

Annex 2: Action Fiche for Azerbaijan AAP 2011

1. Identification

Title/Number	Rural Development Support Programme (RDSP) (ENPI/2011/22821)		
Total cost	EUR 20 million		
Aid method / Method of implementation	Sector Policy Support Programme (SPSP): - Sector budget support (centralised management) - Project mode (centralised management)		
DAC-code	43040	Sector	Rural development

2. Rationale and country context

2.1. Country context and rationale for SPSP

2.1.1. Economic and social situation and poverty analysis

In recent years, Azerbaijan's economy growth has been amongst the highest in the world. The major driver is the oil sector (57.4% of GDP) but the non-oil sector also expands because of large public expenditure. Half (48%) of its population live in rural areas, earning less than those in the cities. The difference in income and job opportunities with the urban centres is increasing and causes an uneven development of the country. Thus, the Government of Azerbaijan attaches a high priority to the balanced development of the country. The EU pays particular attention to the development of rural and remote areas as reflected in the EU-Azerbaijan ENP Action Plan. Since the crisis the economic outlook worsened, however, now with oil prices increasing, the financial future is improving again. In 2009 Azerbaijan's GDP increased by 9.3%, with growth in 2010 estimated at 9.8%.

2.1.2. National development policy

Azerbaijan's challenge is to use its oil revenues to stimulate sustainable broad-based growth and ensure the welfare of current and future generations. The main long-term strategic priorities and orientations of the government are to further reduce poverty by supporting non-oil sector growth, while maintaining macroeconomic stability; improving quality and access to health, education services and infrastructure; better targeting social protection; creating conditions for improving income-generation opportunities; improving gender equality; and achieving environmental sustainability.

The "State Programme on Poverty Reduction and Sustainable Development in the Azerbaijan Republic for 2008-2015" (SPPRSD) is the overall development framework, complemented in particular by the State Programmes on the Social-Economic Development of Regions (2004-2008) and (2009-2013). The SPPRSD also commits the Government to improve employment opportunities of refugees and Internally Displaced Persons (IDP).

Ownership can be considered high as State Programmes derive from proposals from the government that are in turn incorporated into the annual activity plans of individual ministries.

2.2. Sector context: policies and challenges

2.2.1. Sector policy and strategy

The **SPPRSD 2008-2015** is the key strategy for national development, with the Ministry of Economic Development (MoED) coordinating its implementation and it consists in a list of 1,066 measures to be undertaken by various state bodies.

High growth rate in rural areas was achieved also as a result of successful implementation of “The State Program on Socio-Economic Development of Regions for 2004-2008 years” and the strategy played an important role in improving living condition of Azerbaijani population. For example, real volume of GDP for the non-oil sector grew by 1.8 times over these 5 years and in 2008 income of population increased by fourfold compared to 2003. During this period, monthly wages of employees rose by 3.5 times to exceeded inflation level by 1.7 times. At the end of 2008 only 13.2% of population lived in poverty, while that figure was about 45% in 2003.

The Government is now called to consolidate these results and to tackle future challenges for Azerbaijan, by continuing pursuing sound growth opportunities in the non-oil economy, sustainable reduction in poverty levels and a balanced development of society. The uneven development of the capital and rural areas mean that strengthening regional and rural development plays a key role to meeting these challenges.

This is why in 2009 the President of the Republic of Azerbaijan approved the "State Program on Social-Economic Development of Regions of the Republic of Azerbaijan (SPSEDR) for the years of 2009-2013" and appointed the Ministry of Economic Development (MoED) as coordinating body. The **SPSEDR 2009-2013** objective is to achieve: an acceleration of non-oil sector development, diversification of the economy, balanced regional and sustainable social-economic development and further improvement of the living standards of population. It contains a comprehensive series of actions for each of the economic regions of Azerbaijan with clear responsibilities attributed to dozens of institutional Implementing Agencies and companies¹, although it does not detail a timeline and specific budget for each action.

Therefore, the main challenge for each of the state bodies involved, and in particular for the MoED which is called on to coordinate all other actors, is thus to identify priorities and to establish a sequencing of actions, as well as to ensure that required resources are available at the right time for implementation and within respective remits at national and region level.

2.2.2 Macro-economic context

Despite GDP growth in Azerbaijan having slowed from 10.8% in 2008 to 9.3% in 2010 (and projected to be around 4% in 2011) the macro-economic situation of the country is considered, especially if compared with regional trends, as positive. The oil and gas sector (constituting 55% of GDP and 95% of total export revenue) remaining the major driver of growth, helped by higher oil prices in the second half of 2009 and by increased production of hydrocarbons from the Caspian Sea. With falling international commodity prices, the

¹ Both OJSC (Open Joint Stock Company) and CJSC (Closed Joint Stock Company)

consumer price index was only 1.5% in 2010, versus 20.8% in 2009. And lower inflation allowed the central bank to relax monetary policy through phased but steep reductions in the refinancing rate, which will amount to around 6% in 2010 from a high level of 15% in 2008.

2.2.3. Budget and Medium Term Expenditure Framework (MTEF)

The International Monetary Fund (IMF) has advised the government to prepare annual budget spending plans of the various ministries in the context of a medium-term framework, including for multi-year investment programs. A basic form of medium-term expenditure framework (MTEF) exists but there is need to enhance the comprehensiveness and the transparency of the budgeting process.

2.2.4. Public Financial Management (PFM)

The authorities are working on corrective actions in areas related to improving expenditure control and to improving efficiency and coordination between central and sub-national levels related to accounting standards and to timely availability of financial information and transfers.

Moreover and also based on the latest (2009) PEFA report, the authorities have also decided to re-assess the PFM situation and look at strengthening the weakest areas.

Finally, it can be noted that the World Bank is providing assistance to the ongoing programme aimed at gradually improving public and corporate accountability including via the establishment of an integrated computerization system.

2.3. Eligibility for budget support

National development policy and strategy

This Rural Development Support Programme (RDSP) is based on the "State Programme on Poverty Reduction and Sustainable Development in the Azerbaijan Republic for 2008-2015" (SPPRSD 2008-2015) and on the SPSEDR 2009-2013 as the two are complementary. For both Programmes the MoED has been given the coordinating role. Both the SPPRSD 2008-2015 and the SPSEDR 2009-2013 support the same priorities. Most relevant to this RDSP are the following five axes:

- (i) Developing non-oil sector, provision of economic development directed to the reduction of poverty through the creation of favorable condition for extending people's income opportunities especially in regions and rural areas;
- (ii) Implementation of expedient measures on improvement of entrepreneurial climate and further acceleration of development of entrepreneurship;
- (iii) Continuing institutional reforms for ensuring efficient management;
- (iv) Ensuring sustainable growth of people's income;
- (v) Continuing activities for improving life standards of refugees and IDPs;

Macroeconomic policy

Azerbaijan has weathered the economic global crisis relatively well. The last IMF Article IV staff consultation has provided a positive assessment of the macro-economic policy stance

and noted that "*due to the authorities' appropriate policy response, the exchange rate remained stable, inflation dropped dramatically, official poverty rates continued to fall, and financial stability was maintained*".

Some further measures representing an important element of the government's overall economic policy is the improvement of the business legal and regulatory environment, and recent reports (e.g., the World Bank Doing Business) highlights significant improvements in business climate linked also to a decreasing level of controls and regulations.

Macroeconomic prospects for the near future remain positive, although actual macroeconomic performance will be largely dependent on the evolution of the situation in the oil and gas markets. Moreover, key medium- and longer-term objectives for supporting sustainable growth in Azerbaijan will be to diversify and progressively reduce dependency from the non-oil sector, to implement and sustain fiscal consolidation and to further develop its monetary policy.

Public financial management

The challenges facing public finance management have been reviewed in the context of the last PEFA review. Such challenges would require improvements in areas such as: (i) medium term fiscal framework, (ii) Parliamentary budget oversight; (iii) performance focus in external audits and (iv) upgrading public finance systems at central and at decentralised level.

While such relevant challenges can reasonably be met only in a medium- to long-term period, a positive trend can be noted insofar as the Government has expressed willingness to enhance its PFM system through a number of actions in the several areas including budget reclassification; multi-year perspective in fiscal planning, expenditure policy and budgeting; effectiveness of internal controls for non-salary expenditure; availability of information on resources received by service delivery units; quality and timeliness of annual financial statements. It is thus of particular relevance for cooperation partners to support, and to assist in monitoring, the Government's engagement in this field.

In the meantime, some positive developments can be noted as follows:

- The last IMF Executive Board review, following Article IV consultation, commended the authorities for making Azerbaijan the first country to be fully compliant with the Extractive Industries Transparency Initiative, notably with regard to improving transparency and accountability in the extractive sectors.
- Regarding tax administration, the EBRD 'Transition Report 2010' concludes that the Government of Azerbaijan has indeed improved tax administration by, inter alia, reducing tax compliance costs for business.
- The Budget Systems Law has recently been assessed by independent reviews, as providing a sound framework for the budgeting process, and its implementation compliant with strict guidelines.
- Progress in the national treasury system have allowed direct payments to suppliers and controls local expenditures in over one third of the regions by end 2010.

- The Chamber of Accounts has requested and is preparing a PFM-related action plans with support from the World Bank
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- Azerbaijan is receiving technical assistance in the areas of audit and financial control by the World Bank-supported Corporate and Public Sector Accountability Project (CAPSAP), notably in the areas of budget classification and external auditing. To be finally noted that two EC-supported- initiatives are also ongoing: an EC/OECD SIGMA technical assistance project on developing public procurement, and an EC twinning project helping to build capacity in the Chamber of Accounts.

Summary and conclusion

The GoA's macroeconomic policy and outcome show a considerable resiliency to adverse global economic conditions. Progress is slower in terms of public finance reforms but expenditure controls are robust and budgetary procedures are improving.

Based on the above, it is concluded that Azerbaijan can be considered as eligible for EU budget support.

2.4. Lessons learnt

From the side of the Government the SPSEDR 2004-2008 and the SPPRSD 2008-2015 have contributed to a sustainable development of the non-oil sector: new enterprises were established, social infrastructure and the business environment improved, investments and employment increased and poverty reduced. These efforts need to be pursued further under both the SPPRSD 2010-2013 Action Plan and SPSEDR 2009-2013 in order to be effective and sustainable.

From the perspective of EU Sector Policy Budget Support (SPSP) activities, historically, ten years (1996-2006) of EU Budget support to Azerbaijan through the Food Security Programme demonstrated that an achievements oriented budget support programme with clear beneficiary ownership bears results, provides the government with leverage to implement good governance, and offers a framework for policy dialogue and bi-lateral exchange of expertise.

Currently, SPSP operations are governed by a GoA internal mechanism, which processes SPSP funds and monitors progress towards benchmarks. The development phase of this mechanism in 2008-2009 delayed the releases of tranches, but, since 2010, activities have recommenced, with the payment of the first fixed tranche of the AAP 2007 Energy Sector Reform Budget Support programme and the submission of the first request for payment under the AAP2008 Justice Sector Reform Budget Support programme.

Although still in the early stages, these programmes are demonstrating the added value of Budget Support as an aid modality over traditional project approaches. Their more comprehensive approach is helping to provide the foundations for a wider policy dialogue as, for example, seen in the high level steering committee being set up under the Justice Programme. Moreover, the outcome-based nature of Budget Support operations is committing the GoA to deliver results - the Ministry of Justice has, for example, submitted detailed Departmental Action Plans (a significant change to their traditional work-methods).

In addition, as all Budget Support programmes are contingent on PFM-related reforms, they are generating a leveraging effect for further reform in this area. Dialogue on PFM reform has, as a result, been gradually improving since 2009, with a commitment expressed by the GoA to tackle the weakest areas of their public finance system as outlined above.

In terms of the sector, regional and rural development is a key area of reform for Azerbaijan as stressed by the Government during programming and identification phases of this action and as reflected in the National Indicative Programme (2011-2013)². The policy dialogue started for the preparation of this programme will be further developed at the implementation phase of this RDSP and will be essential in focussing the efforts of government, the EU and other donors. In particular, as the Ministry of Economic Development has to coordinate every actor involved in Rural Development³, this Sector Policy Support Programme will further enhance its coordination capacity, with possible benefits for an increasingly effective EU assistance in the Country, especially under Budget Support Operations.

By using a project approach under centralised management, it would have been impossible to manage or even to influence this complex institutional set up. Moreover, a project would create an ineffectual duplication of activities (thus increasing costs for the government and reducing EU funds outreach) while establishing a parallel structure in contradiction with EU Backbone Strategy principles and Technical Cooperation Guidelines.

Besides, the Government has already developed its strategies for Azerbaijan Rural and Regional Development, so there is no need for a self-standing Technical Assistance to design a programme of activities. Technical Assistance alone would have only a fragmented impact, associated with a lower level of ownership from the Beneficiary and with reduced focus on concretely measurable results and long term achievements.

In summary, the comprehensive approach of Budget Support is the most effective modality. Its application in a priority and broad sector like Rural Development is necessary, and will offer the EU the best possible mean to accompany the development of the country, while maintaining pressure for further PFM reforms.

Bearing these developments in mind, budget support is the relevant instrument in Azerbaijan to support a gradual building of a participative and comprehensive policy dialogue in this sector.

2.5. Complementary actions

In terms of EU aid, the Programme complements the 2009 EU-funded “Sector Budget Support Programme focusing on Agricultural and Rural Development” which addresses as one of its areas rural entrepreneurship. However, the implementation and the fulfilment of the conditionalities related to the SBS 2009 will be independent from this SBS 2011. The Programme will also take advantage of the results obtained by two twinning projects, “Support to the Improvement of Legal and Technical Aspects of Food Quality and Safety Assurance and Certification Requirements of Azerbaijani Fishery Products” and “Support to the State Statistical Committee”, which were recently completed. In addition, the Programme is complementary with ongoing technical assistance projects "Support to Investment Climate" and "Support to MoED".

² Sub-priority 2.2: *Diversification of Economy; regional and rural development*

³ Ref. to the Action Plan for “The State Program on socio-economic development of regions of the Republic of Azerbaijan for 2009-2013 years”

In terms of other donor activities, the Programme complements the World Bank's Agricultural Development and Credit Project-II that supports rural businesses to improve the linkages between producers and markets, facilitates investments through enhanced access to financial services as micro credit lines, and improves extension services; Azerbaijan Business environment enabling project (IFC), Private Sector development program (GTZ), Private sector Competiveness Enhancement programme (USAID) and IFAD's two development projects in the rural northern part of Azerbaijan.

In terms of PFM, the World Bank's supported Cooperate and Public Sector Accountability Project to commence in 2011 is expected to positively impact the 2008 PEFA ratings.

2.6. Donor coordination

MoED coordinates all government agencies and donors active in rural development programmes. Projects on micro credit have been implemented with WB, US-AID, GTZ, International Fund for Agriculture development (IFAD). Projects on value chain improvement with GTZ, USAID, WB. Irrigation programmes with WB, Rural roads with IFAD, Asian Development Bank (ADB) and WB.

3. Description

3.1. Objectives

The overall objective is to support Azerbaijan in the development of growth opportunities in the non-oil economy, sustainable reduction in poverty levels and a balanced development of society all over the country.

The two specific programme objectives are:

1. A rapid development of the labour and entrepreneurship potential in the rural areas, able to meet demand of rural businesses to accelerate their integration in the world economy.
2. MoED coordinating rural development effectively and efficiently.

3.2. Expected results and main activities

The expected results derived from these objectives are:

R1: Improved business climate and expanded opportunities in the rural areas for potential entrepreneurs including the establishment of incubators;

R2: Improved access to small loans in rural regions (including for IDPs) from credit institutions with effective lending guidelines, and well trained staff in these credit institutions.

R3: Improved rural development policies, strategies and programmes via improved capacity of coordination by the MoED and use of appropriate indicators and statistics.

The main stakeholder is the MoED in coordination with the Ministry of Finance (MoF), Central Bank of Azerbaijan (CBA), State Statistical Committee (SSC) and the State Committee for Refugees and Internally Displaced People (IDPs).

The main activities under these results will be:

- Establishment of Incubators Special Industrial Zones, and streamlined business licensing systems;
- Developing a strategy on financing in rural areas and its implementation;
- Building capacity of the MoED including for its regional offices.

3.3. Risks and assumptions

Risk 1. Macro economic instability caused by the financial crisis

Assumption: Sound finance management of MoF and the Central Bank lessens the impact of the financial crisis through a balanced monetary policy: Provision of liquidity in Central Bank, injection of the capital in banks, and provision of deposit guarantees are ensured

Risk 2. The capacity of MoED to execute the RDSP is not sufficient to coordinate agencies, regions and donors.

Assumptions: The government maintains supporting the coordinating position of MoED in rural development and encourages a more transparent, stronger coordinating role; MoED will positively strive to defining clear policies translated in measurable objectives and action plans to enable to develop their capacity to implement transparent rural management coordination.

Risk 3. State capture and corruption during the implementation of the rural development activities.

Assumptions: the government remains committed to its fight against corruption; all agencies will enhance their MTF and expenditure control, MoF its treasury payment system; all agencies and the State Statistical Committee will develop a set of indicators for monitoring.

Risk 4. Regional political instabilities.

Assumptions: the potential political instabilities in the region will be contained and will not affect Azerbaijan

3.4. Stakeholders

The main governmental stakeholder in the Programme is the MoED, which has the task of coordinating further development of the government's capacity in strategic planning, monitoring and evaluation of the activities. Also the MoF, will play a role on improving efficiency and transparency of budgeting and expenditure control at regional level. The State Statistics Committee as the main source of statistical data and the State Committee on Deals of Refugees and IDPs are also stakeholders in the Programme. All stakeholders have high ownership of the Programme as they are charged with implementing the elements of the SPPRS on which the Programme is based. The programme will also directly benefit entrepreneurs, which could be represented at a later stage through a relevant association and notably promotes a more equal gender balance within entrepreneurs.

3.5. Crosscutting Issues

The program supports better coordinated rural development policies, strategies, and programmes of different entities in each Economic Region that will lead to successful efficient

achievements in terms of better and sustainable use of scarce resources. The programme is also in line with priority area 4 and 6 of the EU - Azerbaijan Action Plan. The use of Budget Support modality is in line with the Paris Declaration and will result in increased ownership.

4. IMPLEMENTATION ISSUES

4.1. Method of implementation

The Programme will be implemented through Sector Budget Support under direct centralised management. Support will be untargeted and channelled directly into the Unified Treasury Account, after agreed conditions for payment are met. Once released, funds will be used along with other government resources, in accordance with the government's public financial management system.

A component of the Programme will be allocated to technical assistance and will be implemented under centralised management. This component will ensure the review of the conditionalities and the general pre-conditions for budget support as well as the final audit, evaluations and visibility/communications actions.

4.2. Procurement and grant award procedures

The Commission will remain responsible for management and contract issues for the external monitoring and evaluation, which will be done in accordance with the rules and standard procedures as laid down in official documents published by the Commission for implementation of external operation and in force at the time of launching the request for services.

Participation in the award of contracts for the present action shall be open to all natural and legal persons covered by the ENPI Regulation. Further extensions of this participation to other natural or legal persons by the concerned authorising officer shall be subject to the conditions provided for in Article 21(7) of the ENPI Regulation. .

4.3. Budget and calendar

The budget for the Programme totals EUR 20 million, of which EUR 500 000 will be used for technical assistance to support external monitoring and evaluation, review of conditionality fulfilment and visibility/communication actions. The remaining funds will be disbursed tentatively in three years via annual tranches. The first tranche of EUR 4.5 million is fixed; the following two disbursements of EUR 6 million and EUR 9 million respectively are variable and will indicatively follow 12 and 24 months after the first tranche is paid. The maximum foreseen operational phase is 48 months after the entry into force of the Financing Agreement. At the end of the programme, a final review will be carried out to evaluate the overall performance.

4.4. Performance monitoring and criteria for disbursement

The government will be responsible for timely programme implementation. A steering committee including relevant government representatives and the Commission will oversee the programme. The precise membership of the committee will be agreed between the government and the EU.

The General policy conditions applying to all instalments, in place to guarantee the sound implementation of the current programme, require that the Government of Azerbaijan will:

- continue to improve Public Finance Management;
- continue implementation of a sound policy for macro-economic stabilisation
- continue implementation of SPSEDR 2009-2013 and SPPRS 2011-2015.

The disbursement of the first instalment is subject to compliance with two specific conditions applying to this disbursement: (1) the establishment of the Steering Committee of the Programme and (2) the signature of the Financing Agreement.

The disbursement of the variable tranches will be related to the achievement of benchmarks. The benchmarks attached to the variable tranche of the Programme will be agreed with the government to ensure ownership and representing a significant progress towards the achievement of the Programme objectives. All payments will be released after receipt of official requests for payment from the government.

4.5. Evaluation and audit

Prior to the completion of the sector budget support programme, the European Commission will appoint consultants to carry out an independent final evaluation of the programme. Thus the programme will be subject to independent reviews that will assess the level of compliance with the indicators set forth in the Financing Agreement. The European Commission reserves the right to employ consultants to assess the overall compliance of the programme implementation.

4.6. Communication and visibility

Under supervision of the steering committee the stakeholders of the programme will establish a network of internal communication and a procedure of dissemination to make the information on the programme and its results visible to others parties. The programme will have its own communication and visibility component and budget, according to the EU Manual on Visibility of External Actions.