regulations by an autonomous regulator, once such initial contracts are completed. However, the government appears to be uncommitted, as it is not committing to a business model; this in turn delays critical decisions on investment, governance, and management. Consequently, the current approach to the provision of electricity continues to place extraordinary performance and financial risks on the government's shoulders.

Table 4.8: Electricity Tariffs in Azerbaijan, 2006–07
(AZN per kWh)

	2006	2007	Increase (%)
Residential	0.0192	0.0600	212.5
Non-residential	0.0260	0.0600	130.8
Trade and services	0.0600	0.0600	0.0

Source: Tariff Council.

4.22. **Some of the financial issues in the electricity sector have been solved by recent tariff adjustments and metering efforts.** Electricity tariffs seem to have achieved or are near cost recovery levels. The residential rate tripled in January 2007 (Table 4.8). By November 2007, the meter installation rates reached 100 percent in Baku and Sumgait, and nearly this level in the rest of the country.

4.23. **Nonetheless, the sector is not expected to be sustainable even at this cost level, unless collections are raised to near 100 percent.** Even though no government transfers were needed at the writing of this report, unless collections by Azerenerji reach nearly 100 percent, there is potential for the company to run operational deficits. These may materialize in several forms, such as accumulated arrears from distribution companies to Azerenerji or from Azerenerji to the State Oil Company, or otherwise accumulated backlogs of necessary maintenance investments. Collections from distribution companies—in reality from consumers—are improving. The wholesale power collection rate increased from approximately 46 percent in 2005 to nearly 53 percent by September 2007 (Table 4.9), and apparently has continued to climb significantly in 2008. However, the collection level is still unacceptably low and is undermining the financial viability of electricity distribution companies as well as of Azerenerji. It is necessary to improve commercial and technical efficiency, while containing additional unnecessary price increases in the future. Of particular note, the current tariff is a heavy burden on poor households, adding importance to providing an effective social protections system. Azerbaijan's relative price of electricity to PPP-based GDP per capita is exceeding those of the Baltic States and Bulgaria. Some of these countries have not yet fully incorporated increases into international energy prices in their tariffs. However, it is clear that Azerbaijan's electricity prices no longer are among the lowest in the region.

Table 4.9: Electricity Tariff Collection Rate From Distribution Companies, 2005–07 (%)

	2005	2006	2007 Sep.
Total	45.8	35.3	52.5
Barmek	52.2	8.4	
→ Baku electricity network		52.6	60.6
→ Sumgait electricity network		57.3	36.3
Baiva	34.1	24.2	
→ Other areas by Azerenergy		55.3	61.0
Nakhchivan electricity network	38.5	47.2	63.1

Source: Azerenerji.

4.24. **Strengthened demand management has contributed to curb excessive power consumption since the beginning of 2007.** Electricity used to be over-consumed because of uncontrolled non-payment or low electricity tariffs. Given higher power tariffs and universal

metering, consumers now have an incentive to use electricity more wisely. This approach should be applied to other infrastructure sectors as well.

4.25. **To sustain these positive outcomes, several reform agendas need to be strengthened further.** Electricity tariffs tripled to achieve cost recovery, and meters were installed almost everywhere. First, however, raising both retail and wholesale collection rates to nearly 100 percent is the most urgent and fundamental prerequisite for the sustainability of future sector reforms. Collections from distribution companies improved gradually but remain 50 percent to 60 percent in most areas. Second, Azerbaijan has invested a large amount of public money in electricity generation. However, large emphasis also should be laid on improvement in the distribution segment, which holds great potential for the sector to improve efficiency. It can be done through both physical investments and improved payment-incentive mechanisms. In this regard, rehabilitation of the transmission system and introduction of a SCADA/EMS system are important. Private sector participation in power distribution, following the cases of the Sumgait and Sheki networks, could, if done right, contribute significantly to improving commercial efficiency (Box 4.1). Private distributors should be granted a sound legislative framework that specifies the commercial nature of power supply only to those who pay the bills, the right to deny services to any consumer who fails to pay, and simple, fast, and cost-effective measures to recover payment arrears.

Box. 4.1: Private Sector Participation in Power Distribution in Georgia

Private sector participation in electricity distribution can help utilities improve metering, collection, and thus, financial viability. For instance, Georgia invited a private operator to distribute electricity in Tbilisi in 1998. Collections from customers increased from 44 percent in 2000 to 86 percent in 2002. During this period, revenue jumped approximately 170 percent, while the tariff was raised relatively modestly by around 20 percent (from 8.6 lari per kWh in 2000 to 10.3 lari per kWh in 2002). The tariff adjustment contributed to some revenue increases, but an aggressive tariff collection campaign through strengthening metering and enforcement measures explained most of Georgia's success. In addition, Georgia's experience indicates that this aggressive approach can be compatible with social concern by providing suitable subsidy and transfer to low-income households. The minimum amount of subsidy to cover lighting and some small electric appliances, but not heating, will mitigate the negative social effect to a large extent. In later years, following the Rose Revolution in 2003, the Georgian government used management contractors to enhance sector performance, followed by privatization of all the distribution networks outside the capital, both steps being important in securing the power sector's financial viability.

Source: Besant-Jones 2006

4.26. **In addition, the government needs to commit to a clear industrial structure to invite more private investment in the sector.** Azerbaijan may be far away from what could be a competitive environment in power generation. Nonetheless, IPPs could be allowed direct contracting with distribution companies and large customers. Direct, bilateral contracts have had a positive impact on payment collections in neighboring Georgia. They also proved to be effective in achieving a more competitive power sector. To oversee concessions, licenses, tariffs, and sector operations, a regulatory agency with sufficient autonomy, competence, and resources needs to be established. The Tariff Council, or regulatory body successor, also would have to articulate a transparent medium-term price adjustment mechanism, particularly responsive to non-competitive price elements (such as transmission fees) and inflation. Private investors in the power sector would seek predictability and public credibility in electricity prices. If the government fails to allow utilities to increase retail prices to the agreed levels, the public sector would be forced to compensate them for the possible negative spread between wholesale and

retail prices through transfers or subsidies. Otherwise, public credibility in private sector participation in infrastructure would be eroded (Box 4.2).

Box. 4.2: Private Sector Participation in Power Generation

In many countries, new private entrants to the power sector initially have been bound by contract rather than by a regulatory body. Such contracts may cause unintended impacts, such as underinvestment, wrong tariff level, and later become a hindrance to develop a liquid, competitive power market. A typical pitfall of the single-buyer approach is to involve excessive risk exposure when all commercial risk is transferred from private generators to a state-owned power purchaser under long-term power purchasing agreements (PPAs). The single-buyer model also does not involve direct market contract mechanism between generators and distributors, whence allowing a single buyer to commission excess generating capacity and pay too generous purchasing prices. In Poland, the electricity industry was unbundled in the early 1990s, and a single transmission company, Polskie Sieci Elektroenergetyczne, had as many as 24 long-term PPAs with independent power producers to cover two-thirds of total electricity required. These standard agreements complicated later efforts toward further liberalization. Hungary also was faced with the absence of linkage between PPA and retail prices, because the government did not raise retail prices to the full extent. It caused direct budget subsidies to be given to operators. It would be advisable to return to regulation by a regulatory body as soon as possible after an initial contract period.

Sources: Newbery 2001, Kessides 2004, and Besant-Jones 2006.

4.27. **To achieve a more advanced, competitive power sector involving wholesale power liberalization and competition, Azerbaijan should develop more sophisticated institutional mechanisms. But this decision needs to be taken with a broader strategic approach, particularly regarding the potential regional market.** In Kazakhstan, Romania, Turkey and Ukraine, fully competitive structures were adopted through unbundling and privatization. In the same way, Azerenerji could be unbundled more unambiguously by entirely separating operation and ownership of power distribution from the upstream activities. Furthermore, separating generation from transmission would be in line with international practices, notably in EU's competitive system. In Azerbaijan, such separation would make most sense if, at the same time, there would be intent to allow multiple generation companies to compete for the customers. An autonomous regulator needs to be equipped with full powers to oversee new entries to the sector, transmission and retail tariffs, maximum generation tariffs (given the lack of a real, competitive market), customer service levels, and trading arrangements. In addition, a power market operator would be needed in future, if and when a regional power market is introduced. Such regional market (beyond the South Caucasus countries) holds significant potential for efficient service delivery. This can be done by providing access to markets and generation capacities that in part will be complementary and on a larger scale, and thus by letting competition better work in the interest of consumers.

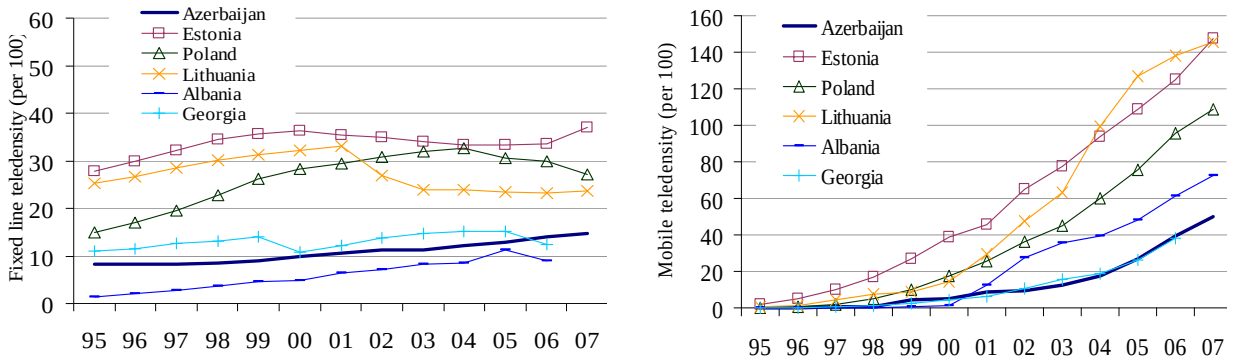
4.28. **Top-priority, short-run sector reforms** are to:

- achieve a near full payment collection at both retail and wholesale levels;
- complete strategic decisions as to structure of markets and exploitation of regional potential in the power sector ; consider the role and ownership of Azerenerji in the future restructured power sector; proceed with IPP contracts, as planned by the government;
- establish an autonomous regulator for independent tariff-setting and oversight of performance and operations of distribution companies, future IPPs, and Azerenerji;
- proceed with additional concession/management contracts for power distribution

E. TELECOMMUNICATIONS

4.29. **Despite a recent pick-up of the mobile market, Azerbaijan's access to telecommunication remains relatively limited compared with that of other regional countries.** Fixed-line *teledensity* is a very low 15 percent. Mobile access is increasing but remains at around 40 percent (Figure 4.6). The *quality* of telecommunications also is poor. Azerbaijan's fixed-line telephone fault rate is 46 per 100 main lines, which is twice as high as Turkey's and three times as high as Georgia's.

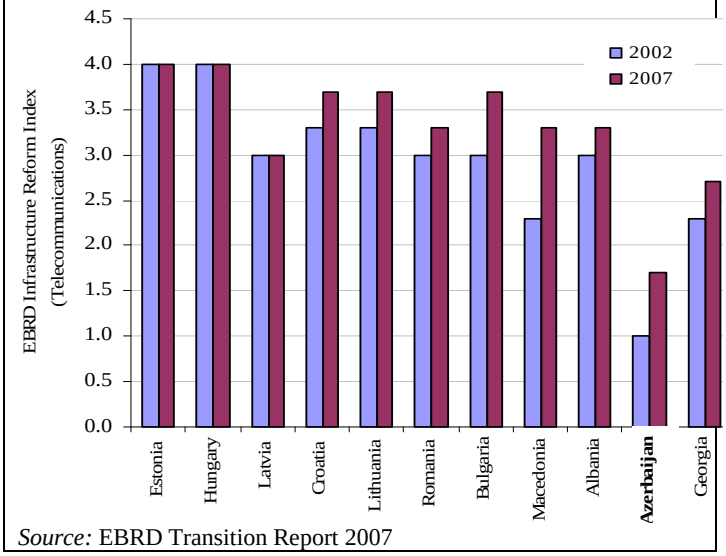
Figure 4.6: Fixed Line and Mobile Teledensity



Sources: WDI, International Telecommunication Union (ITU), and Ministry of Communication and Information Technology

4.30. **The government has embarked on some sector reforms**. Retail prices in the mobile market have been fully liberalized, and, in principle, the market is open to foreign investment. In 2007, a third mobile company, Azerfon (Nar Moblie), launched its operations, stimulating competition and expanding network access in the country. Interconnections are tightly regulated by the government but not in a transparent manner. To proceed with tariff rebalancing between local and long distance rates, the residential monthly fixed-line tariff increased from $0.70 in 2005 to $2.30 in 2007. In contrast, in 2007, the long-distance call rate was lowered from AZN 0.09 to AZN 0.07. There were no adjustments in the telephone tariffs in 2008.

Figure 4.7: Telecommunications Reform Index



Source: EBRD Transition Report 2007

4.31. **However, telecommunications reforms are still largely stagnant –the government can act.** The EBRD infrastructure reform index for telecommunications is the lowest in the region (Figure 4.7). There is still no independent regulator for telecommunications in Azerbaijan. The Ministry of Communications and IT is acting as both a regulator (except for tariff-setting) and a joint owner of telecommunications companies. Azerbaijan is one of the exceptional cases in which the

government still retains full state ownership of fixed-line companies and partial ownership of mobile carriers. The government can proceed to sell the fixed line operator to signal its openness to foreign investors.

4.32. **In the fixed-line market, further tariff rebalancing is also necessary.** The increased monthly charges are still considered below Azerbaijan's norm and are cross-subsidized by other telecommunications segments. Business user tariffs are still kept high. Notably, Azerbaijan has no unit rate for local calls, meaning that the monthly fee is a fixed payment without unlimited use. Furthermore, long distance calls are still expensive, despite a slight reduction in 2007. A seven-minute long distance call costs the same as the monthly fee. The government needs to accelerate tariff rebalancing and remove price distortion, maximizing market-oriented competition in each market segment.

Table 4.10: Interconnection Regulation

	Separate regulator	Accountability to:	Interconnection rates set by:
Estonia	Yes	Line Ministry	Operators
Latvia	Yes	No one	Regulator
Lithuania	Yes	President	Regulator, and operators
Turkey	Yes	Parliament	Regulator
Bulgaria	Yes	Council of Ministers	Regulator
Belarus	No	...	Operators
Azerbaijan	**No**	**...**	**Other Ministry (Tariff Council)**
Georgia	Yes	President	Regulator, and operators
Uzbekistan	No	...	Line Ministry, and operators

Source: International Telecommunication Union (ITU), Regulatory and Competition database.

4.33. **Telecommunications can be led primarily by the private sector, but at least two areas still require government intervention: interconnection regulation and licensing.** In Azerbaijan, Aztelekom and Azercell Telecom are significant operators in the fixed-line and mobile markets, respectively. The government should ensure effective competition through non-discriminatory and cost-based interconnection arrangements between incumbents and new entrants, possibly by spinning off a regulatory role from the Ministry or establishing a new independent regulator with political autonomy, accountability, competence, and resources (Table 4.10). Transparency and neutral dispute resolution measures are essential in regulating interconnection rates and access to essential facilities, such as local loops and international gateways. The state ownership of fixed and mobile operators also must be reduced further toward a more liberalized telecommunications market, because state ownership potentially complicates government regulations between incumbent and extant operators.

Box. 4.3: Accelerating Telecommunications Sector Reforms

In order to proceed further with telecommunications sector reforms, Azerbaijan can examine how to bring the private sector to the fixed-line market, but it should be consistent with the information and communication technology (ICT) market development strategy, on which the country first has to agree. Advanced ICT can be used not only to improve firm productivity but also to develop some new ICT-enabled markets. Based on the national strategy, the current telecommunications legislative and regulatory frameworks may have to be updated. In parallel, an independent regulatory body must be established to supervise not only pricing but also technical standards and license issuance. This sector is technically complicated and evolving rapidly; thus the regulator should be equipped with competent professionals. Interconnection and spectrum right issuance are its important regulatory areas. As a part of the reform package, then, Aztelekom can partly and gradually be privatized to a strategic private operator. The policy over how to unbundle its current and potential ICT services, including international calls, mobile and DSL, must be consistent with the development strategy, with the marketability of the firm taken into consideration. If a new private operator is obliged to maintain or extend the fixed-line network under unprofitable conditions, especially to remote areas, a universal access fund mechanism has to be established, to which all ICT operators would contribute. But the exclusivity granted to a fixed operator, should be kept to a minimum or perhaps to nil. The long-lasting private monopoly would likely undermine rapid and dynamic development of ICT markets. Good pro-competitive regulations on interconnections, open access and number portability are rather essential.

4.34. **Given the growing demand for telecommunications, especially in mobile services, a mechanism to efficiently allocate new licenses also needs to be structured.** Contestability for the market is crucial to maximize efficiency in license allocation. Predictable license issuance will facilitate dynamic market development among operators and across alternative information and communication technologies. There may be good potential to invite more mobile operators, perhaps to the third generation of mobile phone standards and technology (3G) market.

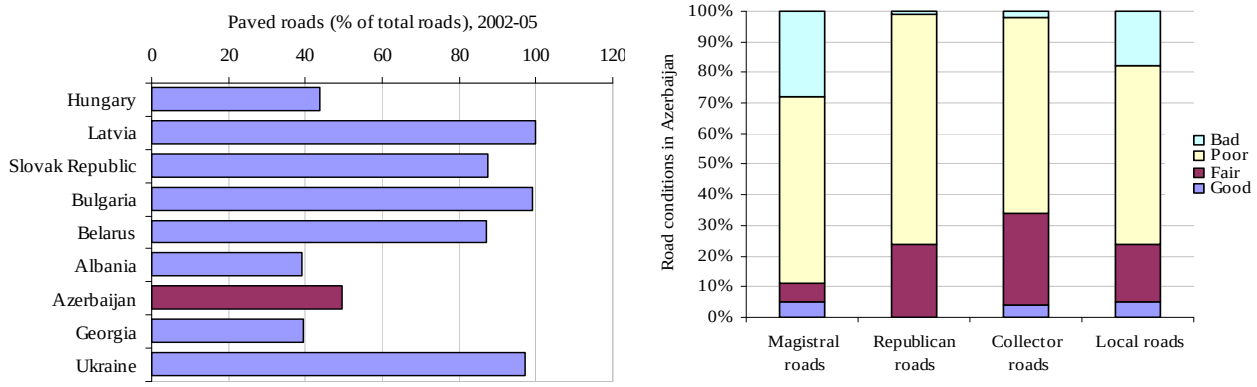
4.35. The **top-priority sector reforms in telecommunications** are to:

- preparation a comprehensive sector modernization strategy;
- establish an independent regulatory authority for telecommunications;
- sell Aztelecomm;
- set a transparent and non-discriminatory interconnection rule;
- reduce state ownership in the mobile joint ventures.

F. ROADS

4.36. **In Azerbaijan, road infrastructure is sufficient in both length and coverage for regional and international connections.** However, the condition of the majority of the network remains poor to dangerous (Figure 4.8). Unpaved roads account for 50 percent of the total network. Of the main corridors, 56 percent are estimated to be in poor condition, and approximately 30 percent need to be repaired urgently. Forty-five percent of regional and local roads are life-expired. Even though business users do not think transport is a serious constraint at the moment, the poor quality of roads represents a risk to Azerbaijan's expansion as a transit country. Furthermore, poor road conditions increase accidents and harm to people, vehicle damage, and CO_2 emissions.

Figure 4.8: Road Quality in Azerbaijan and Other Countries in the Region, 2005



Sources: WDI, PAD for Highway 2 Project

4.37. **Azerbaijan's recent economic buoyancy and accelerating motorization portend even greater risks to road quality.** Every year since 2003, the country has experienced more than 10 percent increases in registered motor vehicles. Without timely maintenance, local roads will deteriorate quickly due to greater domestic vehicle traffic. Finally, the poor quality of local road networks will likely have a negative impact on the anticipated expansion of the non-traditional, non-oil sectors, and the improvement of social and economic conditions in rural areas.

4.38. **With the help of a large amount of donor assistance, and with its own resources, the government has given the highest priority to major corridors, mainly the East-West and North-South corridors.** From 2004 to 2007, road construction and rehabilitation accounted for approximately 10 percent of the consolidated government budget. In addition, PIP has allocated approximately half of its road budget to highways. Investments in other transit corridors and roads around Baku also will be enhanced to accommodate future traffic growth. From 2008, the government intends to accelerate rehabilitation of regional and local roads, of which approximately 45 percent are life-expired.

4.39. **Road-sector development is constrained primarily by the lack of administrative capacity to implement necessary projects rather than financial resources.** The state road agency, Azerbaijan Road Services (ARS), continues to face a critical shortage of highly qualified transport professionals. Given an increasing number of road projects, of particular concern is the poor planning capacity, in which little attention is paid to the design and procurement process, including hiring consultants. In the past three years, the consolidated budgetary allocation to roads and bridges increased more than 20 times. As mentioned above, the acceleration of rehabilitation of regional and local roads from 2008 will impose additional tension on road authorities. Notably, the ARS routine maintenance unit tends to be unreceptive to modernization. There is a need to ramp up capacity in this unit by bringing in young and motivated professional staff.

4.40. **Another critical problem in Azerbaijan that affects roads is the lack of a sound multi-year budget system.** The appropriate multi-year construction and maintenance programming requires a flexible medium-term budgetary formulation. Furthermore, Azerbaijan has not yet developed high-quality road data banks to underpin efficient expenditures. Efficient and transparent procurement-based quality road data would save considerable resources. In

Azerbaijan, the *clarification of road agency accountability may be most important.* Other countries often reinforce accountability by establishing road agencies and road funds under which transparently competitive tendering of works are implemented, desirably against performance-based specifications.[92] Road funds also may attract private investment to develop road networks (Box 4.4).

Box 4.4: Road Fund and Private Motorway Development in Poland and Hungary

In 2004, Poland created a multi-annual off-budget financing institution, the National Road Fund (KFD), for road investments. KFD is designated to collect fuel surcharge revenues, concession fees, and toll revenues. It raises 250 million euros, or approximately 20 percent of total road expenditure, every year. The total allocation of funds reached €1.1 billion in 2005 and €1.5 billion in 2006. In Poland, tolls are charged on 210 km of a total of approximately 540 km (nearly 40 percent) of motorways. For passenger cars, 0.22 zloty, or €0.05 euro per km is charged, for instance, on Motorway A2, which was contracted out to a consortium of 18 Polish companies in 2000. The collected tolls are one of the major financial resources of the road fund. A potential risk of road concessions might be the low acceptance of tolls among motorway users. The charged rate may be considerably higher than consumer's willingness to pay, which is estimated at 0.10 zloty per km in the case of Poland's A2.

Similarly, Hungary's motorway concessionaires have encountered difficulties in charging the maximum toll rate allowed under the contract (initially €0.15 per km, in some cases).

Sources: INECO 2006, World Bank ECA 2006

4.41. **To strengthen institutional capability, in 2007, the Azerbaijan government restructured the former road administration agency, the Road Transport Service Department (RTSD).** RTSD was transformed into an independent joint stock agency, ARS, and separated from the Ministry of Transport (MoTr). ARS is intended to be in charge of ordinary road management; MoTr is expected to focus on monitoring and supervising road-sector performance. However, in practice, the exact division of responsibilities between MoTr and ARS is still unclear, so there is *no systematic or accountable implementation mechanism for road investment and maintenance*.

4.42. **Over the long run, Azerbaijan has the option to invite private operators for road construction and maintenance.** Even though private companies may operate only a small fraction of the total network, they will become an important efficiency vehicle to maintain sustainability of road network development. To encourage private sector participation in the road sector, again, a sound and predictable regulatory framework must be established. Concessions and motorway tolls to finance the development of rural road networks may be a long-term option for Azerbaijan.

4.43. In **the short run, the priority reforms** are to:

- complete road data-gathering to implement multi-year efficient road maintenance;
- obtain highly qualified road transport professionals for ARS;
- strengthen the monitoring functions of the Ministry of Transport through a management mechanism that articulates the discrete performance targets and mandates of MoTr and ARS.

[92] World Bank IEG 2007

G. RAILWAYS

4.44. **Railway is another strategic sector for Azerbaijan.** The demand for railways is increasing strongly due to the increased freight operations for oil and oil-products, which dominate rail cargo traffic. Azerbaijan exports approximately 2.2 million tons per month of oil products, mostly to and through Georgia. Passenger service represents only some 10 percent of railway traffic in Azerbaijan. The railway network is sufficiently covered.

4.45. **The oil and oil-product transport by rail is important not only for Azerbaijan but also for neighboring countries.** The Central Asian Republics are seeking options for their exports and imports to provide competitive alternatives to transport through Russia. Kazakhstan exports a large volume of oil. The route through the Caspian Sea and rail over the Caucasus may be one of the options, but only if inefficient Caspian shipping and port operations are further improved and ambiguous rail prices are reduced. In 2007, the governments of Azerbaijan, Georgia, and Turkey agreed on the long-considered Akhalkalaki-Karsakhi Railway to connect Baku through Georgia to Kars (near the Turkish port of Ceyhan). Azerbaijan Railway (ADDY) is a vertically integrated, state-owned enterprise. It will remain unable to operate at full capacity––80 km per hour for freight and 100 km for passengers—due to deteriorating rail infrastructure, unless proper maintenance and reinvestment take place. For example, on the East-West Corridor, 62 percent of the track is operating under speed restrictions. The aging locomotive fleets often experience frequent breakdowns. Nearly two-thirds of the railway's mainline locomotives are well past their service design lives and urgently need to be replaced. The railway's electric power supply infrastructure is also in extremely poor condition.

4.46. **Financial transparency in the railway sector is still weak.** The audited accounting indicates that in 2008 ADDY generated revenues of $346 million with net cash flow from operating activities of $95 million. In 2008, ADDY's net profit was $45 million. ADDY shows a growing level of account receivables from its customers (AZN159 million), indicating the need to manage its receivables more efficiently. Apparently, the profitable freight operations cross-subsidize loss-making passenger services (particularly domestic and commuter services). Tariff-setting also is not clear enough to outsiders. Actual prices paid for international and transit shipments are determined by government discount rates (in the order of 30 percent to 50 percent) applied to internationally-agreed tariffs. The discounts are not publicly announced. Therefore, since rail transport is arranged through freight forwarders, no customer can know in advance the discounted rate paid to the railway (as opposed to the freight forwarder) for its traffic.

4.47. **The railway structure must be adapted to a market economy.** The draft state program to develop the Azerbaijan State Railways for 2011–15 recognizes the need to make the railway commercially viable and market-oriented, and to create stronger incentives to be efficient and thereby create better service and greater transit potential for Azerbaijan. The government envisages the railways as a commercial entity and plans to create separate entities (subsidiaries) under the different lines of business (for infrastructure, freight, passenger, and non-core activities). A step in this direction was taken with the Presidential Decree issued on July 20, 2009, on the establishment of Azerbaijan Railways as a Closed Joint Stock Company.

4.48. **The government is encouraged to proceed with this corporatization and horizontal unbundling approach.** In particular, the full audit of the ADDY is underway and should be

completed shortly. This audit will provide important information for designing the next step of sector reform. Given the asset evaluation, the government also must examine the ownership issue carefully by comparing the *advantages and disadvantages of vertical separation and competitive access.* In a *vertically integrated system*—even though being overseen by different departments—track, passenger, and freight operations will be coordinated to a large extent and the railway can make reasonable trade-offs between investment/operating costs in infrastructure and investment/operating costs in operations. In a *vertically separated system*, a more complex regulatory system is required for safety, coordination of operations, and investment.

4.49. **There may be potential for multiple passenger operators in the future, but it usually is difficult to inject competition in the railway sector, even in countries with large volumes of traffic.** Although maintaining a state-owned monopoly is the most costly option, there are a variety of approaches to motivate the sector to improve efficiency. Private participation (such as concessions) in passenger and freight services is expected to increase productivity and service quality (Box 4.4). More importantly, however, several international experiences indicate that most of the benefits of structural reform come from flexible pricing and operational management granted to private operators, rather than from privatization *per se*.[93] Inter-modal competition is another important element. In Azerbaijan, competition against the East-West highway and the BTC pipeline cannot be ignored in modernizing the rail sector.

4.50. The **top-priority, short-term reforms** in this sector are to:

- conduct a full audit, asset inventory, and implementation of IFRS accounting;
- complete ongoing track and locomotive rehabilitation works;
- corporatize the railway and create a line-of-business structure;
- increase transparency in tariff-setting;
- assess introducing private participation in the passenger and freight operation segments.

H. WATER SUPPLY AND WASTEWATER

4.51. **In Azerbaijan, access to improved water sources remains very low in rural areas.** While the access rate in urban areas, especially around the Greater Baku Area, is more than 90 percent, rural access may be less than 40 percent, which is among the lowest in the region. The regional disparity between Baku and small rural towns is striking. While 93 percent of households in Baku have access to piped public water services inside their houses, this could range from less than 10 percent to 70 percent in other areas. In rural areas, the dependency on piped water supply is especially low. Only 11 percent to 33 percent of rural residents rely on piped water. The *quality* of water supply services also is much worse. Finally, the *reliability* (or continuity) of water supply remains one of the most critical problems in Azerbaijan.

4.52. **Azerbaijan's wastewater treatment facilities are also poor, even in urban areas, including Baku.** In Baku, 78 percent of residents are covered by the sewerage network. However, only 50 percent of wastewater is treated due to poor treatment facilities. Sewerage network coverage in other urban areas is estimated at 32 percent, and the majority is not treated.

[93] Kessides 2004.

In rural areas, people depend on on-site sanitation. Only 36 percent of the rural population is estimated to have access to improved sanitation facilities. There is no effective regulation to ensure on-site sanitation, which therefore is dependent on households for construction.

4.53. **The most critical problem of the sector is that a state-owned nationwide water enterprise, Azersu, does not generate sufficient financial resources to maintain and improve its existing facilities.** Azersu Group (Azersu and its subsidiaries) is a large public enterprise responsible for providing all water supply and sanitation services in 55 regions or districts (*rayons*) in the country. The exceptions are four cities served by independent subsidiaries and Nakhchivan. The Azersu Group has approximately 910,000 customers (connections); it produces approximately 660 million m^3, and sells 500 million m^3 of water a year. However, performance targets and mandates have not yet been clearly agreed upon between the government and Azersu. All water sector reforms, including billing and revenue improvement measures and demand management practices, such as universal metering, have been relatively slow in comparison with the electricity sector. Consequently, the financial outlook in the water sector has remained poor, in turn affecting the company's ability to make sorely needed investments to improve service quality. The company still depends largely on government and donor funding to finance significant investments in the sector. In 2006, Azersu had $320 million of payables for Greater Baku and the Absheron Peninsula, most of which were due to Azereneji, because half of Azersu's operating costs are electricity. At the same time, Azersu accumulated $321 million of receivables by 2006, mainly from customers.[94]

4.54. **To restore the financial viability of the sector, the government has just initiated gradual sector reforms.** In January 2007, the residential water tariff was doubled from AZN 0.09 to AZN 0.18 per m^3 (Table 4.11). The total operating cost for 2006 is estimated at AZN 0.12 per unit of water produced (m^3), and, in theory, this amount should be covered by the current tariff level. However, Azersu is still running deficits, because the number of households directly affected by the tariff adjustment remains very limited, since the current metering rate is only 30 percent. In 2007, the government reduced the consumption norm for a number of customers without meters from 0.4 m^3 to 0.2 m^3 per capita per day. The full revenue effect will be realized once universal metering is fully achieved. Given the current metering rate**,** the average tariff would have to be AZN 0.53 per m^3 to achieve full cost recovery. The metering program is progressing, but slowly, particularly for residential users. The total metering rate increased from 6 percent in 2005 to 30 percent in 2007.

Table 4.11: Water Tariffs in Azerbaijan, 2005–07 (AZN per m3)

	2005	2006	2007	Increase (%)
Major cities 1/				
Residential	0.087	0.087	0.180	106.9
Commercial enterprises	0.630	0.630	0.700	11.1
Industrial use	10.000	10.000	12.000	20.0
Other areas				
Residential			0.140	
Commercial enterprises			0.700	
Industrial use			12.000	

1/ Baku, Sumqayit, Ganja, Mingachevir Ali-Bayramlı, Xirdalan cities and Absheron district.

Source: Tariff Council.

[94] Based on unaudited 2006 accounts.

4.55. **In addition, ineffective water accounting and unaccounted for water is far above the recommended level in well-maintained systems (less than 15 percent).** Unaccounted for water in Azerbaijan amounts to more than 25 percent of total water produced by Azersu (Table 4.12). Half of this is associated with leakages in service pipes within buildings. These technical losses are greatly hampering effective water provision and financial viability.

4.56. **Collections also need to improve significantly**. The rate of water tariff collection is as low, approximately 60 percent, as that of the electricity sector. The collection rate increased from 52 percent in 2005 to 57 percent in 2007 in the Greater Baku Area, and from 61 percent to 63 percent in other regions during the same period (Table 4.9). The dismal performance is attributed primarily to the large amount of unaccounted for water, absence of meters, and weak legal measures. To improve the situation, a short-term priority should be focused on completing universal metering, followed by strengthened efforts toward full tariff collection. Legal enforceability for non-payers also should be strengthened. Given the implementation of cost recovery tariffs, government funding for operational subsidies should be phased out.

Table 4.12: Unaccounted-for Water in Azerbaijan, 2005-07

	2005	2006	2007 Sep.
Total			
Water production (million m3/year)	659.5	664.5	449.2
Water consumed (million m3/year)	497.6	493.1	271.7
Loss (%)	24.5	25.8	39.5
Greater Baku area			
Water production (million m3/year)	550.6	541.7	371.8
Water consumed (million m3/year)	400.1	389.2	206.8
Loss (%)	27.3	28.2	44.4
Other regions			
Water production (million m3/year)	108.9	122.8	77.3
Water consumed (million m3/year)	97.5	103.9	64.9
Loss (%)	10.4	15.4	16.1

Source: Azersu.

4.57. **Experience elsewhere has shown that private sector participation in management of the water sector can significantly improve operational efficiency** (Box 4.4). There is a wide range of choices to improve efficiency: service contract, management contract, lease, concession, and divestiture. If some specific activities, such as metering or billing, are contracted out, service contracts or managements contract are appropriate. The majority of water-sector private participation in Latin America and East Asia takes the form of concessions. The reason is that some investments are needed to expand the coverage and rehabilitate the existing networks. For example, Estonia, Hungary, and Poland introduced water concessions.

4.58. **The important precondition for private participation is that the regulatory framework, including tariff-setting, must ensure private operators a return on their investments commensurate with the risks.** Too low tariffs are out of the question. Effective legal measures should be granted to both protect and regulate operators. Moreover, the government's ongoing works to rehabilitate water treatment plants and distribution networks would reduce the uncertainties in possible private operation, which would attract more private operators to the sector. For the same reason, Azersu also must reduce water leakage at the service pipe level to lower the rate of unaccounted for water.

4.59. **Toward possible private sector participation in the sector, following the universal metering and full tariff collections, Azersu must be corporatized, and the capacity of local governments to participate in the water supply sector built up.** The next step is for the government to horizontally unbundle the sector into three to five regional utilities covering

several *rayons*, to improve economies of scale and effectiveness in operation at the rayon level. Based on the assessment of financial viability and technical feasibility of individual *rayons*, the regional utilities could operate as subsidiaries under the performance contracts with Azersu. The supervisory regime, including the role of Azersu and local governments, needs to be streamlined at that time.

4.60. The **top-priority, short-term reforms in the water sector** are to:

- corporatize Azersu, build up local governments' capacity, and unbundle the sector horizontally to create three to five regions;
- achieve universal metering;
- achieve a near 100 percent tariff collection;
- complete ongoing rehabilitation works in secondary cities;
- reduce unaccounted for water.

Box 4.5: Private Sector Participation in the Water Sector in the Czech Republic and Bulgaria

Since the early 1990s, the Czech Republic has gradually privatized its water and sewerage sector. In 1999 in České Budějovice, the South Bohemian capital of the republic, a private operator was granted a 12-year lease contract. The private sector participation lowered the ineffective and unaccounted for water rate from 37.4 percent in 1999 to 24 percent in 2004. Similarly, in the second largest urban agglomeration, Ostrava, privatization of the utility reduced unaccounted for water from 45 percent to 9 percent during the same period. Collections improved from 89 percent to 100 percent. A private water operator in Prague, Pražské vodovody a kanalizace, a.s., decreased unaccounted for water from 32 percent in 2000 to 24 percent in 2004. Moreover, the collection rate was raised from 94 percent to 98 percent during the same period.

In many other cases, the agreed performance could not be met by private contractors. For instance, unaccounted for water and collections could not be improved as intended in Brno in the Czech Republic, and in Sofia, the Bulgarian capital. The results depend on the specific investment context as well as the regulatory and contractual design.

Sources: World Bank ECA 2006, PPIAF database.

I. CRITICAL CROSS-SECTORAL ISSUES

4.61. **To date, Azerbaijan's model to develop network utilities has been publicly funded and managed.** The principal reforms have aimed to strengthen service delivery and to secure financial viability. To expedite the improvements in service delivery, Azerbaijan has at once sought to fund critical investments from the consolidated budget, while pursuing financial viability with increases in tariffs and the introduction of metering. The government also has embarked on some structural reforms, gradually implementing corporatization in some cases and inviting the private sector to operate infrastructure in other cases.

4.62. **Financial viability needs to be further strengthened by the adoption of a clear pricing policy that capitalizes on the 2008 adjustments.** In preceding years, utilities have been subject to substantial indirect subsidies, which, in principle, were eliminated in 2008. The implicit subsidies on utilities were estimated at 4.7 percent and 3 percent of non-oil GDP in 2006 and 2007 respectively. The tariff adjustment is expected to eliminate the need for these subsidies. However, going forward, the TC needs to render future tariffs more predictable by specifying a tariff policy that foreign investors can access and assess. The present process is opaque to outsiders. The MOF, the TC, and the SCMSP need to strengthen their coordination efforts to ensure financial viability.

4.63. **Azerbaijan can further differentiate between regulators and service providers.** The current regulator, the Tariff Council, is far from a standard independent regulatory model. Given the sensitivity of tariff adjustment to political developments, this arrangement may have been understandable until 2008. However, with rates now near cost recovery levels and the social assistance system in place, moving to an independent regulator should become a priority, particularly since the January 2007 tariff increases, which for the most part ended the need for energy subsidies (the 2008 consolidated budget included no subsidies for energy).

4.64. **Another important element missing from the government's strategy is private sector participation.** International experience has indicated that efficiency in the provision of service delivery, and service equality are more likely to be gained from: (i) a clear separation of service providers; (ii) structured incentives; and (iii) sound and credible regulation. Particularly given the more limited oil revenues during the next few years, the government needs to reinvigorate its efforts to improve the performance of SOEs, so that it can attract investors in the post crisis period.

CHAPTER 5.
ENCOURAGING A BROADER, MORE COMPETITIVE PRIVATE SECTOR

The preceding analysis, particularly in Chapter 2, provides two general observations: First, in spite of the surge in foreign exchange revenue from oil exports, Azerbaijan's economy is still broad-based, although in dire need of modernization in order to enhance its international competitiveness**.** Although public expenditures in infrastructure should contribute significantly to increasing productivity, private investments, foreign and domestic alike, are required for Azerbaijan to innovate and develop new products consistent with its new terms of trade. They are also indispensable to generating employment and growth through diversification. Second, despite strong growth of the non-oil sector, Azerbaijan's economy often operates below its production frontier. The reasons are diverse, ranging from scarce or poor-quality inputs to high cost of imports to lack of know-how. As shown in Chapter 2, the common denominators are weaknesses in business environment and excessive presence of state, leading to politicization of corporate management and weaknesses in policies supporting agricultural development.

This chapter recommends policies, hereafter referred to as "entry and expansion package," designed to exploit untapped entrepreneurial potential of Azerbaijan through removal of some constraints in economic regime that suppress business activity. The package consists, among other things, of lowering formal and informal barriers to entry and expansion of the private sector in exchange for increased tax reporting of sales and income in the formal economy. It follows naturally from the progress reflected in *Doing Business* and the new State Program for Customs Modernization. Small firms may find the package attractive as due relief for the rising terms of trade that they face. Larger firms may benefit from the growth in market size (although not necessarily in market share), higher-quality local inputs, and fewer hurdles to doing business. Officials accustomed to rent-seeking would lose rents but they would benefit from higher levels of compensation and professionalism and, in the end, more job security.

The chapter, as does the rest of the report, considers that the forthcoming five-year period will be one of relatively high oil revenues for Azerbaijan (even should oil prices have dropped significantly) and presents a unique opportunity for the country to develop a non-oil tax base that would ensure sustainability of Azerbaijan's economy while providing reduced disruption to private sector activity.

A. INTRODUCTION

5.1. Azerbaijan's private sector is reputed for its trading capacity. It also carries a wealth of experience from operating in a diverse economy through the Soviet era and in surviving the transition after independence. For a developing economy, open access to world markets for goods, capital, services, and know-how is key to development. Likewise for Azerbaijan, growth and employment prospects are based on the expansion of agriculture (for domestic consumption and regional trade) and services (transport and transit along the traditional Silk Road route). However, manufacturing can also play a role in the medium term. The government can do much more to enable the private sector to lead the country's development, to reach its productivity and

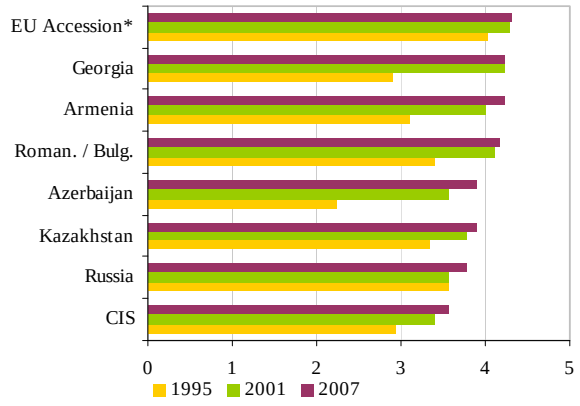
employment potential, and to capitalize on trade opportunities. Some indicators from international surveys suggest that Azerbaijan's government is too involved in the private sector—much more than in other countries—which makes for an uneven playing field and a rather unwelcoming business climate. Inconsistencies in customs data, among others, support this claim. The uneven playing field is exacerbated by a tax system that is biased against formal operation of enterprises—yet collects only approximately 20 percent of total revenues from the smaller "entrepreneurial" tax base. Informality entails efficiency costs for the economy and revenue losses for the state treasury.

5.2. This chapter casts a broad net on the nature of productive sector activities in Azerbaijan, and looks into the relations between the government and the private sector. The purpose of the chapter is to: (i) provide an overview of the operating environment; (ii) identify hindrances to formal operation; and (iii) offer recommendations to improve the private sector environment so that economic activity in the formal sector is encouraged. This chapter continues the discussion in Chapter 2 about the monopolistic nature of Azeri markets, which illustrates the low level of competition in most of Azerbaijan's economic sectors. This chapter seeks to understand how this low level of competition is sustained at a systemic (or "macro") level and to recommend interventions that would mitigate its impact.

B. INTERNATIONAL STANDINGS

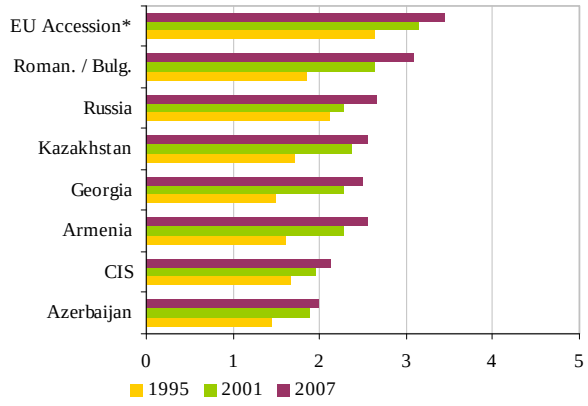
5.3. **A snapshot of Azerbaijan's private sector operating environment reveals substantial progress since 1995. However, it also leaves room for improvement, especially relative to comparators**. The EBRD transition indicators of *first-generation reforms* show that although Azerbaijan started its transition rather late than many comparators, it has made relatively more progress than they have, particularly between 1997 and 2001 (Figure 5.1); the indicators include small-scale privatization, price liberalization, trade, and the foreign exchange system. However, from 2001 to 2007, the pace of Azerbaijan's reforms slowed, particularly relative to neighboring countries.

Figure 5.1: First-Generation Reforms



Source: EBRD Transition Indicators.
Note: (*) Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, and Slovenia.

Figure .5.2: Second-Generation Reforms



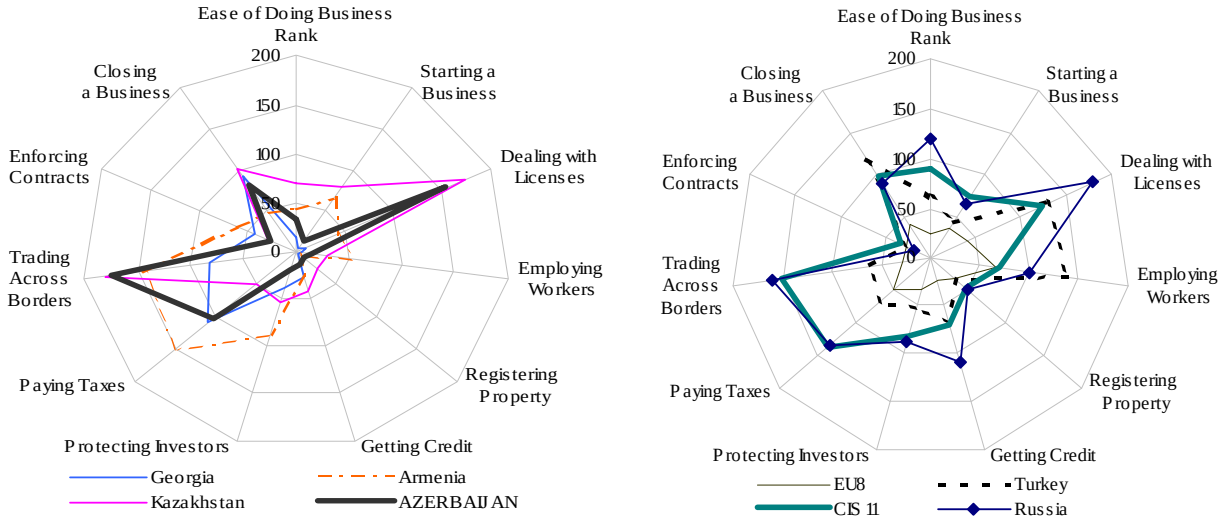
Source: EBRD Transition Indicators.
Note: (*) Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, and Slovenia.

5.4. **Institutional underpinnings supporting competitive markets, as revealed in the progress achieved in second-generation reforms, are not yet fully in place.** *Second-generation reforms* include large-scale privatization, governance and enterprise restructuring, competition policy, banking reform and interest rate liberalization, securities markets and non-bank financial institutions, and infrastructure reform. By these measures, Azerbaijan lags behind all comparators (Figure 5.2) and has made little progress since 2001. While first-generation reforms are considered important to enable the price mechanism to function properly, second-generation reforms are important to develop market institutions. The above ratings of second-generation reforms imply that Azerbaijan's economy maintains significant inefficiencies and distortions in allocation of capital. For example, public utilities and large infrastructure services is still primarily in the hands of the state. To date, the privatization of any large public utilities has not taken place.

5.5. **Azerbaijan has recently made significant progress in facilitating some aspects of private sector operations.** Azerbaijan ranks 33 in IFC's global ranking in *Doing Business 2009* (the report ranks the business environment in 2008), up from 97 in the previous year**.** It won the title of the world's number one reformer in 2008. The most important reform has been the establishment of a one-window system to register enterprises, which has dramatically cut the number of days it takes to register— from 114 in 2005 to 16 in 2008.

5.6. **Yet, little progress has been made in some areas, which are critical if businesses are to take advantage of new opportunities created by reforms.** As can be seen from data presented in Figure 5.3, Azerbaijan's rankings are low for **three critical areas: (i)** dealing with licenses; (ii) paying taxes; and (iii) trading across borders**.** Along with taxation, trading across borders is of particular concern to Azerbaijan because the country's diversification strategy rests on successfully integrating into global markets and transit trade. Of special interest to Azerbaijan are the ongoing reforms in Georgia and Turkey, which favor trading but also ensure the ease of paying taxes and protecting investors.

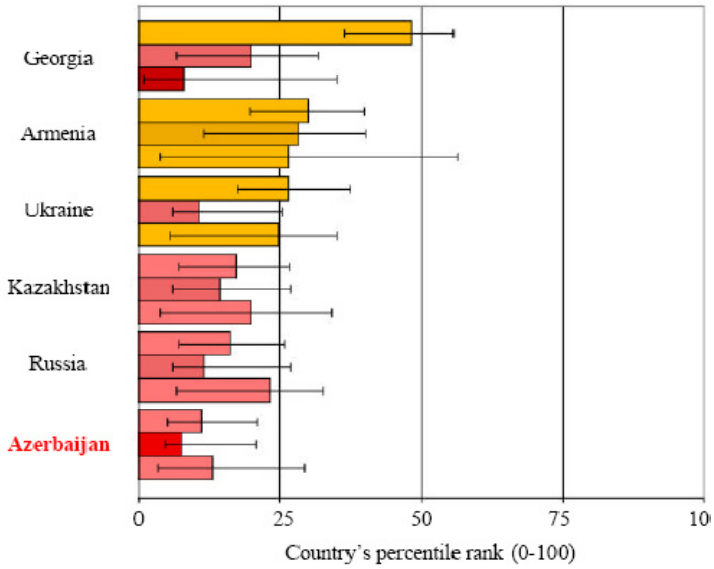
Figure 5.3: Business Environment Regulations in 2008: Europe and Central Asia



Source: Doing Business 2009

5.5. **Azerbaijan's private sector often must contend with significant government involvement in the economy…** As noted in Chapters 1 and 2, Azerbaijan's private sector has three defining characteristics: (i) it operates in the presence of a *very large central government* and competes with it for scarce, non-tradable resources; (ii) it operates alongside a *large state enterprise sector* comprising small, medium, and large enterprises that often operate in a preferential playing field; and (iii), as discussed below, a good part of the private sector has close relationships with the government, either by design or necessity. The large role of the state sector in entrepreneurial activities also contributes to corruption (Figure 5.4).[95] Relationships between the government and favored firms imply lack of contestability in domestic markets. This often results in higher prices, low quality products, and poor product diversity. Likewise, exports also may suffer, especially those requiring imported inputs, since imports of raw materials can be hindered by government agencies. These relationships appear to lead to the emergence of "local monopolies."[96]

Figure 5.4: Control of corruption *(Comparison Between 2007, 2000, and 1996, Top-Bottom Order)*



5.6. **…as supported by micro data on MSMEs (firms below 250 employees)**. This environment restrains the MSME sector's potential contribution to economic transition, diversification, and, more fundamentally, employment creation, raising concerns about policy barriers to entrepreneurial activities. Of 106 countries included in the IFC database of MSMEs, Azerbaijan ranks 81 in the number of MSMEs per 1,000 people.[97] It also ranks much lower than new EU members from Central Europe, but higher than Moldova (Table 5.1). Research on transition economies has demonstrated the important role that MSMEs have played in the transitions of other countries by venturing into new products that steer the economy away from the "old sectors" and by being significant employers.[98] Looking to the future possible size of its MSME sector as a successfully diversified economy with natural resources, Azerbaijan can increase the number of its firms six-fold (relative to the population) to match Chile, or three-fold, to match Malaysia today. Multiplying the number of firms would be one means to enable Azerbaijan's private sector to play its critical role in diversifying the economy.

[95] The figure is based on indicators that measure "the extent to which public power is exercised for private gain, including petty and grand forms of corruption, as well as 'capture' of the state by elites and private interests". See Kaufmann and others 2008.
[96] For illustrations, see Chapter 2.
[97] For instance, Albania, with a population of 3.6 million, had 78,000 active firms in 2007. By this rationale, Azerbaijan, with a population 2.4 times larger than Albania's, should have 186,000 active firms. However, it had only 33,000 active firms, or 17% of the "population"-equivalent number of firms of Albania.
[98] World Bank 2002.

Table 5.1: MSMEs in Selected Countries *(by size and per 1,000 people)*

	Micro and small firms with employment below 50	Medium firms with employment 50–250	MSME employment (% in total)	Total firms per 1,000 people
Albania (2004) (c)	98.5	1.5	44.3	12.3
Azerbaijan (2006)	**99.0**	**1.0**	5.0 (d)	**7.2**
Armenia (2005)	95.7	4.3	34.0	33.1
Botswana (2005)	**96.9**	**3.1**	n/a	**7.4**
Bulgaria (2003)	98.5	1.5	79.0	27.7
Chile (2004) (a)	**96.6**	**3.4**	95.0	**43.9**
Estonia (2005)	98.0	2.0	n/a	48.5
Malaysia (2005) 9b)	**97.8**	**2.2**	65.2	**20.5**
Moldova (2003)	89.3	10.7	21.6	6.1
Poland (2001)	99.2	0.8	67.1	43.3

Sources: For Azerbaijan, based on data from the Ministry of Justice. For other countries, based on data downloaded from World Bank, "Micro, Small, and Medium Enterprises: A Collection of Published Data" database on April 5, 2008.

Notes: (a) Micro and small below US$750,000. (b) Manufacturing sector. (c) Dataset contains only firms employing fewer than 50 people; others include firms with 20–49 employees. (d) Data for 2003.

C. THE STATE AS A MAJOR PRODUCER AND INVESTOR

5.9. **The rapid increase of the public sector since 2005 was intended to improve economic conditions in the country but it has, at least temporarily, stifled the development of the private sector**.[99] With Azerbaijan's consolidated budget expected to reach 85 percent of non-oil GDP in 2008, its public investment will reach 37 percent of non-oil GDP. With total investment in the economy amounting to 50 percent of non-oil GDP, the government will be managing up to 76 percent of the country's non-oil investment in 2008. Given Azerbaijan's poor corruption ratings, the generally slow progress in public sector reforms and increasing contestability of domestic markets, the risk of perpetuating an uneven playing field is quite significant. In fact, although the ratings are a subject of significant debate, Azerbaijan's corruption ratings significantly deteriorated from 2005 to 2007. This suggests that domestic markets are being increasingly protected at the cost of entrepreneurship development.

5.10. **Non-oil private investment declined in 2007, suggesting that crowding out may be taking place**.[100] A careful examination of the 2007 non-oil private investment data for Azerbaijan shows investment fell by about 4 percent of non-oil GDP since 2006. Of this drop, about half was owed to a decline in residential construction, and one-third to the transport (Table 1.6).[101] *Over 2006–07, this report estimates that non-oil private investment (excluding investment in government-owned sectors -mainly utilities and petrochemicals- and excluding*

[99] Note that SOEs account for more than two thirds of value added created by the non-oil private sector (see Chapter 2).

[100] Crowding out typically refers to a reduction in private investment due to increased government spending financed by public borrowing. *The mechanism for crowding out is the interest rates*. Government borrowing normally raises the interest rate by increasing the demand for investable funds, which, in turn, raises the cost of investment. This results in declining private investment.

[101] Construction of residential buildings was essentially frozen in 2007, following the collapse of a building in downtown Baku. Construction is expected to resume in late 2008, once norms have been revised and inspections completed. In 2007, investment in transport, retail, and wholesale trade, dropped by 1.7 percentage points of non-oil GDP, while investment in processing industries, including food, increased by 0.7 percentage points of non-oil GDP.

residential construction) dropped approximately 19 percent in real terms. This suggests an important decline in investment toward diversification of the economy.

5.11. **Azerbaijan also has a large number of SOEs (in this context excluding utilities and social services), which may hamper competition.** In 2007, Azerbaijan had 11,666 state-owned enterprises out of the total of 74,534 enterprises.[102] In 2006, the state sector accounted for 32 percent of total employment (declining slightly from 34 percent in 2004). State enterprises are often attached to line ministries or budgetary agencies, and in effect implement projects that these agencies fund. In 2006, SOEs made up approximately 25 percent of construction, 25 percent of transportation, and 13 percent of manufacturing enterprises. The June 2008 *Country Procurement Assessment Review* points to significant flaws in the Public Procurement Law that hinder fair competition. These flaws underline the fact that: (i) only contracts above a certain threshold need to be advertised; (ii) implementing agencies can restrict bidding by regulation; and (iii) the open bidding threshold is set at AZN 250 million.

5.12. **The regulatory gaps for SOEs create operational loopholes for public agencies that limit competition, and thus require further study**. Citing the opportunities provided by the legal and regulatory frameworks to limit competition, several members of the business community have indicated that they do not bid for government contracts. This seems to be true, because the pace of privatization has slowed dramatically: 1,280 enterprises were privatized during 2002–05, compared to 125—just one-tenth —during 2006–07. This suggests that the pace of government disengagement from production during a period of high oil revenue is slowing rather than accelerating. Two EBRD Transition Indicators for Azerbaijan—"large scale privatization" and "enterprise restructuring"—also show that it trailed its comparators in 2007.

5.13. **The aforementioned discussion raises a strategic question for Azerbaijan**. Should the government seek to broaden the direct reach of the state, or should it just seek a greater *regulatory* role for itself and accelerate second-generation reforms? John Maynard Keynes usefully stated, "The important thing for government is not to do things which individuals are doing already, and to do them a little better or a little worse; but to do those things which at present are not done at all".[103] The unambiguous answer to Azerbaijan's strategic quandary is that the state should focus on creating incentives for private business rather than on production. With great urgency, Azerbaijan needs to slow the increases in public spending and intensify its reform program. The oil boom provides ample opportunity to compensate potential "losers" for the consequences of second-generation economic reforms, particularly small- and large-scale privatizations. While legislative action on procurement and licensing may level the playing field for SOEs and the private sector, the pressures from SOEs for favorable treatment are likely not only to remain but also to prevail. As such, transparent privatization would be the best option to assure effective corporate governance.

[102] While precise figures for comparators are difficult to come by, EBRD Transition Indicators suggest that Azerbaijan's rating (2.00) is below the EBRD average (3.7 of 4+ scale) for large-scale privatization, while it is much closer to the EBRD average for small-scale privatization (3.7 for Azerbaijan vs. 3.9 for the average) and for enterprise restructuring (2.0 for Azerbaijan vs. 2.5 for the average).

[103] John Maynard Keynes, "The End of *Laissez-Faire*."

D. INCENTIVES FOR ENTRY AND EXPANSION

Overarching Framework, Competition, and Protection of Investors

5.14. **More than a decade after Azerbaijan submitted an application to join the World Trade Organization (WTO), the country's foreign trade policies and institutions still are not WTO compatible.** WTO membership by itself does not guarantee a higher-quality foreign trade regime. However, it does require transparency, stability, and predictability in market access conditions for both exporters and importers. As long as Azerbaijan is not a member, its exporters will not enjoy the protections of WTO's multilateral discipline. Moreover, this lack of WTO protection also depresses trade-related investment, both foreign and domestic, and suppresses competition from imports. Therefore, *the success of Azerbaijan's diversification strategy hinges critically on WTO membership*.

5.15. **Azerbaijan has also been facing delays in the preparation of its investment law and its competition law.** Both have been submitted several times to parliamentarians, however, adoption of these laws continues to be delayed. At this stage, it remains important that these draft laws be adopted according to international standards.

Registration, Licensing, and Land Issues

5.16. **Azerbaijan has undertaken a host of regulatory reforms in recent years, which culminated in a very high global ranking in *Doing Business* for 2007/8.** Because of its recent private sector enabling reforms, Azerbaijan had been recognized as a top reformer, globally and regionally. In September 2007, it eliminated the minimum threshold for reporting loans to the public credit registry, which now records information on all loans made by the financial system. This has more than doubled the coverage of borrowers with credit histories. Moreover, major amendments to the labor code in May 2007 made it easier to hire workers by allowing employ*ers to use fixed-term contracts for permanent tasks, easing restrictions on night work, and* reducing requirements for redundancy dismissals. Azerbaijan also created a second commercial court in Baku, while increasing the number of judges dealing with commercial cases from five to nine. A new law strengthened investor protections by requiring shareholder approval of all transactions between interested parties, who are allowed to vote on the matter. In addition, directors who are held liable must now pay damages and refund profits. Azerbaijan also introduced a new unified property registry, reducing the number of procedures required to register property from seven to four. The State Registry Service now also has the option of expediting two of the four procedures, making it possible to register property in 11 days, down from 61 in the previous year. In the same vein, the country created a one-stop shop for company registration (below), cutting the number of procedures from 13 to six and reducing the time required by half. Finally, Azerbaijan has also simplified dealing with the tax administration by introducing online filing and payment system with advanced accounting software for calculating taxes due. On average, this saves over 500 hours a year, thanks to reduced paperwork.

5.17. **Of most notable achievement has been streamlining of business registration**. Azerbaijan's new "one-stop shop" or "one-window" system for business registration, under the aegis of the Ministry of Taxes (MoT), has been welcomed by businesses. They can now file all pertinent information in these one-stop shops, including the submission and approval of

documentation by the MoT, registration with the State Social Protection Fund and Statistical Committee, and the opening of a bank account. Fourteen of these one-stop shops—called "State Business Registries"—have been opened across the nation. A standardized two-page guide helps entrepreneurs through the new process; which includes the completion of a one-page form, which contains all relevant information for either registering a new entity or updating existing information. Consequently, registrations rose 45 percent in the first half of 2008; more than 2000 enterprises were registered in Baku alone, and 3,465 limited liabilities companies were established across Azerbaijan. Not surprisingly, Azerbaijan's global ranking for starting business rose in *Doing Business 2009* from 97 to 33, becoming comparable to Bulgaria, Russia, and Turkey.

5.18. **Azerbaijan's next reform priorities need to be in licensing and issuing permits…** In the absence of a uniform system for issuing licenses, permits, and approvals, a major problem arises from discrepancies between the licensing and permit issuing systems. While the Licensing Rules establish a set of criteria to administer and issue *licenses*, no legal authority provides clear guidance on *permits and authorizations.* There is neither a clear definition of what constitutes a permit, authorization, or certification, nor a review mechanism to analyze their legal basis, regulatory purposes, or efficiency. Consequently, nearly all government agencies, executive authorities, and municipalities issue authorizations, permits, and/or certifications. The absence of a standardized licensing and permits regime risks allowing public institutions to engage in: (i) opportunistic behavior to supplement their budgets; and (ii) corrupt and arbitrary decision-making.[104]

5.19. **...and should include mechanisms for appeal, revocation, supervision, and suspension**. While current laws specify limits to the time that agencies may take to process applications for licensing, they do not mandate any sanctions for non-observance of the deadlines by licensors. Additionally, the license-issuing authorities must supervise compliance of the licensee with the license conditions, because a standardized approach for supervision does not exist. The grounds for suspension and revocation of licenses are also very broad, giving significant discretion to the licensing authority and causing unpredictability for the licensee. Finally, Azeri licensing laws and regulations do not provide for an administrative appeal process for a rejected or revoked application.

5.20. **Azerbaijan needs to standardize its licensing and permits regime**. To minimize the aforementioned administrative discretion in licensing and permits, Azerbaijan may wish to: (i) proclaim a list of legal permits; (ii) issue a regulation clearly specifying which ministries may issue which permits (and that any new permits will require amendments to existing regulations); (iii) introduce legal provisions that ensure the fees for any license or permit are sufficient to cover no more than "reasonable administrative costs" (to reduce attempts at supplementary financing); (iv) publish a fee scale; (v) provide equal opportunity for all companies (state- and privately-owned) to compete; and (vi) grant applicants the right to review the explanations for any decision (rejection or revocation of an application). Azerbaijan is also working on a one-

[104] Another fundamental governance problem is that the licensing regime discriminates between the state-owned and private companies. In Azerbaijan, enterprises or organizations established by a Presidential Decree or funded by the state budget can engage in licensable activities without a license. This decree can be, and is, used to limit competition between the public and private sectors.

stop shop to issue construction permits, following the collapse of a building in central Baku in 2007.

5.21. **Land issues**. Azerbaijan has no legal barriers to urban land ownership. However, land rights are poorly defined. This ambiguity has led to privatization-restitution disputes, an anemic land market, and multi-family lands that have not been allocated to privatized buildings and dwellings. Azerbaijan also has problems with urban land use planning, zoning, and permits and approvals for land development. Following the June 2004 passage of the Law on State Real Estate Register, the State Service for the Registration of Real Estate is responsible for registering all land and building rights. It is making good progress in establishing a viable registration system.

5.22. **A new mortgage law has also been passed, reducing the number of legal impediments to the development of a land market**. Therefore, the number of transactions is on the rise. However, the overall transaction rate remains low, suggesting that most people still do not use the official system to record property rights. As noted above, Azerbaijan has made significant progress across the board in the regulatory environment for businesses, according to Doing Business 2009. Among the reforms made in 2007/8, the number of procedures required to register a business was reduced from seven to four, and the time it takes to register property was reduced from 61 to 11 days, putting Azerbaijan in approximately the top 20 percent of ECA countries. Azerbaijan's regional ranking in the cost of registering property is similarly in about the lowest 20 percent, and amounts to 0.3 percent of property value. Azerbaijan's reforms propelled it from a global ranking of 61 in 2006/7 to 9 in 2007/8. Problems remain with foreign land ownership, accessing government land (buying or renting), and corruption. Although Azerbaijan is not doing worse than the regional average, it is engaged in a reform program with the World Bank. The Bank's priorities are to establish a single cadastre for movable and immovable property, and to merge the two institutions that manage land transfers in Azerbaijan.

Tax System for the non-Oil Economy

Tax Policies: Rates

5.23. **Soon after independence, Azerbaijan was among the transition countries that adopted reasonable, market-friendly tax systems in the late 1990s**.[105] In the past five years, Azerbaijan's tax system has not changed significantly. It consists of a VAT, a STR, corporate and individual income, social security contributions, excise taxes, and customs duties. Since 2003, the most important rate changes have been regular increases in excise taxes, the reduction of the corporate tax rate in 2005 (from 24 percent to 22 percent), and the reduction of the social security contribution (from 28 to 25 percent) in 2004. On average, since 2003, the largest contribution to non-oil revenues from various taxes has been as follows: 38 percent from VAT, 28.3 percent from income taxes, and 14.3 percent from social security contributions.[106]

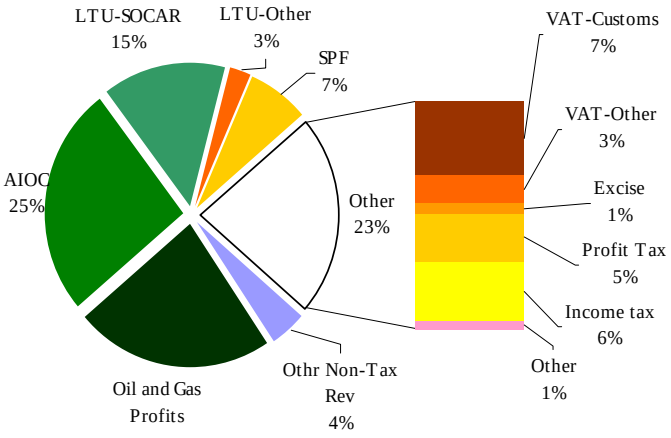
[105] Azerbaijan maintains a tax system differentiated between the oil and non-oil sectors. The tax treatment of foreign participants in Azerbaijan's oil sector is governed by PSAs, as is the tax treatment of imports for PSA use and the taxation of foreign employees or contractors. The discussion in this section pertains to the taxation of the non-oil economy, namely, all sectors other than the foreign-managed extraction of oil and gas.
[106] Zermeno 2008.

Table 5.2: Non-Oil Tax Revenue, 2003-07

	2003	2005	2007
	(In percent of non-oil GDP)		
Non-oil taxes & SSCs	19.7	23.6	31.7
Non-oil taxes	16.7	20.8	26.8
SSCs	3	2.8	4.9
	(In percent of non-oil tax revenues and SSCs)		
Income taxes	23.1	30	29
Personal	15.3	19.2	16.7
Corporate	7.8	10.8	12.3
SSCs	15.1	12	15.9
VAT and STR	42.8	38	34.7
Excises	6.8	8.5	11.4
Customs	6	6.1	4.5
Other	6.2	5.3	4.8
Total	100	99.9	100.3

Source: Zermeno 2008. Excerpt from Table 2.

Figure 5.5: Breakdown of 2007 Fiscal Revenues (AZN 7.9 Billion)



Source: Ministry of Finance and Bank staff estimates.
Notes: LTU = Large Taxpayers Unit; AIOC = Azerbaijan International Oil Consortium; SOCAR = State Oil Company of Azerbaijan; SPF = Social Protection Fund

5.24. **The revenue performance of Azerbaijan's non-oil tax system has been strong**. Non-oil revenues increased from 19.4 percent of non-oil GDP in 2003 to 31.8 percent in 2007 (Table 5.2). The primary cause of the rise has been the buoyant economy and the improvements made in tax administration, particularly for large taxpayers, especially SOEs.

5.25. **However, the tax system hides an important inefficiency, namely, that transitioning from a special regime intended for MSMEs to the "regular" tax regime is costly. The VAT imposes a very high marginal tax rate**. Azerbaijan's STR of 2 percent (4 percent for Baku) is levied on enterprises with a turnover below AZN 22,500 per quarter, or AZN 90,000 per year.[107] Enterprises subject to the STR do not pay corporate income tax (CIT) of 22 percent or property tax, nor collect VAT (18 percent), although they do make social security tax (SST) contributions of 22 percent—as is mandatory under the regular tax regime. However, the individuals engaged in entrepreneurial activities do not pay personal income tax (PIT). A firm's "graduation" from the STR to a VAT regime not only increases the firm's tax burden, but also significantly increases the number of mandatory procedures it has to go through with various government agencies. It is no surprise, then, that firms reportedly are splitting their operations into smaller segments to be able to continue hiding under the STR. A firm with a turnover exceeding the VAT threshold would either hide it entirely or split into two or more smaller firms, thereby entirely avoiding entering the regular tax system. Under the latter, instead of only paying 2 percent on its turnover, a firm would have to pay VAT, SST and CIT, besides having to make multiple filings with the tax administration. Table 5.6 presents a simulation of a notional firm's change in tax obligations when crossing the STR turnover threshold: for an AZN 10,000 increase in turnover (and jumping from below to above the STR threshold), total tax obligations can increase, in the most extreme case, from AZN 7,080 to AZN 14,380. The table does not illustrate the possibility that firms operating in the STR regime may hide or understate the number of employees—something that interviews indicated was an occurrence**.**

[107] The STR profit rate is 2% for enterprises located outside of the Baku area.

Table 5.3: Simulation: Effect of Crossing the VAT Threshold on Tax Burden (In AZN) Using Statutory Rates

Taxpayer characteristics	Turnover	STR	CIT assuming 22% profit on turnover	VAT ** w/ 40% value added on turnover	SST w/ two employees & annual salary of AZN 12,000 each	Total tax *
Firm below threshold – Baku	90,000	3,600	-		5,280	8,880
Firm below threshold – non-Baku	90,000	1,800	-		5,280	7,080
Firm just above threshold	100,000	-	3,058	6,100	5,280	14,438

Source: Bank staff estimates.

Notes: (*) PIT is not included in the table since it is paid by individuals and not by firms, even though firms have to withhold it from their employees; (**) Although firms merely collect VAT from consumers, the real tax incidence is at least partially on the firm, depending on price elasticity.

5.26. **Compounding the challenge is that Azerbaijan's tax rates are generally high when compared to the region**. The *Doing Business 2009* survey showed significant improvement in Azerbaijan's global ranking, from 143 in 2008 to 102 in 2009. The upgrading was attributed to important improvements in tax administration. However, paradoxically, Azerbaijan's total tax rate, estimated at 41.1 percent of profits in 2009, increased from 40.9 percent over the previous year. Azerbaijan's rate puts it in the middle of the ECA rankings for paying taxes, but above that of Kazakhstan (whose rate is 36.4 percent) and below Russia's (whose rate is 48.7 percent); while Armenia and Georgia have rates of 36.6 percent and 38.6 percent respectively.[108] Estimated profit rates for Arab oil producers are lower than those of ECA countries. These are expected given their oil revenue profile, but are an interesting reference point for Azerbaijan, as it is seeking to front-load its oil spending (relative to GDP) and boost its economy. The estimated profit rates listed for Arab oil producers in *Doing Business 2009* are: Qatar 11 percent; Kuwait, Saudi Arabia, and UAE 14 percent; and Bahrain 15 percent. Azeri businesses also are handicapped by the high "duty" costs of imports. In 2006, the simple average tariff rate was 9.4 percent for imports to Azerbaijan. The rate was less than one-tenth —0.03 percent—for imports to Georgia. In addition, although their imports are subject to the same VAT rate of 18 percent, Georgian importers can use bonded warehouses, which are unavailable in Azerbaijan.

5.27. **High direct taxation of labor (PIT and SST) in combination with weak enforcement fosters informal employment**. With the exception of the employees of public sector and foreign firms, most of the working population has no formal labor contract and thus escapes PIT and SST entirely. In addition to the loss of fiscal revenue, this has created a potentially dangerous outcome—where a large proportion of the population is forced out of the social security system because their employers have no incentive to formalize their labor. When these individuals reach retirement age and leave the labor force, they will be left with no social or health protection, at a time when they will need it the most. This outcome may result in significant social tensions and burden future generations.

[108] The European Tax Handbook (2008) of CIS countries shows that average corporate income tax (CIT) for the CIS is 18.1 percent (in Azerbaijan it is 22 percent, and has been legislated to drop to 20 percent from 2010), the average for PIT for CIS countries is 19.25 percent (in Azerbaijan 14 percent and 35 percent, while the top rate has been legislated to drop to 30 percent from 2010), and the average VAT rate for the CIS 18.8 percent (in Azerbaijan 18 percent).

Table 5.4: Tax Rates in the CIS Countries (%)

Country	Profits tax	VAT	Social security tax	Personal income tax
Armenia	20	20	AMD 7,000 + 18	Top rate 20
Azerbaijan	22	18	25	Top rate 35
Belarus	24	18 (RR10)	36	Top rate 30
Georgia	20	18	0	Flat rate 25
			Combined with PIT	Combined PIT + SST
Kazakhstan (2)	30 (15)	13 (12)	30	Top rate 20
Kyrgyzstan	10	20	29	Flat rate 10
Moldova	18	20 (RR 5 & 8)	29	Top rate 20
Russia	24	18 (RR10)	26	Flat rate 13
Tajikistan	25	20	26	Top rate 13
Turkmenistan	8 & 20	20	22	Flat rate 10
Ukraine	15	20	43	Flat rate 13
Uzbekistan	12	20 (RR15)	25	Top rate 30

Source: Adapted from Khadka 2008.

Notes: "RR" = "reduced rate." The column on total social security contributions illustrates contributions to be paid by both employers and employees. The percentage represents an illustrative indication. Some of the tax systems regard pension fund contributions as part of social tax or contribution; others do not. In addition, many countries employ sophisticated regressive or progressive schedules. For these cases, the top marginal rate is used in Table 2 For Kazakhstan, proposed rates (in parentheses) are to be considered by the Parliament in September 2008.

5.28. **Taken together, the generally high rates and the progressivity of taxation from STR to "normal" regime likely contribute to most of the Azeri entrepreneurs operating entirely or in part in the informal economy**. PIT is paid mainly by approximately 1 million employees in the public sector and municipalities, and by the over 60,000 local and foreign employees working for foreign enterprises. Most of the rest of the working population has no formal labor contract and thus escapes paying PIT. According to the State Social protection Fund, in 2008, 1,828,376 contributors were paying SIT: 1,377,641 employees, 196,393 self-employed and 294,342 farmers. Most farmers do not pay contributions (it is estimated that agriculture employs about 1.6 million people). Of 74,534 enterprises, only approximately 10,000 are registered VAT payers. As in the case of PIT, most VAT is paid by *public sector enterprises* (which numbered 11,666 in 2007) and foreign enterprises. There are very few VAT payers outside the public sector and foreign enterprises.[109] For 2007, only 23 percent of total revenue came from what might generally be regarded as the private sector (non-oil and not large tax payers) (Figure 5.5)**.** The rest came from AIOC profit taxes and SOCAR taxes on oil and gas profits (48 percent), the Large Taxpayers Unit (LTU, 18 percent), social security contributions that went into the Social Protection Fund (SPF, 7 percent), and other non-tax revenues (4 percent). If one excludes the part of the VAT that is levied at Customs, which collected 7 percent of total revenues, the aforementioned tax system collected 16 percent of total revenues in 2007, and at the same time provided significant incentives to operate in the informal sector.

Tax Policies: Exemptions

5.29. **Although many problems associated with the VAT collection regime in Azerbaijan have been corrected in the recent past, problems resulting from the large number of**

[109] From interviews, it emerged that in a typical regional tax office, of the 14,600 registered taxpayers, 9,000 would be filing under the STR and only 857 would be VAT payers.

exemptions persist. The IMF estimated losses due to tax exemptions to be as high as AZM 62 million in 2007, albeit lower than the estimated loss of AZM 209 million in 2006.[110] Currently, firms participating in production-sharing agreements (PSAs) and joint ventures (JVs), largely in the hydrocarbon sector, are granted special exemptions. Their inputs have a zero-rate VAT. The PSA signatory companies and subcontractors of the PSAs are given certificates that permit them to acquire goods and services free of VAT. To purchase at zero VAT, these enterprises have to merely show a photocopy of their certificates to their domestic suppliers or, when importing goods, to the customs agents. This framework not only calls into question the integrity of the tax system but also makes compliance difficult to enforce. Moreover, although VAT exemptions have been granted to several other goods outside the hydrocarbon sector, their number has decreased.[111] In fact, the IMF estimates that in 2007 nearly 32 percent of potential VAT was not collected because of the exemptions granted by legislation.

Tax Administration

5.30. **Azerbaijan has most recently made improvements in tax administration, but the regulatory burden on taxpayers remains significant**. Of the 181 countries listed in *Doing Business 2009*, Azerbaijan was ranked 102 globally in the ease of paying taxes category, up from 141 in the 2008 exercise. With the 2007/08 reforms discussed below, a hypothetical Azeri firm needs to make 23 payments a year (down from 38 last year), compared to 30 in Armenia and Georgia, and 47 for the ECA average, and 13 for the OECD average. Azerbaijan has also reduced the time it takes a notional firm to pay taxes, to 376 hours in 2007/8 (down from 952 last year), compared to 958 for Armenia and 387 for Georgia. For reference, the ECA average is 267, while the OECD average is 367. Azerbaijan's policymakers will have to watch closely to ensure that changes in the regulatory system translate to a more dynamic, and more formal private sector. To date, however, the character of the private sector (small and informal) is partially shaped by the difficulty of paying taxes through 2006/7 and the high existing tax rates.

5.31. **In the last two years, several improvements in administration appreciably reduced the compliance burden as well as taxpayer-tax official contact.** Most notably: (i) Azerbaijan has introduced electronic filing (96 percent of VAT payers and 35 percent of all taxpaying businesses took advantage of it in 2007); (ii) established nationwide call centres; (iii) enabled taxpayer account information on the Internet; (iv) reduced the number of forms approximately from 90 to 15, over the last several years, improving efficiency and reducing the close contact between taxpayers and tax officials; and (v) linked the tax database to those of other agencies, namely, Treasury, Customs, commercial banks, and the Ministry of Interior. Consequently, most tax functions, including desk audits, have been automated. Any mismatches in tax returns are generated without human intervention and sent to taxpayers within five days. Although initially controversial, the special deposit account for VAT seems to have been well received by the large taxpayers that form the backbone of the tax system. Six hundred large taxpayers are served by the Large Taxpayer Office, since they account for 80 percent of the total revenue collected by the Ministry of Taxes.

[110] "Current and Proposed Non-Oil Tax System in Azerbaijan," Zermeno, Mayra, IMF, 2008.

[111] At the beginning of 2008, numerous agricultural goods and fertilizers, pharmaceuticals, military equipment, as well as some food items were entirely exempt from VAT.

5.32. **Corruption is a serious issue in both tax and customs administration**. The private sector repeatedly mentions corruption as an important hindrance to formalization of its activities. Anecdotal evidence indicates that it is very difficult to obtain VAT refunds, even for genuine transactions. Interviews with the private sector suggest that the under-invoicing of imported goods has reduced import duties, VAT, and other taxes due at Customs. However, this practice has resulted in discrepancies between physical stocks available onsite—in establishments—and the receipts for these stocks sought by tax inspectors. Therefore, difficulty in clearing customs creates opportunities for both fraud and corruption by tax administrators.

E. Foreign Trade Regime and Competition

5.33. **The existence of large discrepancies in figures between partners' exports to Azerbaijan and imports received in Azerbaijan and registered at Customs indicates a significant number of unreported imports**. Azerbaijan had a *"positive mirror trade gap"* in 2006.[112] In other words, *the total value* of *all exports to Azerbaijan* from its trading partners is much larger than the *official imports of Azerbaijan*. The value of unreported imports was large in 2006 and is on the increase. In 2006, the value of *all exports to Azerbaijan* from its trading partners increased by 43 percent (in US$) over 2005, whereas the value of *official U.S. dollar imports* to Azerbaijan increased by only 23 percent. Over 2003–06, the value of official imports increased two-fold from $2.6 billion to $5.3 billion, whereas the value of all exports to Azerbaijan increased 2.2 times from $3 billion in 2003 to $6.7 billion in 2006. Increasing the value of mirror imports by an estimate of the cost of insurance and freight (15 percent of the value of mirror imports) would raise the 2006 mirror gap from $1.4 billion to $2.4 billion.

5.34. **Unreported imports are signs that competition in domestic market is distorted and that some firms have an unfair advantage over those that comply with foreign trade regulations**. The presence of significant unreported imports implies that a good portion of Azeri imports receives differential treatment, due to either smuggling or collusion between importers and border authorities. However, the authorities also appear to grant additional differential treatment—VAT and duty exemption status—to certain importers. In 2006, the implicit duty collection rate, that is, the ratio of "taxes on international trade" to imports freight-on-board (fob) was 4 percent. However, the revenue from VAT collected on imported products amounted to merely 6 percent of the fob value of imports instead of close to *18 percent*, that is, the VAT rate. Additionally, "preferential importers" do not have to incur the total transaction costs associated with complying with administrative regulations governing foreign trade activities. Both time and compliance costs in Azerbaijan are very high. Compared to a firm in Georgia, an Azeri firm must spend eight additional days to complete an export transaction and six additional days to complete an import transaction. Moreover, in Azerbaijan, these transactions cost $175 and $5 more, respectively, than for a firm registered in Georgia. The transactions costs are also likely affected by the small number of trained customs brokers and customs experts; their limited number is likely to cause bottlenecks in the clearance process.

[112] The mirror trade gap is the difference between the value of exports (also referred to as mirror imports) to Azerbaijan, as reported by its trading partners, and the value of imports officially reported by Azerbaijan. Since imports include the cost of insurance and freight (cif) and exports are free on board (fob), the mirror trade gap should be negative. Considering the significant cost of transport to Azerbaijan, the difference should be approximately minus 15%, if not more. For Armenia, during 2003–06, it was approximately minus 20%.

5.35. **Azeri exporters also are at a disadvantage *vis-à-vis* firms in WTO member countries**. Conditions encountered in accessing foreign markets are not regulated by the multilateral trade agreements that form the basis of the WTO. They can be changed at the discretion of governments, since they are not constrained by WTO rules, *vis-à-vis* countries that are not members. This arbitrariness adversely affects investment in the export sector because potential investors cannot take current tariffs and other charges for granted. In contrast, exporters from WTO member countries are largely shielded from actions that violate WTO regulations.

5.36. **Azeri exporters and importers face higher transaction costs due to weaknesses in Azerbaijan's "trade facilitation infrastructure".** The value of the Logistics Performance Indicator (LPI) includes both the perception of the extant logistics climate and objective measures shaping logistics friendliness for 150 countries.[113] Azerbaijan's LPI is below that of most other CIS economies (Table 5.5). Azerbaijan scores lower on the value of LPI than that of customs, not for reasons related to efficiency and effectiveness of customs, but to higher costs of local logistics. These include transportation, terminal handling, and warehousing; timeliness of shipments in reaching destinations; and direct freight costs. Azerbaijan's score is 36 percent of that of the best performer, Singapore; and is on a par with Uzbekistan, slightly above the values of LPI for Kazakhstan (35), and significantly above Tajikistan (29). However, Azerbaijan's LPI is significantly lower than those of two other land-locked economies: Kyrgyz Republic (42) and Armenia (40).

5.37. **In recent years the Customs department has made significant investments in infrastructure, facilities, and the IT system. These improvements need to translate to reduced clearance times in order to improve Azerbaijan's international ranking, which is among the lowest in the world**. Serious commitment from Azeri leadership to reforming Customs' regulation would significantly reduce the number of border clearance documents, move away from physical control of most transactions to a post-control audit system, use modern risk management techniques to control trade flows, and rely on a system-based audit of enterprises rather than on a transaction-based audit. In particular, this would reduce the clearance time and compliance costs for enterprises in the low risk category, since these enterprises would not be controlled for every consignment passing the border. They would instead go through a comprehensive audit of their accounts no more than once a year. Although the single-window concept is being implemented in principle by Azeri Customs, several agencies control the *de facto* flow of goods at the borders. This considerably raises the cost of international trade and it is no surprise that the public attributes all delays to

Table 5.5: Logistical Performance Indices and Customs Assessments of CIS Economies, 2006

	LPI (Logistics Performance Indicator)	Customs
Ukraine	49	41
Belarus	48	56
Russia	43	31
Kyrgyz Republic	42	40
Moldova	41	38
Armenia	40	41
Azerbaijan	**36**	**37**
Uzbekistan	36	31
Kazakhstan	35	30
Tajikistan	29	30

Source: Derived from data available at http://web.worldbank.org/wbsite/external/topics/exttransport/exttlf
Note: No data are available for Georgia and Turkmenistan.

[113] LPI measures performance along the logistics supply chain within a country and has three parts: perceptions of the logistics environment of trading partner countries; efficiency and effectiveness of customs and other border procedures; and quality of transport and IT infrastructure for logistics.

Customs. In most modern border systems, there is only one agency at the border, usually Customs, with the power to control the respective concerns of the phytosanitary, veterinary, transport, and other government agencies. However, in the case of Azerbaijan, these agencies continue to make policies in their respective areas and, where necessary, grant permits or request documentation. Changing this would require the development of an integrated tariff system whereby, based on the consignment and documentation, a comprehensive IT system would then alert the appropriate official as to which documents are required and what fees are to be levied.

F. PRO-GROWTH/DIVERSIFICATION REFORM PACKAGE

5.38. **An Integrated Reform Package should be implemented with the key objective of increasing employment and economic diversification through reducing the tax burden, eliminating distortions created by the tax regime, and liberalizing market access**. Azerbaijan's poor regulatory and tax regimes argue for simplification and streamlining while simultaneously reducing the tax burden. Liberalizing market access will increase competitive pressures and create new possibilities for Azeri businesses to participate in the global division of labor. Moreover, suggested measures to improve the business climate by reducing the transaction costs of doing business will increase the likelihood of a positive supply response. This report contends that Azerbaijan would benefit from adopting a "quick" approach to expanding the private sector by designing, announcing, and implementing the Integrated Reforms Package in the next two years. This package would consist of several medium-term measures necessary to achieve the key objectives.

5.39. **Azerbaijan's tax policy strategy should examine how best to direct private investment to the non-oil sector and away from the shadow economy**. Due to the oil boom and improved revenue performance, Azerbaijan is in a good fiscal position, which gives it the unique opportunity to adjust its tax policy strategy. Tax policy no longer needs to focus on maximizing revenue; it can now instead focus on helping formalize the shadow economy and encouraging voluntary compliance. Since the oil surplus is expected to peak soon, the period of 2009–10 provides the opportunity to adjust tax policy and improve tax administration. This would help Azerbaijan prepare for a broad tax base in the post-oil boom period. As part of a package to reduce the size of government and public spending (by freezing spending in real terms, and adopting a PI approach), the government can potentially make a 3 percent reduction in revenues over 2009–10 (Chapter 3), depending on the course of non-oil revenues during the global crisis.

5.40. **Reduction of the non-oil tax burden would be consistent with relative spending reduction stemming from the "constant" real rule**. Chapter 3 explains in greater detail the implications of adopting a PI approach to spending oil revenues. It suggests that if Azerbaijan were to abide by this rule, it would need to keep real spending constant for the foreseeable future. This would mean reducing spending by approximately 20 percent of non-oil GDP through 2012 (that is the 2009–12 MTEF). Of this 20 percent, the non-oil tax burden would be reduced by 8 percent of non-oil GDP. Azerbaijan would be overdrawing the OF by 15 percent of non-oil GDP above the PI strategy but, over time, would continue to accumulate assets. However, not keeping real spending constant would mean that, in the event of adverse circumstances, Azerbaijan would have no margin of error and would have to cut back further on expenditures or deplete the OF assets.

5.41. **The tax regime should be attractive enough for domestic investors to invest in the formal economy, and competitive enough intra-regionally for non-oil foreign investors to consider moving to Azerbaijan after the crisis, in preference to other countries in the region**. A pro-growth tax package that helps broaden the tax base should envisage a **significant reduction in the rates of direct taxes** (CIT, PIT and SST) and very significant improvements in tax and customs administration, both of which are important reasons for driving much of the economy into the shadows. Such a strategy would greatly alleviate pressure on the tradable sector and enable it to pursue new categories of products, consistent with Azerbaijan's new terms of trade as an oil producer. This report has prepared first round estimates of the potential impact of reducing CIT, PIT and SST for the purpose of illustration during the 2009-2010 period: (i) a replacement of the current PIT rate structure (14 percent and 35 percent) with a flat rate of 11 percent; (ii) a gradual reduction of SST from 25 percent (22 + 3) to 20 percent (18 + 2) in the period 2010-2012, with an adequate arrangement to cover the potential deficit in revenues of the SSPF to avoid any disruption in benefit delivery; and (iii) the reduction of CIT from 22 percent to 18 percent by 2010. Table 5.6 shows how the proposed measures would help reduce the non-oil tax-GDP ratio from 34.3 percent in 2008 to 30 percent in 2010. Naturally, such reductions would only be warranted if fiscal balance can be maintained during the global crisis period. Should non-oil revenues decline significantly during the crisis period, the brunt of the reduction in the "tax-burden" (broadly defined) will have to be carried by improvements in tax and customs administration.

Table 5.6: Estimated Effect of a Reform Package on Reducing Tax GDP Ratio: An Illustration

Reform Package 2009-2010	Measures	2007	2008	2009	2010
			% of non-oil GDP		
PIT	11% flat rate in 2009	5.3%	5.5%	3.0%	3.0%
CIT	18% rate in 2010	3.9%	4.0%	4.0%	3.3%
VAT	No change	10.6%	12.6%	12.6%	12.6%
SST*	20% rate in 2010	4.9%	4.2%	4.0%	3.2%
Excise	No change	3.6%	3.1%	3.1%	3.1%
Land tax	No change	0.2%	0.2%	0.2%	0.2%
Property tax	No change	0.6%	0.6%	0.6%	0.6%
STR	No change	0.4%	0.4%	0.4%	0.4%
Customs tariff	No change	1.4%	1.4%	1.4%	1.4%
Other revenues	No change	2.1%	2.3%	2.2%	2.2%
TOTAL		**33.2%**	**34.3%**	**31.5%**	**30.0%**

Note (*): The policy of decreasing SST rates will need to be carefully examined and planned to ensure that State Social Protection Fund (SSPF) delivers pensions and other social insurance benefits in timely fashion. Currently, the SSPF covers about 2/3 of expenditures from SST revenues, while 1/3 is covered from the state budget. The decreased rate will inevitably drive the revenues down requiring higher budget transfers. One potential policy option would be to keep pensions constant. However, the pensions in Azerbaijan are low (about 20-25% of the average wage); extremely important for poverty reduction and an important political economy issue.
Source: Bank staff estimations.

5.42. **Reduction in CIT and SST rates would be expected to reduce the tax burden of firms and increase their competitiveness.** The reduction in CIT rate from 22 percent to 18 percent will bring it below that of neighboring Armenia and Georgia (both 20 percent) and may attract non-oil foreign investment into the country. The reduction in the employer's contribution

to SST (from 22 percent to 18 percent) would encourage private sector employers to formalize contracts with their employees. The proposed SST rate of 18 percent will be lower than in most countries in ECA region (it will still be higher than the rate in Georgia, which currently has a combined PIT/SST rate of 25 percent). Table 5.7 presents a simulation to show the effect of the proposed tax reduction on the tax burden of typical small, medium and large enterprises.

Table 5.7: Effect of Rate Reduction on Tax Burden of Firms

	Current rates			Proposed rates		
Taxpayer characteristics	**CIT** assuming 20% profit on turnover	**SST** assuming annual salary of AZN 1000 per month each	**Total tax**	**CIT** assuming 20% profit on turnover	**SST** w/ annual salary of AZN 1000 per month each	**Total tax**
Small firm (turnover AZN 200,000 with 5 employees)	8,800	13,200	**22,000**	7,200	10,800	**18,000**
Medium firm (turnover AZN 1 million with 50 employees)	44,000	132,000	**176,000**	36,000	108,000	**144,000**
Large firm (turnover AZN 20 million with 200 employees)	880,000	528,000	**1,408,000**	720,000	432,000	**1,152,000**

5.43. **The government should not keep high tax rates with the purpose of extracting resources from the SOEs, but instead avail dividends on equity and interest on loans**. Reportedly, the government is reluctant to lower tax rates out of fear of losing significant revenues it receives from SOEs. The consequence has been to maintain high rates for private firms and agents in the nonoil economy, thus castigating entry. This report recommends that when reducing the tax rates, the government maintain the same tax burden on SOEs, but extract those revenues through regulation, or through dividends.

Table 5.8: Effect of Rate Reduction on Tax Burden of Firms

	Current rates			Proposed rates		
Taxpayer characteristics	**CIT** assuming 20% profit on turnover	**SST** assuming annual salary of AZN 1000 per month each	**Total tax**	**CIT** assuming 20% profit on turnover	**SST** w/ annual salary of AZN 1000 per month each	**Total tax**
Small firm (turnover AZN 200,000 with 5 employees)	8,800	13,200	**22,000**	7,200	10,800	**18,000**
Medium firm (turnover AZN 1 million with 50 employees)	44,000	132,000	**176,000**	36,000	108,000	**144,000**
Large firm (turnover AZN 20 million with 200 employees)	880,000	528,000	**1,408,000**	720,000	432,000	**1,152,000**

5.44. **The reduction in PIT and SST rates would reduce the cost of labor for firms and individuals, and combined with improved enforcement it is expected to** encourage private sector employers to formalize contracts with their employees and to stop the practice of underreporting wages for the purpose of taxation. Ultimately, the coverage of the population by social insurance may improve. Table 5.7 presents a simulation to demonstrate the effect of the proposed tax reduction on the cost of taxes on labor. It shows that, at a salary of AZN 1,000 per

month, the annual reduction is AZN 940, while for a salary of AZN 10,000 per month the reduction is approximately AZN 9,000. At the same time, while pursuing tax rates reduction policies, the government should ensure that potential deficit in the SSPF revenues is covered and social insurance benefits delivered.

Table 5.9: Effect of Rate Reduction on Cost of Labor Taxation Assuming Taxes are paid in Full

Monthly salary levels AZN	Annual taxes at current rates				Annual taxes at proposed rates			
	PIT AZN	**SST** paid by employer	**SST** paid by employee	**Total tax**	**PIT** AZN	**SST** paid by employer	**SST** paid by employee	**Total tax**
1,000	1,680	2,640	360	**4,680**	1,320	2,160	240	**3,720**
2,000	3,360	5,280	720	**9,360**	2,640	4,320	480	**7,440**
3,000	7,560	7,920	1,080	**16,560**	3,960	6,480	720	**11,160**
5,000	15,960	13,200	1,800	**30,960**	6,600	10,800	1,200	**18,600**
10,000	36,960	26,400	3,600	**6,960**	13,200	21,600	2,400	**37,200**

5.45. **Although the World Bank, the government, and the IMF will review the recommendations *and further analysis is needed,* preliminary analysis suggests that the recommendations might have to be adjusted upward (higher rates than in Paragraph 5.39) to produce the 4 percent cut in non-oil revenues sought over the next three years**. Closing the loopholes in the foreign trade regime, together with a uniform tariff rate of 5 percent, would generate extra revenue of between $233 million and $330 million in terms of 2006 imports, counted as either fob or cif, respectively. The experience of countries that have cut their tax rates and simplified their tax codes amply demonstrates that tax revenues tend to increase and the tax base to widen.

Table 5.10: Effect of Rate Reduction on Cost of Labor Taxation Assuming Taxes Are Paid in Full

Monthly salary levels AZN	Annual taxes at current rates				Annual taxes at proposed rates			
	PIT AZN	**SST** paid by employer	**SST** paid by employee	**Total tax**	**PIT** AZN	**SST** paid by employer	**SST** paid by employee	**Total tax**
1,000	1,680	2,640	360	**4,680**	1,320	2,160	240	**3,720**
2,000	3,360	5,280	720	**9,360**	2,640	4,320	480	**7,440**
3,000	7,560	7,920	1,080	**16,560**	3,960	6,480	720	**11,160**
5,000	15,960	13,200	1,800	**30,960**	6,600	10,800	1,200	**18,600**
10,000	36,960	26,400	3,600	**66,960**	13,200	21,600	2,400	**37,200**

CHAPTER 6.
AZERBAIJAN'S FINANCIAL AND BANKING SECTORS

Azerbaijan's financial sector is in the early phase of development and has played a limited role in intermediating financial resources and pooling risk between savers and investors. Its banking sector, by far the largest component of the financial sector, has nevertheless been growing particularly fast since 2005, as credit has been increasing—mirroring the increases in the monetary base that have supported the government's stable exchange rate policy against the US dollar. The regulation of Azerbaijan's banking sector has been improving, though it has been shielded from external competition as none of the large international banks are operating in Azerbaijan. This may have inadvertently helped dampen the impact of the global financial crisis. Azerbaijan seems to also have largely avoided one of the pitfalls of natural resource economies, which borrow internationally during booms and rely on the appreciating local currency to ease the borrowing terms. While Azerbaijan does have some international debt, the amounts are still relatively small and, in the event of an adverse situation (exchange rate appreciation, or as has occurred, the global crisis), the external liabilities of the banking system could be covered by national reserves in the extreme situation. However, given the volatile course of developments in the global economy today, in order to mitigate vulnerabilities that exist or may arise, high frequency monitoring of the banking system should be maintained.

Azerbaijan's challenge is, nevertheless, to develop its financial system so that it plays a more proactive role in channeling credit to private enterprises rather than to households. It needs to strengthen some of the institutional infrastructure (credit bureau, collateral, etc.). It must also prepare to attract more international banks once the global crisis subsides and once it becomes clear which banks are the healthiest. The prospects for the Azeri economy are still good, and the country should be attractive to foreign banks. Azerbaijan should also maintain supervision efforts on the part of its monetary authorities.

A. INTRODUCTION

6.1. **Azerbaijan's financial sector has seen large swings in foreign currency inflows in the past 10 years**. Chapter 1 documented the large FDI inflows that came in two cycles (late 1990s and mid 2000s), supporting the construction of the oil and gas installations and the BTC pipeline. These cycles were associated with conservative fiscal policies, large oil sector imports and low inflation. In 2006–08, the increase in public spending, coupled with a stable exchange rate policy, discussed in Chapter 1, brought large swings in foreign currency inflows. These inflows were accompanied by much smaller inflows by commercial banks and the private sector. The challenge then—at the macro level—had been to: (i) avoid excessive foreign borrowing by commercial banks and avoid the creation of contingent liabilities by SOEs; (ii) mitigate the possibly destabilizing impact of inflows on inflation, by encouraging a more flexible exchange rate; and (iii) improve institutional factors to ensure that credit to the private enterprise sector increased. The government took many important measures to strengthen macroeconomic stability before September 2008. Most notably, these included reduction of the discount rate,

increase of reserve requirements, the introduction of additional reserve requirements on foreign borrowings, and strengthened supervisory efforts.

6.2. **In October 2008, the world changed, and the implications for the short-term future of global finance are still being worked out**. With the global financial crisis materializing in October 2008 and global credit markets drying up, the world found itself in turmoil. Short-term implications are that otherwise creditworthy countries no longer have access to credit. For Azerbaijan, this means that the risks for some individual banks identified in 2008 as this chapter was prepared may well materialize. It may also mean that roll-over of short-term debt may not be feasible. A third implication may be that the real appreciation pressure on the exchange rate may subside, if the government curtails spending (as is recommended in Chapter 3) or the appreciation of the currencies of the trading partners subside. But Azerbaijan—to date—seems to have been relatively isolated from the international financial system and did not suffer very significantly in the early part of the crisis, as have the U.S. or Europe. However, given the volatile course of developments, in the global economy the aforementioned risks need to be monitored vigilantly.

6.3. **This chapter suggests that the best policy for Azerbaijan in the uncertain global environment is prudence for the short term, and deepening of structural reforms for the medium to long term**. This chapter reviews recent financial sector developments to establish a context for the future reforms. It reviews the level of financial intermediation, the behavior of the banking sector, government polices to increase access to credit, and risks to the banking system before the global crisis. The global crisis may turn some of these risks into reality. However, the crisis does not alter the institutional challenges faced in financial intermediation in Azerbaijan before the crisis; it *will* alter how Azerbaijan addresses the challenges.

B. FINANCIAL INTERMEDIATION

6.4. **Azerbaijan's financial sector plays a limited role in intermediating resources, pooling risks and diversifying the economy...** In 2008, gross domestic savings were 65 percent of GDP, among the highest, regionally and internationally. However, Azerbaijan's financial depth was still relatively low (Table 6.1 compares financial intermediation in Azerbaijan and other economies in the region, several of which are resource rich). Credit expanded rapidly from 2005 to 2008, due to a combination of monetary, exchange rate, and fiscal policies (see Chapter 1 and below). In June 2008, the ratio of total lending to GDP was approximately 17 percent, while the ratio of total lending to non-oil GDP was 50.2 percent; in comparison, the lending to GDP was about 50 percent for EU-accession countries. This is especially low given that banks are by far the most important financial intermediaries in Azerbaijan.

6.5. **...even though the regulation of the sector has improved**. Azerbaijan's financial sector was the first to adopt International Financial Reporting Standards. It has also been the first to strengthen the corporate governance of its banking sector, based on extensive collaboration with IFC, EBRD, and other development partners. The National Bank of Azerbaijan has developed key legislation to improve the legal and regulatory framework in the sector and to bring it closer to international standards, and to strengthen its capacity as a regulator

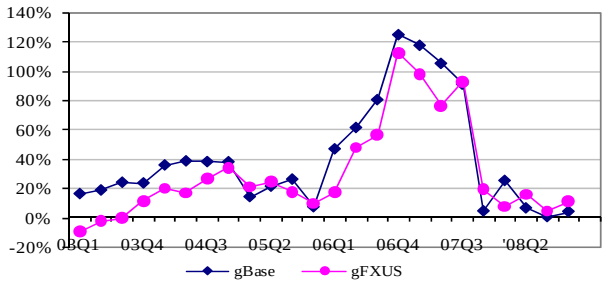
6.6. **However, in recent years, financial depth in Azerbaijan has increased very rapidly. Under those circumstances, international experience indicates that, in a slowdown, the quality of banks' loan portfolio may well deteriorate rapidly**. In this regard, the introduction of dynamic provisioning might be appropriate and prudent. From 2005 to 2008, money and domestic credit grew almost 360 percent in nominal terms and have doubled as a ratio of non-oil GDP. This increased money supply reflects the oil revenue financing of the non-oil deficit. Due to the limited flexibility of its exchange rate regime (especially through March 2008), the National Bank of Azerbaijan (NBA) has responded passively to foreign exchange (FX) movements. Consequently, the monetary base has mirrored changes in these FX inflows (Figure 6.1).

Table 6.1: Financial Intermediation, 2008 *(% of GDP)*

	GDS	Financial Depth, M2/GDP	Banking Sector Penetration*	Domestic Credit by Banking Sect.
Azerbaijan	**65**	**19**	**27**	**17**
Estonia	n.a.	50	n.a.	99
Georgia	3	22	n.a.	33
Kazakhstan	55	34	90	34
Russia	36	39	61	27

Source: World Bank database.
Notes ** 2006 Assets/GDP, Source: Moody's Global Banking.

Figure 6.1: Monetary Base and Net International Reserves (*Rate of Change*) , 2003-08



Source: NBA.

Market Participants

6.7. **Azerbaijan has a growing banking sector relative to its loan portfolio. While still concentrated, the sector has opened up in recent years**. As of end 2008, 46 banks have been operating in the market, indicating the end of the restructuring period that started in the mid-1990s.[114] In 2006 and 2007, the number of branches increased sharply, mirroring the system's growth. Azerbaijan's two largest banks—the International Bank of Azerbaijan (IBA) and Kapital Bank—hold a dominant share of banking system assets. While the IBA is a state bank, the Kapital Bank was privatized in 2008. From 2004 through 2008, the loan portfolio of state banks grew almost 50 percent faster than that of private banks: 776.9 percent versus 568.3 percent. For the banking system, the loan to deposit ratio reached 173 at end 2008.

6.8. **However, the banking system remains highly concentrated**. As of the end of 2008, 83 percent of total bank assets were concentrated in Azerbaijan's five largest banks. At end 2008, 42.5 percent of banking system assets were held by the state-owned bank, IBA. Of the remaining 45 banks, the top 9 banks by assets held about 35 per cent of total banking system assets with the share of each individual bank being 6 percent or less. The number of banks with foreign capital increased and is now 23 from 15 at end 2004, with seven banks having majority foreign

[114] From end 1996 – end 2004, 97 banking licenses were cancelled, and only 5 were granted.

ownership. However, only one such bank is controlled by a prominent western bank, UniCredit of Italy.[115]

6.9. **The number of other financial institutions has also increased significantly, but their contribution to the sector remains small.** The number of non-bank financial institutions has nearly doubled—from 47 in 2002 to 94 in 2008. In 2007, leasing comprised 4 percent of total bank loan financing; non-bank financial institutions, approximately 2.7 percent; and micro financing loans, approximately 2.8 percent. Since 1999, a number of government financial institutions have been created to help channel oil money to the non-oil private sector. Box 6.1 presents evidence from the benefits of greater competition in the banking sector.

6.10. **Micro financing is rapidly expanding through the Micro Finance Bank of Azerbaijan.** This institution has a number of international donors as its shareholders, including the EBRD, IFC, and the German Government Development Bank. From December 2005 to November 2007, the Micro Finance Bank's loan portfolio increased by 515 percent and its number of outstanding loans by 653 percent. In 2007, the bank issued 60,000 loans, averaging less than $3,000 (totaling $170 million).

Box 6.1: The Impact of Competition in the Banking Sector

Bank finance is the main source of financing for firms across the globe. High transaction costs for banking services are often banks' rational reactions to the level of competition they face. Banks that are open to foreign competition are forced to adopt the latest technologies and lower transactions costs. Cross-country evidence in Beck, et al (2004)[116] shows that bank development disproportionately boosts the income of the poor as income inequality (measured by the Gini coefficient) falls faster in countries with superior banking sectors, as resources are allocated more efficiently. Beck, et al, (2007)[117] look at a sample of 209 banks in 62 countries. They note that private credit in Switzerland exceeds 150 percent of GDP and there are no fees for SME loans, which on average gets processed in 1.6 days. This compares with the entire sample where the average fee for a SME loan of 3.5 percent of the country's per capita GDP and it takes 10.7 days on average to process. Pasadilla and Milo[118] (2005) found that after the Philippines eased entry restrictions into banking, the number of new banks jumped over 50 percent from 1990 to 1995. Therefore, from 1995 to 2003 the spread of Bank lending rates over deposit rates were cut by almost half.

6.11. **Azerbaijan's formal capital market is very shallow.** Approximately 90 percent of securities transactions take place over the counter (OTC) and are not disseminated as market information. This has led to poor price discovery and market transparency. In 2007, annual equity turnover on the organized exchange was about 1 percent of GDP, and in 2008 that ratio dropped to about half. Approximately 90 percent of the primary and secondary turnover on the organized exchange is in short-term government debt instruments (T-bills and NBA notes). The remaining 10 percent is highly dominated by banks. Nearly 50 companies' shares are admitted for trading but, importantly, are not listed on the organized exchange. Corporate bond issuance has increased rapidly from a very low base over the last two years, but maturities do not exceed

[115] In fact, at the drafting of the report, Yapi Kredi Azerbaijan, Microfinance Bank and Nikoil Bank were operating in Azerbaijan with 100 percent foreign capital, Pakistan Milli Bank and Iran Milli Bank had branches, and 18 banks had some foreign capital.

[116] "Finance, Inequality and Poverty: Cross-Country Evidence," Beck, Demirgüç-Kunt, and Levine, World Bank Policy Research Working Paper 3338, June 2004.

[117] "Banking Services for Everyone? Barriers to Bank Access and Use Around the World," Beck, Demirguc-Kunt and Martinez Peria, World Bank, February 2007.

[118] "Effect of Liberalization on Banking Competition," Pasadilla and Milo, World Bank (2005)

15 months. The problems faced by the Azeri capital markets are discussed further in Box 6.2 below.

Interest Rates and Maturity

6.12. **Because of a high rate of savings, one would expect real interest rates to be relatively low. Also, a contributing factor to low (ex-post) real interest rates should have been the high rate of inflation and international arbitrage.** However, because of extremely high-income growth, demand for resources was very high and, during 2006, real lending interest rates were as high as 12 percent, compared to the CIS average of 4.7 percent. Nonetheless, inflation jumped from 8.4 percent in 2006 to nearly 20 percent, year over year, from June 2007 to June 2008. At the same time, the reported, or nominal lending rate, changed very little, from 18 percent in 2006 to 20 percent in June 2008. This implied a real interest rate of close to zero percent.[119] The lending interest rate is evidently being restrained by increasing international arbitrage. Encouraged by expectations of appreciating local currency prior to the global crisis, arbitragers could take out single-digit, foreign-currency-denominated loans and lend them at a rate of 20 percent domestically.

6.13. **The trends in the lending rates in Azerbaijan through mid-2007 suggest that banking sector competition was limited, although some progress toward competition was being made given the gradually shrinking spreads and the increased proliferation of banking products. However, the subsequent developments toward de-dollarization from mid-2007 till the crisis, and toward dollarization during the crisis, have come with increasing spreads.** Azerbaijan's deposit rates increased significantly since 2005; the decline in the spreads (lending rate minus deposit rate) for both domestic and foreign currencies through end-2006 or early 2007 was very encouraging. While under strictly limited competition rising deposit rates would have been expected to push lending rates up, the observed decline in the spreads through mid-2007 (see charts below) suggests that monopolistic profits began to gradually diminish during the period.[120] However, since end-2007, the financial crisis seems to have disrupted the rules of the game, as interest rates began to show significant changes. The local banking customers, slowly but steadily, switched to foreign currency deposits away from manat-denominated deposits, and to avoid currency mismatch some banks pressured their clients to switch their loans from Azeri manats to US dollars. Consequently, the average borrowing and lending rates in dollar-denominated currencies fell and the opposite was experienced in manat-denominated operations. The crisis probably disrupted any "follow the leader" rule or other non-competitive arrangement regarding interest rates, and we do no longer observe flat lending rates. The spread in foreign currencies shows typical volatility of the drastic changes involving the crisis, and no trend can be ascertained yet. The spread on local currency deposits edged upwards as banks increased borrowing rates to discourage clients to borrow in domestic currency.

[119] This compares with real lending rates in June 2008 of 3 percent in Armenia, 18 percent in Georgia, and minus 4 percent in Russia.

[120] The argument for more competition is supported by studies carried out by Freixas and Rochet, based on the Monti-Klein model of a monopolistic bank (Freixas and Rochet, 1997).

Figure 6.2: Average Interest Rates: Domestic Currency, 2005–2008

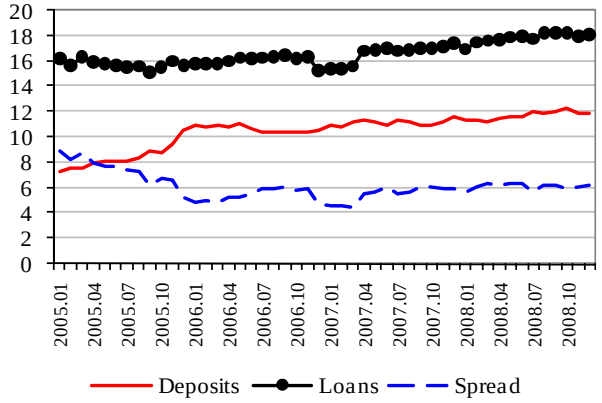
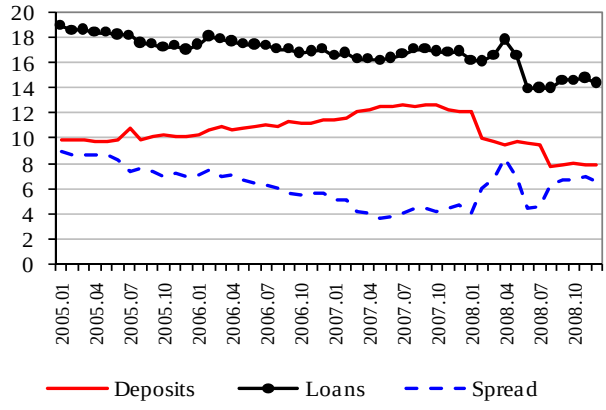


Figure 6.3: Average Interest Rates: Foreign Currency, 2005–2008



6.14. **The global financial crisis should not deter Azerbaijan from continuing to seek prominent international banks to increase competition and innovation in the banking sector**. Prior to the global crisis, it was expected that one or more of the large international banks would enter the Azeri market in the coming year. Their presence would boost competition, increase innovation and decrease borrowing costs in the financial sector. However, as discussed below, in the midst of the global crisis, large foreign financial institutions are making recent inroads into Kazakhstan and Vietnam—they should be invited to come to Azerbaijan as well.[121]

C. Access to Commercial Bank Financing

6.15. **Azerbaijan's very significant credit increase has primarily benefited households, but has had limited impact on the trade and service sectors**. Credit in Azerbaijan nearly tripled from 2005 to 2008. In Q3 2008 approximately 36 percent of total credit went to households, 23 percent to trade and services, and much smaller proportions to agriculture (4 percent) and industry/manufacturing (6 percent).

6.16. **The increased proportion of longer-term loans can be attributed to increased loans to households (Table 6.2)**. At the same time, the ratio of short-term credit to total credit dropped from 73 percent in 2001 to 31 percent in September 2008. This ratio declined even faster for credit in domestic currency in the same period, from 95 percent to 39 percent.

6.17. **Agriculture and agri-processing have encountered problems in accessing credit**. Agriculture and agri-processing have faced the most difficulties in accessing credit. From 2005 to 2008, total sector credit increased nearly 168 percent, while credit to A&P grew only 90 percent. Relative to non-oil GDP, total credit grew from 20 percent in 2005 to an estimated 42 percent by the first half of 2008. During the same period, agriculture and agri-processing were granted credit in the equivalent of a low 1.1 percent of non-oil GDP in 2005, and approximately

[121] To date, CitiBank, CommerzBank, and Société Générale have representative offices in Azerbijan, although branch offices or subsidiaries remain to be established.

1.7 percent by the first half of 2008. Considering the low base and the tremendous growth in total credit, the increment in credit to agriculture and agri-processing has been very small.

Table 6.2: Credit by Sector *(AZN mil., end of period)*

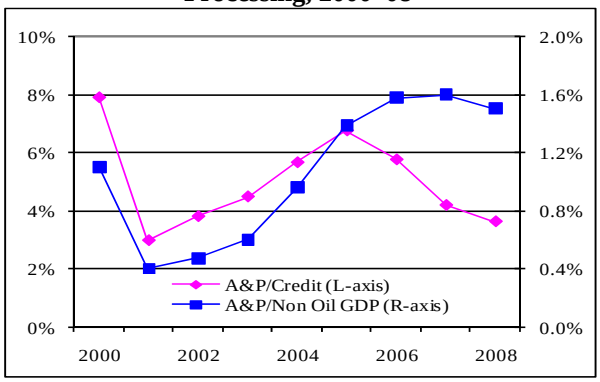
	2003	2007 Q3	2008 Q4	%Δ 03-08	Composite prop. '03	Composite prop. '08Q3
Total	670	3757	7163	969	100	100
Households	143	1376	2335	1533	21	33
Trade & services	113	989	1911	1591	17	27
Constr. & real estate	30	255	461	1438	4	6
Industry & mfg.	44	270	428	872	7	6
Transport & comm.	57	278	669	1074	9	9
Power, chem.	39	179	856	2095	6	12
Agri. & processing	30	163	262	773	4	4
Claims on banks	47	95	95	102	7	1
Cr. to fin. sector	21	83	181	762	3	3
Cr. to other sectors	111	47	16	..	17	0
Cr. to gen. gov.	35	44	..	..	5	..
Cr. to pub. orgs.	0	3	..	..	0	0

Source: Central Bank of Azerbaijan

6.18. **At the same time, smaller MSMEs also have had difficulty in accessing credit.** A survey of 1,800 MSMEs in January 2008 found that approximately 20 percent of them had applied for credit and half of their applications had been rejected. The main reason cited (nearly 60 percent) for rejection was lack of collateral. In the survey sample**,** only 10 percent of the MSMEs were in agriculture and 5 percent in agri-processing.

6.19. **Today, in Azerbaijan, access to credit is more likely to be limited by the legal infrastructure and the credit culture of the economy than by the availability of credit**. Financial institutions provide financing based on information about the borrower, and the availability of collateral. Collectively, data on credit information from surveys and field visits suggest that the most important factors constraining access to credit are the lack of necessary credit information and the weak enforcement of property rights. Reducing the cost to creditors of getting borrower information and reducing the time and recovery costs to execute on collateral would substantially enhance credit access, for both the agricultural and MSME sectors.

Figure 6.4: Credit Granted for Agriculture and Processing, 2000–08



Source: NBA

6.20. **Azerbaijan's access to credit ranking improved significantly in the *Doing Business 2009*.** Its ranking in *Doing Business 2009* is 12 out of 181 countries in. The credit ranking surpasses the overall ranking of 33 in the overall Ease of Doing Business for Azerbaijan. *Doing Business*'s access to credit indicator, actually called Getting Credit, is based on the coverage of

public and/or private credit registries and the strength of legal rights of borrowers and lenders. It is not a measure of the relative or absolute volume of credit that goes to any part of or-- the entire private sector. Azerbaijan ranks in the top 20 percent of the ECA countries on the strength of legal rights. The country's public registry covers 3.1 percent of the adult population; no private registry exists in the country. Armenia has a public registry covering 2.6 percent and a private one covering 24.4 percent of the adult population. Kazakhstan's private registry covers 25.6 percent of adults while Turkey's covers 26.3 percent, and Russia's 10 percent, and Georgia's 4.5 percent.

6.21. **Azerbaijan can improve access to credit for the private sector**. In order to improve access to credit by increasing the availability of *information to creditors*, Azerbaijan may wish to extend the coverage of the public registry to both small borrowers and firms, and broaden the scope of the registry to distribute credit information from retailers, trade creditors, or utility companies as well as financial institutions. To strengthen the *accessibility of collateral*, Azerbaijan may wish to: (i) amend legislation to enable all citizens to be party to collateral agreements; (ii) create a unified registry for all security rights in movable and immovable properties; (iii) amend legislation to enable parties to have recourse to out-of-court enforcement without restrictions; and (iv) reduce the costs of enforcing financial contracts, including seizure of collateral.

- **Azerbaijan may also wish to further the development of leasing and introduce legislation on warrants.** Both instruments "transform" illiquid collateral into a liquid financial instrument that is easy to recover in the event of default by the lessee or borrower. Leasing has been developing; total assets are less than $150 million (4 percent of the banks' loan portfolio). Legislation on financial trusts could make the financing of leasing companies much more effective and accessible. We understand that a draft of such legislation has already been presented under the aegis of technical assistance from the IFC. Under this framework, leasing companies will be able to securitize the portfolio of credits by transferring them to a financial trust, providing liquidity to the leasing companies to initiate the next round.
- Similarly, introducing legislation on warrants[122] could help small firms, especially from the agricultural sector, finance their crops by pledging (in a warrant house) their products. The warrant house issues a warrant certificate that can be discounted in any financial institution.

D. EQUITY FINANCING

6.22. **Capital markets, once developed, can mitigate credit, foreign exchange and rollover risks by enabling firms to issue debt or equity, minimizing their reliance on bank borrowings.** However, Azerbaijan must consolidate certain fundamentals of equity financing to make it viable.[123] Enterprises do not currently turn to the equity market for financing because barriers remain high. The tax structure provides incentive for enterprises to engage in shadow

[122] A loan secured with goods stored in a bonded warehouse.

[123] The Azerbaijan Investment Corporation, set up by the government in 2006 to provide equity financing to strategic enterprises, is discussed in the next section.

activities, as well as rent-seeking opportunities by some government agencies. This is a disincentive for formalization and transparency, as shown by the IFC 2008 SME Survey.[124] However, to make equity financing a reality, Azerbaijan can move on reform in three areas.

6.23. **First, technical improvements in the operation of the equity market**. The Azeri equity market is still awaiting its first listing on the Baku Stock Exchange; moreover, there is no liquid secondary market. It will be essential to: (i) establish a balanced set of listing requirements, thus better ensuring transparency, accountability, and governance practices for listed companies; (ii) establish a relevant segmentation of the equity market; (iii) promote independent initial public offerings (IPOs); and (iv) build new investor groups with a longer-term (passive) portfolio approach rather than seeking control.[125]

6.24. **Second, strengthening minority shareholder rights protection.** Portfolio equity trading is virtually non-existent, a fact that indicates poor protection of minority shareholder rights as well as embedded asymmetries of information. This calls for the robust regulation of the related-party transactions that currently could allow siphoning resources off of the public enterprise into a closely held one, leaving minority shareholders vulnerable to potential abuse.

Box 6.2: The Development of Bond and Equity Markets

A seminal work on the relationship between economic growth and financial market development (Gurley and Shaw, 1967) describes financial innovation as a dynamic process that both influences and is influenced by the development of the real sector. As the economy grows, specialized lending institutions, such as banks, emerge and help finance additional capital investment. With further increases in per capita income and wealth, markets for tradable securities, first debt and then equity, emerge and complement bank lending. This issue is further examined theoretically by Greenwood and Smith (1995) and Boyd and Smith (1996), and they have similar findings.

Azerbaijan's bond and equity markets are currently illiquid and small. There are several coordination problems that hinder the development of bond and equity markets. These problems arise from shortcomings in markets for information and in markets for sharing risk. Both types of problems exist in all economies, but the problems and the consequences tend to be worse in developing/transition economies. (See Stiglitz (1993) for a more detailed analysis of the various market failures inherent in the financial markets of all economies, and why these problems are likely to be more pronounced in developing/transition countries).

Azerbaijan's poor accounting standards and lack of merchant banks and other institutions to monitor corporate performances have resulted in both bond and equity markets being almost entirely absent. Moreover, the transformations inherent in transition, such as the creation of new firms and new industries, and the absorption of new technologies heighten insecurities among potential investors. Finally, Azerbaijan does not have a large number of personnel with experience and training in evaluating corporate debt and equity. With time, market participants will gain experience and learn to price equity more effectively. It is likely that, as noted above, economic growth will lead to capital market development, which, in turn, will further stimulate economic growth.

6.25. **Third, adoption of international accounting standards.** Adopting international accounting standards is another essential step. In turn, this action would require the development of a corps of well-trained accountants and relevant educational programs.

[124] See for instance the 2005 EBRD-World Bank Business Environment and Enterprise Performance Survey.

[125] World Bank, *Azerbaijan - Financial Services Modernization Project*, 2008.

E. GOVERNMENT FINANCIAL INSTITUTIONS

6.26. **The traditional role of government in the development and regulation of financial markets for developed as well as developing countries may seem to have been overturned in the last few months of 2008, but it is important to keep the context in mind.** October 2008 saw unprecedented government efforts to save the global financial system by, first and foremost, seeking to strengthen the banking sector in many countries. However, these efforts are evolving at the time of writing of this report. These actions by world governments should, however, be interpreted as unique solutions taking place in unprecedented circumstances. Economic historians will determine if the cause of the global crisis was lack of regulation or too much government involvement in economic activity, which created a self-fulfilling expectation (and moral hazard) that if large sectors of the economy, including banks or other financial intermediaries failed, then governments would step in.

6.27. **Direct government involvement in finance, through government financial institutions, is often attractive and feasible in resource-rich countries—but poses many risks**. Developing countries in general—and cash-abundant, resource-rich countries in particular—often try to leapfrog the time-consuming development of the legislation and institutions to enable the growth of banking and securities markets. They are also often keen to boost production in specific industries or specific parts of the country to ensure employment generation. Most of these institutions, particularly development banks, failed in the 1970s and 1980s because they could not break away from their political and financial ties to governments. Either below-market interest rates created shortages in funds, and political links were needed to access credit, and/or these institutions funded poorly managed businesses and collapsed under the pressure of non-performing loans (NPLs). Some government-backed financial institutions, such as the Dutch agricultural bank or the BNDESAR equity fund in Brazil, were successful because these countries chose a corporate governance framework that enabled the institutions to work on market principles (i.e., like private institutions).

6.28. **For Azerbaijan, while international lessons are relevant, there is an important macroeconomic dimension that was particularly relevant before the global crisis**. Like many developing countries, Azerbaijan has had difficulties with inefficient, state-run financial institutions (State Savings Bank, AGROPROM, and PROMINVEST). These lessons, together with lessons from international practices, provide Azeri policymakers with guidance on where the pitfalls of government financial institutions lie. But Azerbaijan's policymakers should also review the macroeconomic framework when considering the role of public financial institutions. Its fiscal and monetary policies placed heavy pressure on the private sector for two reasons: (i) the non-oil deficit requires large inflows of foreign exchange; and (ii) the undervalued nominal exchange rate encourages private capital inflows. Any policy to broaden the government's role in increasing access to credit by injecting oil revenues in U.S. dollars into the domestic economy needs to be weighed against the downside risks of further increasing appreciation pressures.

6.29. **Azerbaijan recently created three state financial institutions**. The *Azerbaijan Investment Company* (AIC), with announced capital of AZN 90 million, was established in 2006. AIC takes equity stakes (of at least $1,000,000) in well-established companies and provides venture capital. The AIC's strategy has been to provide equity support for approximately five years and then exit according to a previously planned strategy. Since it started operating, it has

invested AZN 55 million in different projects, which have led to domestic and foreign investment of AZN 600 million. On November 6, 2008, AIC announced that it would be expanding its activity and is currently considering a package of new investments totaling AZN 64 million. This, in turn, is expected to result in additional domestic and external investment of AZN 697 million. The *National Entrepreneurship Fund* (NEF) provides highly subsidized loans (of up to $3.2 million) to SMEs. The *Mortgage Fund* has two groups of borrowers, both receiving highly subsidized loans. These funds deserve special attention as they issue debt at below market rates and are non-sustainable. Since they are using oil resources, they add to fiscal expenditure and also create microeconomic distortions in the financial sector. The IMF guidelines regarding Sovereign Funds could be a reference for these institutions regarding disclosure and other governance issues.

6.30. **The AIC requires an adequate rate of return and minimum standards of corporate governance and accounting practices.** During the investment period, the fund's purpose is to support progress in accounting to attain internationally accepted practices, improve corporate governance, and enhance transparency. While it is not clear how these objectives may be achieved by the AIC, all of these steps are in the context of preparing the company for an eventual IPO or direct divestiture after a period of maturity.

Table 6.3: State Financial Institutions in Azerbaijan

State financial institutions	Target	Assets (mil. AZN), Sept. 2007
Mortgage Fund	Housing	45
Azerbaijan Investment Company	Equity support	100
National Entrepreneurship Fund	SME financing	280

Source: Bank staff.

Source: Bank staff.

6.31. **The Mortgage Fund has two groups of borrowers, both receiving loans at highly subsidized interest rates.** The government's desire to subsidize housing loans for specific groups would be more transparent and less distortionary if the government refrains from regulating the interest rate and instead provide an initial, or one-time, explicit subsidy on the capital.[126] Because the fund does not address the root causes of lack of term financing in the housing market, the fund will not likely result in the development of longer-term financing or the housing market. Moreover, as do most subsidization schemes, the fund raises serious concerns regarding its opacity and incentives for corruption.

6.32. **The Mortgage Fund and the NEF have certain common features and yield similar consequences**: (i) substantial subsidy is granted by negative interest rates; (ii) size of subsidy is uncertain because it depends on the inflation rate; (iii) interest rate subsidization distorts resource allocation; (iv) favored individuals/enterprises are chosen/short-listed by the government; (v) subsidies give incentives for opaque practices; and (vi) real estate finance will not develop, as a consequence of the Mortgage Fund. To expand and make sustainable such longer-term financing, institutional reforms and macro-economic stability are needed.

[126] The American Community Reinvestment Act of 1977, requiring all Banks to provide loans to low-income borrowers, is thought to have contributed to the explosion of high-risk credit in the last 10 years, which, in turn, led to the current global credit crisis.

6.33. **Azerbaijan's efforts to increase access to credit with government-supported institutions should rely on enhanced governance systems...** Azerbaijan's three special funds try to facilitate market development and expand access to credit. While the IMF has published guidelines for the governance of sovereign funds, international experience suggests that such funds are often vulnerable to political pressure. If Azeri policymakers feel the need to maintain the three funds, *inter alia*, they should build up the governance and financial reporting of the funds as the first priority and consider subsidizing capital rather than interest rates.

6.34. **...and should not undermine or kill the efforts to bring in international banks**. Nevertheless, government efforts to improve access to finance are most likely to pay off by attracting foreign banks to open local branches, strengthening the institutional framework for micro-finance, leasing and warrants, and putting in place the institutional infrastructure for the development of equity markets. Even during a time of global crisis, developing countries are attracting foreign banks, as can be seen recently in Vietnam[127] and neighboring Kazakhstan,[128] where private credit flows into developing/transition economies have not entirely dried up. Both of these countries have enabling environments and prospects that make them attractive destinations for private capital. Azerbaijan can replicate those experiences.

F. RISKS TO THE FINANCIAL SECTOR

6.35. **Azerbaijan reported substantial improvement in Non-Performing Loans (NPLs) through September 2008 –but caution is warranted**. **The banks' asset quality is likely to deteriorate sharply amid a slowing economy and significant amount of recent loans in the portfolio.** In September 2008, NPLs were 2.2 percent, less than one-tenth of their levels in 2001 (29 percent). Despite this dramatic improvement through that time, the ratio of NPLs to total loans remains high by international standards. In addition, it is probable that the observed improvement of the quality of the credit portfolio is partly due to the recent rapid growth of credit. A the drafting of the report, the level of provisioning in the banking sector (on average more than 100 percent of NPLs) has seemed adequate; 16 banks with a ratio of Specific Provisions/NPL less than 100 percent but no banks with a ratio for Provisions/NPL less than 100 percent.[129]

6.36. **Although the composition of assets and liabilities of the financial sector does not suggest the existence of currency mismatches indirect credit risks are significantly increased due to higher foreign currency lending in 2008.** The proportion of banks' outstanding lending in U.S. dollars increased to 49 per cent at end 2008, after declining sharply from 2004 to 2007, from 64 percent to 44 percent.

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[127] Foreign investors responded to declining real estate prices in Vietnam by increasing their investments. On November 4, VinaCapital announced the creation of a new fund of US$400 million to invest in real estate. Additional real estate investments in Vietnam were announced in November by Aseana Properties and Prudential Insurance.

[128] In September 2008, both Raiffeisen International and Bank of Tokyo Mitsubishi announced that they would be opening offices in Almaty, in 2009, for corporate lending. Alnair Capital also bought a stake in a local bank, Kazkommertsbank, while HSBC announced the opening of another new office in Astana.

[129] Specific provisions are the provisions created for the possible losses of the non-standard banking assets. Banking assets are divided into two categories: standard and non-standard. Standard assets are satisfactory assets and assets under watch. Non-standard assets are non-satisfactory assets, doubtful assets and bad assets.

6.37. **The banking system became more long-term oriented through 2008**. The ratio of short-term credit to total credit declined from 73 percent in 2001 to 39 percent in September 2007, and further to 32 percent in December2008. This trend is even stronger for domestic currency, for which this ratio declined from 95 percent to 36.9 percent in December 2008. Developments during the crisis could halt this healthy trend.

6.38. **The overall banking sector indicators show strong performance, however profitability could come under pressure as access to external funding sources is drying up**. In the first nine months of 2008, the average return on assets was 2.2 percent. This is slightly lower than in 2007, when it was 2.4 percent, but was more than double the international standards. In addition, in the first nine months of 2008, return on equity was 18.7 percent, much higher than in 2007 (14.3 percent). Banks are indirectly benefiting from the implicit inflation tax on sight deposits, since they pay no interest. This situation generates extraordinary profitability, close to 13 percent of total equity. However, in light of the current global credit crisis, this is unlikely to last, as credit becomes scarcer and more expensive to borrow from abroad.

6.39. **The main sources of vulnerability are lending to related parties, the dominance of the state-owned bank in the market, external borrowings and the low supply of human capital for risk assessment**. Lending to related parties is the banking system's main cause of concern, and as such it is recommended that the NBA put special emphasis on this matter. In addition, 13.7 per cent of all loans are to state owned enterprises and are primarily concentrated in the portfolio of IBA. Moreover, there is considerable merit in Moody's observation on July 9, 2008 that high concentrations on both sides of bank balance sheets have raised the risk of large losses as well as liquidity strain, if adverse scenarios were to arise. Similarly, in one of Azerbaijan's largest banks, loans to related parties were nearly 43 percent of bank capital, while deposits from shareholders and key management represented nearly 18 percent of the bank's liabilities. This issue was flagged by the bank's international auditors. The dominance of the state-owned bank has the potential to de-stabilize the banking system and the economy in the event of any worsening of credit and liquidity conditions. Furthermore, as in many emerging markets, external borrowings have grown sharply amongst Azeri banks; they are estimated at about $3 billion as of late 2008. And whilst most borrowings are concentrated in a few banks, in the current global financial environment, the respective banks and the NBA alike have to ensure that adequate resources are available to fund such commitments and mitigate rollover risks.

Systemic and Idiosyncratic Risk

6.40. **Azerbaijan's systemic risk potential is low**. Given the low level of the multipliers, high level of foreign exchange reserves, and comfortable fiscal position in the first part of 2008, the probability of systemic risk in Azerbaijan was relatively low for most of 2008. NBA's foreign exchange holdings are nearly six times higher than deposits denominated in U.S. dollars and almost three times the monetary base. However, with the aforementioned collapse of world prices, along with the increased cost of capital due to the global credit crisis, there is no room for complacency going forward.

6.41. **Nevertheless, individual banks may face dire problems if the economy worsens.** As long as the economy continues growing at a very high rate, most loans are likely to continue to perform. However, it is quite likely that banks have not exercised adequate due diligence about

the creditworthiness, in an environment of staggering credit growth and limited human resources being devoted to risk management. Also, a number of banks are less well placed to deal with the negative external and domestic developments. The second largest bank was rated B1 by Moody's in July 2008, which implies a probability of default close to 13 percent. It is estimated that the remaining banks could have ratings not higher than B1; consequently, the overall minimum expected probability of default could be close to 13 percent.[130]

6.42. **In both cases, idiosyncratic risk could be as high as 20 percent of total deposits, equivalent to 10 percent of international reserves**. To sum up, it is quite clear that although the idiosyncratic risk could be as high as 20 percent, the systemic risk is extremely low, given the magnitude of NBA's international reserves. This low systemic risk implies that any possible crisis could be successfully managed, but it does not deny that it could arise. Nonetheless, bank supervision and resolution should be strengthened regardless of the low systemic risk.

[130] Differing views prevail on this type of analysis; while the analysis argues that –in the absence of system-wide information-- an estimate of the minimum default probability of the banking sector can be obtained by looking at a systemically important and better run bank, others argue that the default probability should be based on the sovereign rankling of the country.

CHAPTER 7.
ENSURING A QUALIFIED LABOR FORCE AND BETTER USE OF HUMAN CAPITAL

Although Azerbaijan became independent in 1991 with a well-developed educational system, its education system failed to subsequently meet the needs of the changing Azeri economy. This is particularly true of tertiary education, due primarily to corruption and under-investment. This has not only eroded the value of degrees earned from Azeri Universities but has also led to shortages of workers with training in agriculture and the service sector, where they are most in demand. Most degrees are being granted in education, health, and manufacturing, where there has been little demand. This has simultaneously led to labor shortages as well as increased unemployment. In the long run, higher wages as a reward for higher productivity are critical for Azerbaijan to improve the standard of living of its citizens as it diversifies its economy away from oil. By targeting tertiary education toward areas where workers are in demand, Azerbaijan will not only improve graduates' job prospects, but also improve overall productivity in the non-oil economy. Therefore, curricula need to be adjusted, ideally to meet the findings of a comprehensive study of current and future labor market needs. Higher spending in tertiary education is necessary to build new universities and increase faculty salaries. In addition, by developing a modern system of vocational education and adult training, Azerbaijan will equip workers with the skills that employers are currently demanding. Furthermore, Azerbaijan should explore the possibility of attracting foreign universities or private training companies to educate students to meet future needs. Azeri employers have identified inadequate training in Information Technology (IT) and English as shortcomings in the labor force. In India, in the 1980's, numerous private companies trained students in IT. India's booming IT sector in the 1990s led to its emergence as a major player in the global economy. Moreover, Japan and China invited graduates of American universities to conduct English courses for their workers in the 1980s and 1990s respectively.

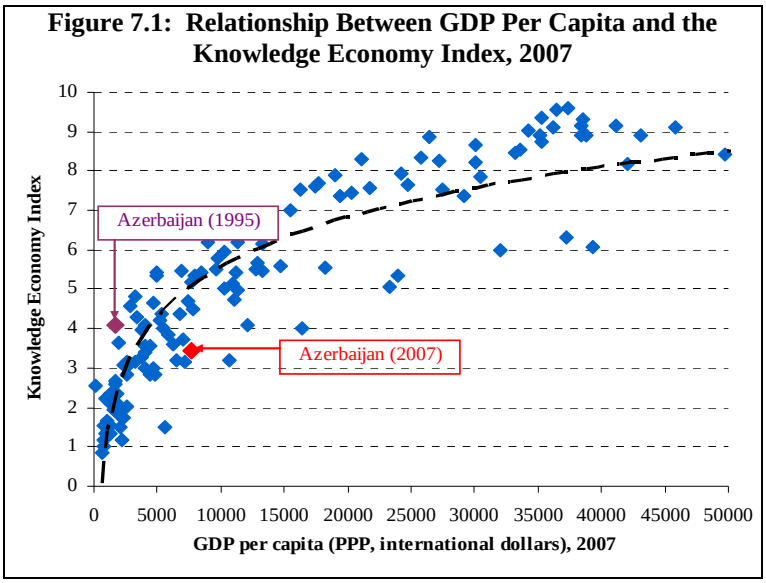
A. A NECESSARY PART OF AZERBAIJAN'S DEVELOPMENT STRATEGY

7.1. **Although economic growth has boosted Azerbaijan's employment, productive job opportunities are still insignificant.** Between 2003 and 2006, economic growth enabled strong growth in employment (+ 18 percent). In 2006, unemployment was low at 6.8 percent of the population aged 15 and over. According to the 2006 Labor Force Survey (LFS), approximately 64 percent of the working age population (15–64) was employed. This figure was slightly below the EU-15 average of 66 percent. It was less than in most successful transition economies, such as Estonia (68 percent) and the Czech Republic (65 percent), but higher than in other Central and Eastern Europe (CEE) transition countries. Azerbaijan's growth in employment since 2003 has occurred primarily in less productive, lower paying sectors, and most new jobs have been created in the already large informal sector, especially in agriculture. The "new" private sector, consisting of *de novo* private, usually small, firms, is very small, and has not yet developed the critical mass to generate enough jobs to replace public sector jobs. Hence, facilitating the entry of new firms and the growth of SMEs is a prerequisite for faster private sector job creation and overall employment growth.

7.2. Azerbaijan has fallen behind in the quality and efficient use of its human capital, due mainly to the inadequacy of its education system and labor market policies. While Azerbaijan inherited relatively good education indicators from the Soviet period, the supply of qualified labor diminished significantly during the transition years, and the quality of education deteriorated. The Azeri education system suffers from corruption of professors and school administrators, which decreases the value of diplomas; under-investment (public spending on education decreased from 3.9 percent of GDP in 2000 to 2.7 percent in 2006, compared to 5.2 percent on average in OECD countries); and a serious mismatch between graduates' specializations and the current and future needs of the economy.

7.3. As a result, Azerbaijan lags behind its comparators in the quality and quantity of human capital. While in 2007 the country had the 4th highest GDP per capita in the CIS, Azerbaijan ranked 23rd in ECA in the Knowledge Economy Index (KEI)[131] of the World Bank Institute (2008), ahead of only Uzbekistan and Tajikistan. Figure 7.1 also suggests that, given its level of GDP per capita, Azerbaijan's performance in the KEI should be higher. The figure also emphasizes that this performance has actually worsened in the last decade, despite the rise of per capita income. In particular, Azerbaijan has the worst score in ECA for the "education and human resources" indicator,[132] due especially to insufficient enrollment in higher education. In addition, labor market policies are not fully developed. Reforms are still needed, especially in active labor programs, including training and retraining, labor redeployment, and labor market institutions. In particular, although labor legislation is quite flexible, enforcement of labor laws is weak.

Figure 7.1: Relationship Between GDP Per Capita and the Knowledge Economy Index, 2007



7.4. **Building human capital will be key to increasing productivity in both private and public sectors, and to reducing unemployment and poverty.** Upgrading the skills of the labor force is essential to diversify employment opportunities away from the informal sector and to reallocate workers from low-productive into higher value-added jobs. Upgrading skills will also result in individuals increasing their value in the labor market, thus enabling them to increase

[131] The World Bank's Knowledge Economy Framework organizes the determinants of innovation under four key pillars: (a) Economic Incentives and Institutional Regime (tariff and non-tariff barriers, regulatory quality, rule of law), (b) Education (adult literacy rate, secondary enrollment, tertiary enrollment), (c) Innovation System (royalty and license fees payments and receipts, patent applications granted by the U.S. Patent and Trademark Office, scientific and technical journal articles), and (d) Information Infrastructure (telephone, computer, and Internet penetrations). The framework ranks countries by pillar and an overall Knowledge Economy Index (KEI).

[132] Calculated as the simple average of the normalized scores on three key variables: adult literacy rate, secondary enrollment, and tertiary enrollment.

their earnings and reduce poverty.[133] Finally, human resources are a necessary part of capacity building in the public sector in order to create the conditions for sustained growth. As such, human capital is an essential part of the development strategy of Azerbaijan and a priority investment in its future.

B. Labor Market Developments

Rapidly Growing Labor Supply

7.5. **Due to relatively high fertility rates in the past and a favorable age structure in the population, Azerbaijan's working age population (15–64) has been growing rapidly. It soared from 4.99 million in 1999 to 5.77 million in 2006—or 16 percent (2.1 percent per annum).** According to the medium-term scenario of the UN population forecast, the number of able-bodied individuals aged 15–64 will increase to 6.55 million by 2015. This population growth will stimulate competition for employment. On the other hand, in the 1990s, birthrates declined rapidly. Thus, as that generation of youth enters the labor force, the 15–24-year-old population will shrink from 1.74 million in 2006 to 1.54 million in 2015 and to 1.19 million in 2020. The result will be an aging labor force.

7.6. **Population also is affected by migration. Unofficial estimates place the net emigration estimates rather high, close to 1 million people during the transition.[134]** Migrants headed mainly to Germany, Russia, and Turkey. In particular, for economic reasons, significant numbers of young people reportedly migrated temporarily to work in Russia, mostly in commercial and informal activities. When the economic situation and salary levels improve in Azerbaijan, some migrants may return, adding pressure to the labor market.

7.7. **Concurrently, the economically active population increased significantly**. In 2006, the labor participation rate reached 66.4 percent of the population aged 15 and older (up from 64.7 percent in 1999). Also in 2006, the economically active population hit 4.28 million, an increase of 25.8 percent from the 1999 census. In particular, the female participation rate rose from 57 percent in 1999 to over 60 percent in 2006; the rate for males remained flat. Participation rates may increase further if women continue to enter the job market and some discouraged workers again job-hunt as the economy develops.

Unemployment, Job Creation, and the Informal Sector

7.8. **Thanks to high job creation, unemployment has remained low, but it is of long duration**. In 2006, despite the large increase in the economically active population, unemployment stayed low, at 6.8 percent of the population aged 15 and over (7.1 percent of the population aged 15 to 64). This was possible because of the rapid growth of employment; 608,000 new jobs were created between 2003 and 2006.[135] However, two-thirds of job seekers stay unemployed for more than 12 months. Data on labor force participation also show

[133] For a quantitative analysis of the returns to education in Azerbaijan, see World Bank 2007.
[134] See European Training Foundation 2006.
[135] The 2003 and 2006 labor force surveys were conducted by the State Statistical Committee of Azerbaijan with the technical and financial support of the ILO and UNDP. These LFSs can be considered the most reliable sources of information on Azerbaijan's labor dynamics.

considerable disparity by region. There is almost no unemployment in Nakhichevan economic district. Unemployment also is much below average in Absheron, Aran, and Sheki-Zagatala districts. It is average in Baku City (6.8 percent). In contrast, the rate is very high in Kalbajar-Lachin and Guba-Khachmaz districts (21.2 percent and 13.5 percent respectively).

Table 7.1: Employment Dynamics, 2003 and 2006 (x 1,000)

	Total employment		Urban employment		Rural employment	
	2003	2006	2003	2006	2003	2006
Employed – total	3,377.8	3,985.9	1,715.2	1,984.2	1,662.6	2,001.7
Including:						
• Public enterprises and organizations	988.7	984.0	740.7	694.4	248.0	289.6
• Non-public enterprises and organizations	369.0	470.6	318.0	404.8	51.0	65.8
• Agricultural farms	918.5	1,379.0	130.1	79.2	788.4	1,299.8
• Self-employment; hired by physical persons and employed in production cooperatives	1,101.7	1,152.3	526.4	805.9	575.3	346.4

Source: State Statistical Committee (SSC)/Ministry of Labor and Social Protection of the Population of **Azerbaijan** Republic (MoLSPP), Labor Force Survey 2003 and 2006.

7.9. **The recent upsurge in job growth was due mainly to the expansion of agricultural employment.** Between 2003 and 2006, 76 percent of new jobs (465,000 jobs) were created in agriculture, predominantly in subsistence farming (Table 7.1). By type of employment, agriculture became the main "employer." Non-public (non-state) enterprises also created approximately 100,000 new jobs. Self-employment and employment hired by individuals created approximately 50,000 new jobs. During the same period, employment in public enterprises and organizations did not change much. It accounted for 984,000 employees, approximately 25 percent of the total.

7.10. **The distorted nature of the labor market can be judged from the contrast in employment, wages, and productivity among sectors**. The sectors that generate GDP (and growth) are not the same sectors that generate employment (Table 7.2). While 52 percent of GDP is generated by the mining sector (which provides only 1 percent of employment), 39 percent of employment is in agriculture (which generated a mere 7 percent of GDP in 2006), and 50 percent of employment is in rural areas. Value-added generated by one worker in agriculture is less than one-sixth of that in manufacturing or construction, and less than 1 percent of value-added produced by one employee in oil- and gas-extracting industries. Only 44,000 of the country's workers gain access to high-productivity, high-wage jobs in the oil sector. The rest of the labor force is squeezed into low-productivity work in the non-oil sector and into unemployment. Thus, the main "sponge" sector, which absorbs the bulk of the labor force but at the cost of falling productivity, is agriculture.

Table 7.2: Contrasts in Employment, Wages, and Productivity Among Sectors (2006)

Sector	Total employment, (1000s)	Total employment (%)	GDP (%)	Value added/ employee (AZN)	Average wage/ month. (AZN)
Agriculture, forestry, fishing	1,558	39.1	7.1	854	52.5
Non-oil manufacturing	195	4.9	5.8	5,567	140.5
Mining	44	1.1	50.9	217,627	633.7
Electricity, gas and water supply and distribution	40	1.0	0.6	2,822	146.7
Construction	223	5.6	7.7	6,467	298.7
Public administration, defense	271	6.8	-	-	175.4
Education	339	8.5	-	-	80.1
Other services	1,315	33.0	-	-	235.4
Total	3,986	100.0	100.0	4,703	149.0

Source: **SSC 2007**

7.11. **The informal sector employment is sizable in Azerbaijan.** Between 2003 and 2006, the share of workers employed without employment contracts increased from 45.3 percent to 59.5 percent (Table 7.3). Informal employment within the formal sector is large as well. It is estimated by the MoLSPP that, for example, of 223,000 employed in construction, only one-fourth of the workforce had written labor contracts with their employers. This estimate tended to confirm the importance in the economy of unprotected forms of labor, informal labor, and work in precarious conditions.

Table 7.3: Workers Without Labor Contracts in Total Employment, 2003 and 2006 *(%)*

	2003	2006
Total	45.3	59.5
Urban	18.1	39.1
Rural	69.4	70.9

Source: SSC/MoLSPP LFS 2006.

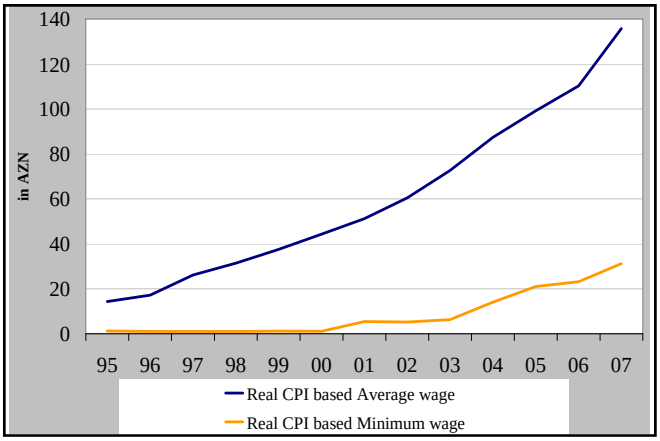
Wages

7.12. **Average wages have tripled since 2000**. In 2000–07, the average real monthly wage increased at an annual rate of 17.5 percent and reached AZN 214 in 2007. Disparities in average wages also were enormous (see figure 7.2 for 2006 wage dispersion). In 2007, in the mining sector, the average monthly wage was AZN 846, or 6–10 times higher than in the lowest paid sectors: agriculture, health, and education. It is also important to note that a significant portion of wages and "top-ups"[136] were not reported to authorities.[137]

7.13. **The government increased the minimum wage six-fold in real terms between 2001 and 2007, but from a low base.** In Azerbaijan, the minimum wage was kept low for a long period. Only since 2001 did minimum wage levels start to slowly increase but, by 2007, the level was still only 23 percent of average wages in the country (Figure 7.2). The November 2006 wage survey found that, during that period, only 1.7 percent of full-time employees earned salaries below the minimum wage of AZN 30 per month.[138] This level is indeed too low to be binding, that is, to affect wage and employment decisions.

[136] Salary "top-ups" refer to official cash payments or in-kind benefits that a civil servant receives above what colleagues in the same grade and pay scale receive.
[137] SSC 2007.
[138] SSC 2007.

Figure 7.2: Monthly Wages in Azerbaijan, 1995-07



Sources: Azerbaijan authorities and World Bank staff estimates.

C. INEFFICIENCIES OF THE EDUCATION SYSTEM

Access to Education

7.14. **Azerbaijan inherited relatively good education indicators at independence but, during the transition years, the supply of qualified graduates significantly diminished.** At independence, Azerbaijan inherited a relatively well-developed education system, with better education indicators than countries with a similar GDP per capita. The 1989 census indicated an overall literacy rate of 99.6 percent. At that time, virtually all children, regardless of gender, poverty level, or geographic location, completed a nine-year basic education. However, from 1989 until the mid-1990s, for many reasons including economic depression, the admission, enrollment, and graduation of students, especially in secondary, specialized and vocational education establishments, dropped very significantly before recovering gradually. As a result, younger cohorts of employed individuals tend to have lower education levels (Table 7.4).

Table 7.4: Structure of Employed and Unemployed Population by Education Level, 2006 (%)

		Including:				
Age	Total	Higher	Incomplete higher and secondary specialized	Vocational	Secondary general	Below secondary general
25–34	100.0	18.3	9.2	4.2	64.1	4.2
35–44	100.0	19.0	12.3	6.1	60.0	2.6
45–54	100.0	24.0	15.2	6.8	50.7	3.3

Source: SSC/MoLSPP LFS 2006.

7.15. **While access to general compulsory education is nearly universal, enrollment in higher education remains low.** The general tendency of participation in schooling is as follows: very low enrollment in preschool, followed by nearly 100 percent enrollment in primary and secondary schools (most of them being in the public domain), and a precipitously declining participation at ages corresponding to higher education (in which the enrollment rate is 15 percent). In other words, Azerbaijan's continued commitment to equitable access is evident at

the primary and secondary levels, but disappointingly lacking at the preschool and higher education levels.

7.16. **Moreover, large disparities exist in access to higher education among populations, depending on their wealth and location.** The enrollment rate for the richest quintile was twice as high as the one for the poorest quintile. Similarly, in 2005, higher education enrollment rates in rural areas were more than three times lower than in Baku and two times lower than that in non-Baku urban areas. It also is notable that there is a large and growing gap between the demand and number of places available in higher education institutions. While the number of applicants for higher education admission examinations has almost tripled since 1992, the number of places available has remained flat. In 2006, there were five applicants for each available place.

7.17. **Public spending on education as a percentage of GDP has fallen continually since the end of the Soviet era** (from 7.6 in 1993 to 2.7 percent of GDP in 2006) (Table 7.5). While the level of education spending has been growing by double digits since 2003, it compares less favorably to the rates of increase in total public spending. Compared to the OECD countries, in which public spending on education averaged 5.2 percent of GDP in 2006, Azerbaijan's spending on education is very low. Moreover, Azerbaijan spends less than 0.2 percent of GDP on higher education—less than one-fifth of the EU25 average of 1.14 percent. As public spending on education decreased, households assumed more roles in educational spending, which negatively impacted the participation of children from poor backgrounds, particularly at non-compulsory education levels. The richest 20 percent of the population consistently accounts for nearly 40 percent of private spending, while the poorest 20 percent spends only approximately 10 percent of the total private spending on education. Furthermore, this gap between the spending of the poorest and richest wealth groups has grown over time.

Table 7.5: Total Public Expenditures on Education, 2000–06 (%)

Year	GDP	Total public expenditures	Annual growth (%)
2000	3.9	23.8	-
2001	3.5	23.8	2.3
2002	3.2	20.5	2.8
2003	3.3	19.0	22.8
2004	3.4	19.6	25.3
2005	3.0	17.4	26.7
2006	2.7	12.6	28.6

Source: Ministry of Finance.

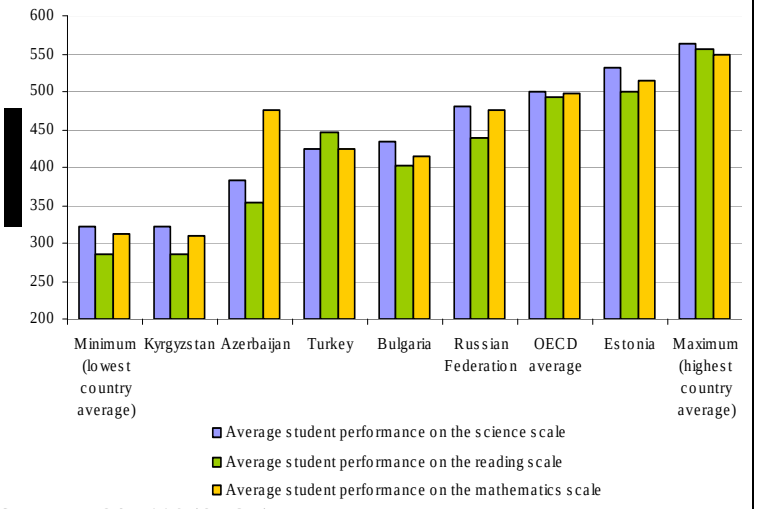
Poor Quality of Education

7.18. **The quality of education in Azerbaijan is worrisome.** The OECD's Program for International Student Assessment (PISA) study evaluates the quality and performance of education. PISA shows that Azerbaijan's general secondary education system is performing poorly. The analysis of the performance of the 2006 high school graduates shows that, while their performance is close to that of Russia and the OECD average in mathematics, it is very low in reading and science (Figure 7.3). These results indicate that most Azeri graduates may lack key competencies to succeed in higher education. Moreover, most of the country's tertiary educational institutions, public and private, are perceived as operating at below standards, despite the competitive university entrance examination. This disappointing overall performance is explained by, among other reasons, the absence of a comprehensive quality assurance system, poor quality teaching, and corruption. In particular, the quality of teaching personnel has deteriorated considerably due to sharp drop in relative real teacher salaries and deteriorating conditions of the school environment. These major disincentives have prompted many of the best

teachers to leave and have demoralized the remaining teaching staff. Low salaries also create an incentive for corruption among teachers, which is known to be widespread in education. This perhaps explains why diplomas awarded to students are a poor measure of competence.

7.19. **There also is an important mismatch between the specialization of graduates and the present and future needs of the economy.** In professional and higher education establishments, there is an overproduction of specialists in areas such as education and health, which provide relatively limited job opportunities in a chosen specialty, whereas very few graduates are specializing in agriculture and services, in which the bulk of employment is concentrated. For instance, half of the graduates of higher education establishments are specialized in education, a sector that provides only 8.6 percent of employment plus unattractive wages. Moreover, there is an "excess supply" of workers with general secondary education and no vocational skills.[139] They represent 70 percent of the unemployed population, whereas only a maximum of 60 percent of all jobs require general secondary education. This mismatch leads to a higher unemployment rate among workers with general education. Lack of vocational/technical skills severely limits workers' employment chances.[140]

Figure 7.3:Average Student Performance in PISA 2006 International Comparison



Source: PISA 2006 (OECD)

7.20. **This mismatch is perceived by employers**. For instance, while SMEs find it very easy to find unqualified laborers (which constitute the bulk of recruited employees), they have difficulties finding available qualified crafts and related trade personnel, technicians, employees with computer proficiency, and managers.[141] *At the November 2007 Baku Job Fair, no suitable candidates could be found for 50 percent of the 7,000 jobs offered.*[142] The General Employment Department under the MoLSPP gives as a reason for this relative failure is that many of the jobs had high requirements for key competencies that are not usually well developed in Azeri education curricula, such as personal computer skills and English. As mentioned before, this difficulty in finding qualified workers is also experienced by the public sector, and by foreign investors, who often must train every Azeri operational employee, both in-house and abroad. For instance, *for the first time in its world experience, British Petroleum (BP), the key investor in the oil sector, was compelled to establish from scratch a large training center in Azerbaijan to deal with the low competence levels.*

[139] World Bank 2008.
[140] Rutkowski 2007.
[141] See the results of the 2007 IFC survey on the business environment for SMEs in Azerbaijan, and Kuddo and others 2005.
[142] World Bank 2008.

D. Improving Labor Market Policies and the Education System

Government's Strategy

7.21. **The government has recognized the need to tackle human capital issues to improve its long-term economic prospects.** This recognition is reflected in the new SPPRED (2006–2015), which chose poverty reduction, diversification of the economy, and regional, social, and economic development as its overriding objectives. A National Employment Strategy was adopted in 2005, and its operationalization has begun through the National Action Plan adopted in 2007. The "substance" of the strategy is that it is not the role of government, but of the private sector, to create jobs.

7.22. **The National Employment Strategy identified multiple priorities.** They include reforms in labor market institutions and policies; modernization of vocational education and the introduction of life-long learning; improved social protection of job seekers and unemployed citizens; and promotion of employment of youth, women, disabled, internally displaced persons (IDPs), and refugees. To address the youth employment challenge, the government, in 2003, volunteered to be a lead country of the UN Secretary General's Youth Employment Network (YEN). In cooperation with the International Labor Organization (ILO), the government also developed the "Decent Work Country Program 2006–2009" to promote opportunities for adults to obtain decent and productive work in conditions of freedom, equity, security, and human dignity. In 2004, the government approved the State Program for Socio-Economic Development of the Regions (SPSEDR) to create 600,000 new jobs over five years (2004–08), a goal that has been achieved, according to official statistics, although approximately half of the jobs created are temporary.

7.23. **Some progress has recently been made on the regulatory side**. After ranking Azerbaijan 67 in employment practices in Doing Business 2008, Doing Business 2009 ranked Azerbaijan 15, while ranking Armenia 19 and Russia 54. This ranking was based on: (i) the cost of firing, in terms of weeks of salary; and (ii) an employment rigidity index, which averages the difficulty of hiring, rigidity of hours and difficulty of firing. Although Azerbaijan's cost of firing remained unchanged at 22 weeks, the rigidity index dropped from 31 to 3.3 in the last year due to labor reforms. Not only are there no government mandated restrictions on fixed-term contracts, but the "minimum wage" also does not exceed the average worker's value added. This absence of government interference in the efficient allocation of labor resources will contribute to the development of the private non-oil economy.

Reforming the Education/Training System

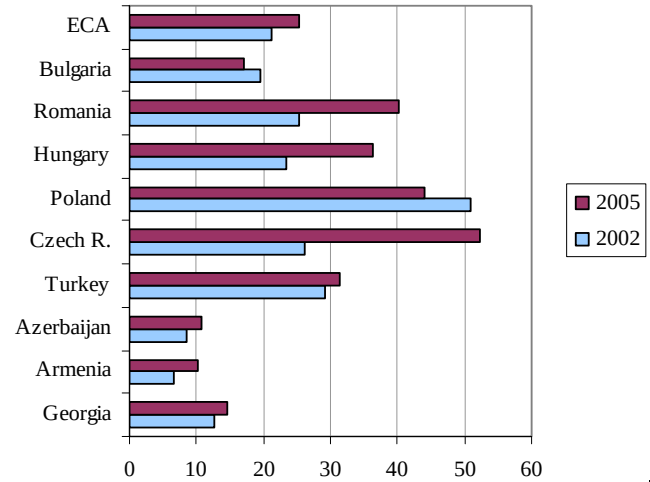
7.24. **Large improvements in the education system are urgently needed** if all Azeris are to have opportunities to develop the knowledge, skills, and attitudes required to prosper in a world increasingly based on technology and the rapid exchange of information. Achieving these key competencies should be the core objective of the education system. Investment in human capital indeed will be the critical factor to improve the employment prospects of the population and the increase in non-oil productivity.

7.25. **The government needs to invest more in education, particularly at the tertiary level.** It is essential that the government revise public spending priorities to make education a top objective in order to ensure quality and improve enrollment rates in higher education (Chapter 3). On the one hand, an important effort to increase r wage is necessary to recruit better teachers, as well as give them appropriate incentives and limit corruption. This effort might be financed partially through raising the very low student-teacher ratio in secondary education (9.4, compared to the OECD average of 14). And it should be linked with measures to reduce corruption in the education system so that diplomas regain real value. On the other, public spending on higher education also should gradually increase to 1.1 percent of non-oil GDP to create new universities (especially outside of Baku) and increase the number of places available in tertiary education institutions. Azerbaijan also could explore attracting foreign universities and private training companies.

7.26. **Education and training must be linked to today's labor market needs.** Increasing employment opportunities means intervening in the mismatch between graduates' specializations and the structure and needs of the economy. Such interventions entail increasing cooperation between the labor and education ministries. This can be done: (i) through career counseling, offering better information to students on recruiting sectors and wages offered; and (ii) revising the curricula of public universities and professional schools based on communication with the private sector and a comprehensive study of current and future labor market needs.

7.27. **Concurrently, there is a need to develop a modern system of vocational education and training** (VET) as well as adult training (lifelong learning) that will equip workers with the skills required by employers and the global economy. This system restructure and modernize and subsequently expand the network of regional training centers and VET schools, as well as create a Common Quality Assurance Framework and a standardized, competence-based qualification system. In doing so, Azerbaijan can benefit from the recent experience of certain OECD countries such as Hungary.

Figure 7.4: Labor Relations as a Problem for Doing Business BEEPS Survey *(% of Respondents)*



Sources: EBRD and World Bank

Improving Labor Policies

7.28. **While there are relatively few complaints among the employers in Azerbaijan with respect to the rigidity of labor legislation, social security contributions and informality remain high.** The 2005 BEEPS survey of local employers found that only 8 percent of them listed labor regulations as a problem to doing business. (Figure 7.4). This was confirmed by the 2008 IFC survey (only 1 percent of the respondents mention the labor code as one of the three major obstacles to doing business). The current weak regulation of the labor market may have helped employment flexibility. However, weak regulation also appears to have had trade-offs by promoting informalization of the economy, lower worker productivity, and reduced worker

welfare, such as low wages, growth of in-kind substitutes for remuneration, and wage arrears. Informality might also be spurred by the relatively high level of social security contribution (25 percent in Azerbaijan compared to 20 percent and 18 percent, respectively, in Georgia and Armenia).

7.29. **Given its scope in Azerbaijan, the issue of undeclared work should be addressed.** The size of undeclared work reduces social security contributions and leads to a high tax burden on registered labor. As discussed in Chapter 5, effective strategies to reduce undeclared work require a combination of "carrots" (reforms and actions to facilitate, reduce the costs, and increase the benefits of formalization) and "sticks" (enhanced, even-handed enforcement of such improved laws and regulations).

7.30. **Insufficient enforcement of existing labor laws has led to the deterioration of work conditions and occupational safety.** A number of enterprises have been, to a great extent, neglecting labor safety standards. In addition, in recent years, very few investments were made in new technology or in improving existing ones. The depreciation of machinery, therefore, has been very quick, and some machines have even become dangerous. In many cases, new technology was purchased by an enterprise, but training was not sufficient to manage it, resulting in increased work-related accidents. Although not all cases of industrial accidents have been reported and some have been "paid for" by employers, official statistics show that between 50 and 80 workers die annually from accidents in industry alone. Therefore, enhancing the capacity of the Labor Inspectorate to enforce the labor laws is a critical reform of labor market institutions.

7.31. **The MoLSPP/General Employment Department (GED) could develop active labor market policies.** Strategies to "activate" the unemployed with the help of high-quality employment services can help ensure that benefit recipients and other job seekers have better opportunities to find employment. In Azerbaijan, this requires improving initial job counseling, job fairs, training programs, and public works projects, through better assessment of previous programs and better tailoring to the needs and characteristics of the beneficiaries and of the labor market. It also entails networking with social and health services, the housing sector, and communities.

7.32. **Labor market policies would benefit from modern occupational classifications and standards, as well as from improved labor market monitoring.** Azerbaijan lacks modern occupational classifications and standards as key factors to refer to in setting requirements in employment (for example, at entry level; skilled worker level; middle technician level) within an industry sector, or in particular jobs. For example, there is no international compatibility/transparency of occupational standards with reference to ISCO-88/ISCO-08 standards. As a result, workers do not have a means of communicating to employers and employment agencies any skills learned through informal and formal channels. Also, employers do not have a means of defining skill requirements by occupation or evaluating the skills of individuals presenting themselves for employment. Regarding labor market monitoring, labor force surveys and wage statistics need further improvement. It would also be useful to complement them with employer-based surveys of current and projected labor market conditions (actual and planned job creation and job destruction, key determinants of hiring and firing) and with studies aimed at keeping track of graduates to analyze the links between education and the

labor market.[143] Such surveys and studies would help policy-making and facilitate adjustment of policies to current and future change of labor market conditions.

E. Attracting, Retaining, and Managing Public Sector Employees

7.33. **Azerbaijan's public sector is experiencing two challenges: rising wages and poorly qualified employees**. Azerbaijan's high public sector spending is creating a need for greater numbers of more qualified public sector employees. Yet, rising disparities between public and private sector pay are making it more difficult for the government to attract and retain well-qualified public sector employees. In 2006, for instance, wages in the private sector were 118 percent and 65 percent higher in health and education respectively (Table 7.6), and twice as high on average, compared to the public sector. Figure 7.2 also suggests that the gap between average wages in largely government-funded sectors (public administration, health, and education) and average wages in largely privately-run sectors (mining, construction, financial services, transport) increased through 2007. Ideally, the government would like to pay its top public sector employees more, but it needs to find a way to link additional pay to performance. Azerbaijan's 16 salary grades for public sector employees have a compression ratio of only 1.56, although this ratio increases to 3.6 when including grades 17–19, which were reintroduced in early 2007.

Linking Pay to Performance: Too Difficult?

7.34. **Significant reforms in management practices have been deemed prerequisites to link pay with performance.** Improving pay policies and practices is not, by itself, a meaningful strategy to improve the quality and cost-effectiveness of service delivery. Underlying managerial incentives also need to be properly aligned. In turn, to properly align management incentives, the government must first establish and ensure continuous monitoring of performance. In short, performance management requires organizational units to figure out precisely what progress would look like and how to measure it. Subsequently, organizational units actually need to measure the indicators that would provide systematic evidence of what is being accomplished.

Table 7.6: Comparison of Average Wages Between the Public and Private Sectors, 2006 *(AZN)*

	Public Sector	Private Sector
Agriculture, hunting and forestry	52.5	52.3
Fishing	55.4	35
Health and social work	65.1	142.4
Education	77.5	128.1
Wholesale and retail trade	102	125.9
Manufacturing	116.7	124.3
Electricity, gas and water supply	128.7	271.8
Public administration and defense	132.4	55.9
Hotels and restaurants	161.1	164
Transport, storage, communications	164.5	270.6
Construction	189.6	406.1
Real estate	199.6	869.7
Financial intermediation	228.1	511.1
Mining and quarrying	349.1	1269.7
Average	***109.4***	***220.9***

Source: Statcom.

7.35. **Experience has shown that linking pay to performance is difficult to manage...** OECD countries that have made significant progress on performance-focused reform agendas have

[143] See World Bank 2008.

found the process of developing and measuring performance (whether it be activities, outputs, or outcomes) to be extremely challenging and to require a considerable gestation. Based on the results of such reforms, the empirical literature on performance-based pay reforms is discouraging[144]. U.K.[145], New Zealand[146], and Chile[147] provide, perhaps, a few of the more significant and extensively researched examples. The discouraging results from empirical research on these countries is an especially telling finding, given that most of this literature examines reforms in quite sophisticated OECD countries, rather than in the more challenging management environments found in countries such as Azerbaijan.

7.36. **...and that it may provide the wrong incentives for managers or organizational units.** Conditioning budgets on organizational and unit performance also is not a very good idea because it poses the very real risk that organizational units facing more difficult external or demand-driven circumstances (such as schools facing poorly prepared or qualified students) will face budget cuts due to factors outside their direct control. In short, it is risky and problematic to use performance information as triggers for either budget adjustments or individual performance bonuses. Rather, information on organization or unit performance is generally better used to inform management actions aimed at encouraging particularly productive behavior by organizational units and their staff, and to encourage such units and staff to consider adjusting their behaviors when they are not achieving the desired results (outputs, outcomes).

Linking pay to Promotions: the "Old" New Idea

7.37. **A more promising approach to pay reform than performance bonuses focuses on *establishing a competitive remuneration structure* (to attract and retain qualified staff), coupled with promotions practices that promise salary improvements primarily through promotions based on performance.** This approach requires, among other things, reducing the extent to which seniority brings with it automatic increases in pay, and instead using these resources to finance greater salary increases through performance-linked promotions.

7.38. **Under a promotion-performance linkage strategy, pay should be viewed primarily as a means to attract and retain qualified staff.** This view makes it all the more important to get right the structure of overall remuneration (all elements of pay) across positions to ensure roughly consistent competitiveness (with respect to the relevant domestic comparators) across all positions. Most public administrations in developing countries fail to accomplish this. Instead, they tend to pay more competitive salaries for low-skilled positions (gardeners, drivers, day laborers) than for high-skilled positions (professionals, managers). This pattern poses at least two major problems:

- It makes it progressively more difficult to attract and retain qualified staff as the skill requirements of positions rise;

[144] See, for example, OECD 2005a.
[145] See, for example, AUT 2003 and Office of Manpower Economics 200, and the literature cited therein for examples.
[146] See Perris 1998 and its bibliography for examples.
[147] See Thorn and others 2004 and its bibliography for examples.

- It undermines incentives for staff in the higher-skilled ranks to try to make a career in the public administration, since the more skilled they become through work experience, the less competitive is the remuneration.

7.39. **One of the major difficulties with annual performance-related payments (either one-off bonuses or increases in core salary) is to get supervisors to reliably assign annual bonuses on the basis of performance.** Managers are under significant pressure to keep all their staff happy, so they tend to give roughly the same bonuses to everybody. Worse, they may assign bonuses on the basis of non-performance factors, such as being a good friend or member of the same ethnic group. Such patterns are difficult to counteract, since such decisions must be made each year and there are too few incentives to build enough checks and balances to keep the annual performance-related pay process honest. If the primary means of rewarding performance with pay increases is through the promotions process, those responsible stand a better chance of being able to build sufficient checks and balances on these promotions processes. It is not easy but, compared to the options above, the odds of success are better:

- This route is more promising because the employer must invest resources on reviewing such decisions only every several years for any given employee, rather than every year.
- It is easier to establish expectations that promotions are not automatic than to establish expectations that annual pay increases (or bonuses) are not deserved by all or most staff.

7.40. **Finally, to make promotions the primary vehicle for linking performance to pay, it is essential to make sure that the annual personnel performance assessment process reliably sorts staff according to performance.** Fortunately, it is possible to systematically track data that give at least some sense of whether performance is the measure being used by tracking the fraction of performance ratings falling in the top or top two rating categories. Excessive concentration of ratings in these top two categories is a signal that the annual performance appraisal process is not working well. In addition, it is possible to impose various constraints on the annual performance appraisal process that can help to ensure that it does reliably sort staff on the basis of performance.[148]

Monitoring Impact is Still Relevant, but for Management Purposes

7.41. **Developing information on the objectives and performance of organizational units is important to improve management, not for other purposes**. The primary use of monitoring information is to improve management, rather than to condition either budgets or bonuses on performance. Such information can improve management in two distinct ways:

- It can provide feedback to managers, who can use that feedback to continuously adjust course and encourage and nudge their staff to either keep doing what is working or adjust their efforts where the feedback is less encouraging.
- It can be used by central authorities to manage their managers in exactly the same way that this information can be used by managers to manage their staff.

[148] See, for instance, Reid 2003 and 1999.

The point is that the information gained from monitoring allows for the timely flow of information to management.

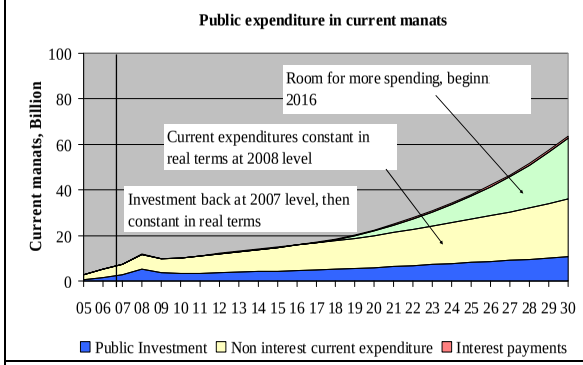
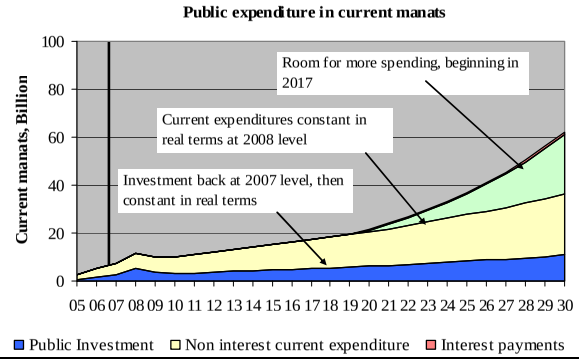
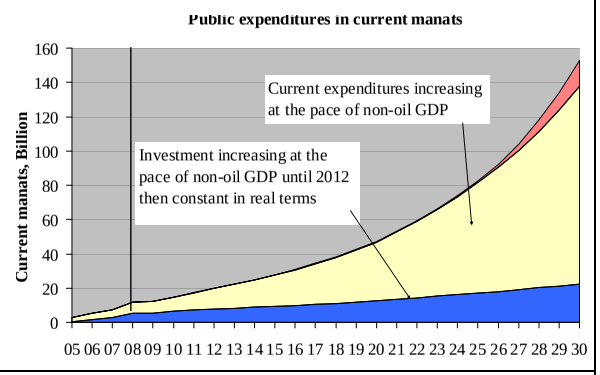
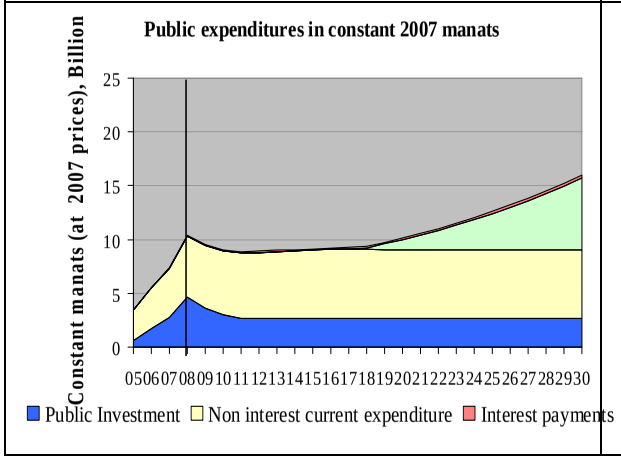
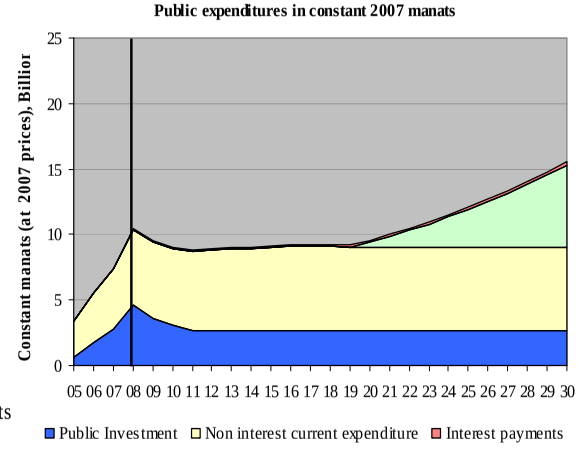
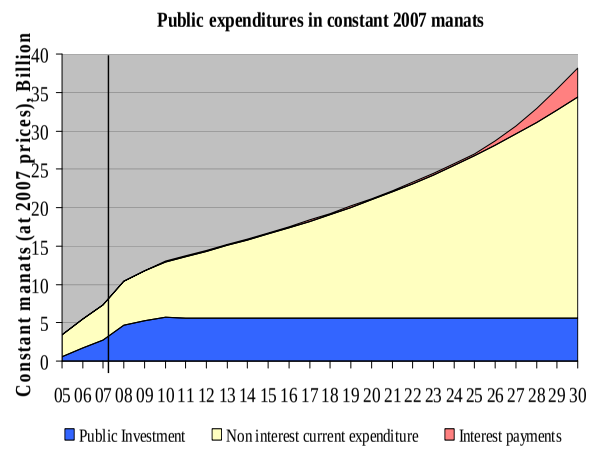
F. CONCLUSION: THE RETURNS TO INVESTING IN HUMAN CAPITAL

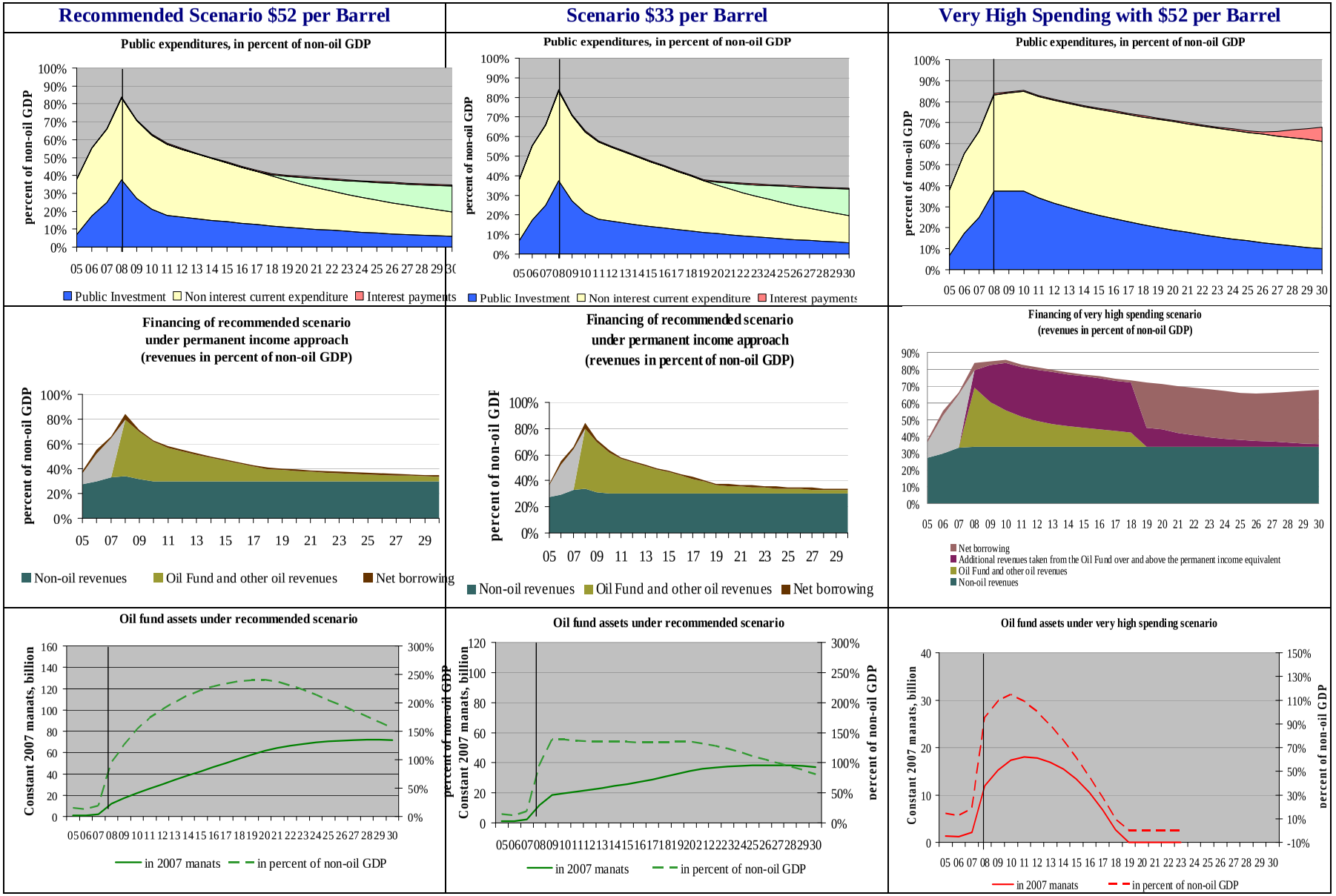
7.42. **Investment in human capital must be regarded as an essential pillar of Azerbaijan's medium-term development strategy**. Building an education system with higher tertiary enrollment, better quality of teaching, more reliable diplomas, specialization in accordance with present and future needs of the economy, and improved lifelong training would ensure a more qualified labor force. Building an educated workforce also would create the foundation and potential for important productivity gains, facilitate the diversification of the economy, and accelerate the technological catch-up process. All of these are necessary elements to foster sustained growth in Azerbaijan beyond the oil windfalls.

7.43. Concerning the labor market itself-- addressing the issue of undeclared work; improving work conditions and safety; and developing modern, active labor policies are crucial for increasing workers' welfare while reducing structural unemployment.

7.44. Finally, an enhanced public sector pay— and management strategy— will help develop a more efficient and adaptable government.

ANNEX 1: COMPARISON OF THE RECOMMENDED SCENARIO & VERY HIGH SPENDING SCENARIO, 2005–30

Recommended Scenario $52 per Barrel	Scenario $33 per Barrel	Very High Spending with $52 per Barrel
		
		



Notes: Oil prices in 2007 US$. Simulations, permanent income is calculated based on the net present value of oil revenues for 2008–24 and phasing out AIOC from 2025–29.

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