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ANNEX 1 TO THE DECISION ON THE ENPI ANNUAL ACTION PROGRAMME 2009 IN FAVOUR OF AZERBAIJAN

1. IDENTIFICATION

Title/Number	Agricultural and Rural Development Support Programme – Azerbaijan CRIS N° ENPI/2008/020-482		
Total cost	EUR 14 million		
Aid method / Method of implementation	<i>Sector Policy Support Programme:</i> - Sector budget support (centralised management) €13 million; - Project mode (centralised management) €1 million		
DAC-code	31110	Sector	Agriculture policy and administrative management

2. RATIONALE AND COUNTRY CONTEXT

2.1. Country context and rationale for SPSP

2.1.1. Economic and social situation and poverty analysis

Azerbaijan's economy continued to demonstrate strong growth in 2007 with the highest GDP growth rate in the world. On the basis of the oil production profile and current macroeconomic policy intentions, GDP is expected to grow by 18 % in 2008. Oil fund assets and international reserves are projected at US\$25 billion at end 2008, more than three times their level compared to 2007.

However, large revenues from oil and gas production are not distributed equally across the population. As a result, inequalities among Azerbaijanis and also between regions are rising. Smaller towns and rural areas are particularly affected.

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 GoA is to reduce poverty and achieve the national Millennium Development Goals (MDGs) by supporting non-oil sector growth, while maintaining macroeconomic stability, improving quality and access to health and education services and infrastructure, better targeting social protection, creating conditions for improving income-generation opportunities, improving gender equality, and achieving environmental sustainability.

The "State Program on poverty reduction and sustainable development in the Azerbaijan Republic between 2008-2015" (SPPRSD) and the "Reliable Food Supply Programme", both adopted by Presidential Decrees in mid-2008, pointed out the Azerbaijani strategic orientations. The policy links growth to poverty reduction. Targets have been set to measure the achievement of strategic goals, and the aim is to achieve these quantifiable outcomes by 2015 through implementation of the policy measures set out in the SPPRSD Action Plan.

The draft of the "State Programme on social and economic development of the regions in the Republic of Azerbaijan for 2009-2013" foresees implementation of relevant activities for the development of all sectors of the economy, including agricultural production and processing, and addressing specific problems of each village. The final draft of the State Programme is under development.

2.2. Sector context: policies and challenges

- The Government of Azerbaijan (GoA) recognizes the importance of developing the agricultural sector as a counterbalance and as a means of reducing differences in living standards between urban and rural areas. The *State Programme on Reliable Food Supply of population in the Azerbaijan Republic* adopted on 25th August 2008 and the *State Programme on Poverty Reduction and Sustainable Development during the period 2008-2015* (SPRSD) adopted on 15th September 2008 are

a positive sign that the country is willing to progress and to pay more attention to the non-oil sector and in particular to focus on the agricultural sector and rural areas. The goals of these two official programmes are in line and have the same targets: economic growth and support to the non-oil sector. They are relevant to the EU sector policy support programme considering the common targets that they convey and the major issue they want to address namely strengthening competitiveness and diversifying the domestic economy.

- The SPPRSD incorporates the budget preparation process, especially the multi-year budgeting through the preparation of a Mid-Term Expenditure Framework (MTEF), still at an early stage of development. The regulations related to the Budget Systems Law have been adopted, and budget process manuals approved, but it will take some years to bring these strategic exercises to a satisfactory level of quality. The budget system has been further enhanced by the introduction of international budget classifications, a single Treasury account and the inclusion of all previously extra-budgetary operations of budget organisations in the annual consolidated budget approved by Parliament, including expenditures (except administrative costs) financed by the State Oil Fund of the Azerbaijan Republic (SOFAZ).

- Weak institutional capacity, absence of institutional incentive, and high staff turnover are major challenges. The Ministry of Agriculture (MoA) and the Ministry of Economic Development (MoED) are the driving ministries for this programme, having a need to coordinate and mutually reinforce each other's activities.

- Azerbaijani public sector institutions have systems for collecting statistical information. The State Statistical Committee keeps up to date on-line records. The "Agriculture of Azerbaijan" Yearbook contains significant indicators on population and area, irrigated lands, distribution of employed population, gross domestic product, capital investment etc. by economic fields, gross product of agriculture, number of agricultural enterprises etc. But the overall framework for performance monitoring of sector policies is still weak. As the reliability of statistics remains to be ascertained, field visits, meetings, direct observation and raw data may be needed in order to validate the official statistics, the standard sources of verification as well as the indicators noted in the Logical Framework Matrix.

- According to the IMF Article IV macroeconomic assessment, the growth and external outlook is expected to remain very favourable. Real GDP is set to expand in 2008, mainly due to a further large increase in oil production. This, together with higher oil prices, will lead to a significant widening in the external current account surplus. The possible risks centre on properly managing oil revenue to maintain macroeconomic stability, keeping fiscal prudence, tackle mounting inflationary pressures, Dutch disease and avoid excessive appreciation of the exchange rate. Azerbaijani authorities' intention to realize expenditure savings and reduce significantly the non-oil primary fiscal deficit are steps in the right direction in addressing key macroeconomic risks. Real and external sector developments continue to be dominated by the dynamism of the oil sector. Exceptionally rapid growth and a further strengthening of the external position are anticipated to continue.

The Sector Budget Support (SBS) will have a long-term positive impact, given the fact that environmental and sustainable development considerations are an integral part of the country's sector policy. The SBS will aim at supporting the GoA-led capacity development plan which is part of the Paris declaration.

2.3. Eligibility for budget support

- With the adoption of the two state programmes related to the agriculture and to poverty reduction, a well-defined policy is in place in respect of the Ministry of Agriculture, the Ministry of Economic Development and the Ministry of Emergency Situations and provides the necessary framework for EU budget support. This Sector Policy Support Programme (SPSP) is designed to support the GoA to achieve its official policy objectives in the field of agricultural and rural development. It focuses on selected priorities of the National Food Security Programme. This SPSP is in line with the previous EC Food Security Programme, which was implemented for 10 years until 2006, using the Sector Budget Support modality. The 2007 Energy Reform Sector Budget Support Programme, and the 2008 Justice Reform Support Programme, use the same financing modality.

- Macroeconomic stability and economic growth will continue to evolve favourably in 2009. The real GDP will expand in the next years thanks to the increase in oil production. This will significantly maintain the external current account surplus. The macroeconomic management will continue to be cautious to avert Dutch disease and keep fiscal prudence, tackle inflationary pressures during the current investment boom and spike in oil revenues. Azerbaijan has an independent central bank which has guaranteed currency stability in recent years. The recent developments, as described by the 2007 IMF Article IV Macroeconomic Assessment, confirming the GoA's intention to realise expenditure savings and reduce the non-oil primary fiscal deficit in 2008 are appropriate steps to address key macroeconomic risks.

- The analysis of PFM diagnostics and reform programme shows that the overall state of Public Finance Management (PFM) is improving and a relevant and credible programme of reform for the improvement of PFM is being developed. Treasury modernisation with the introduction of the new Treasury Information Management System (TIMS) is an example.

The Public Expenditure Financial Accountability assessment was conducted in 2007 and agreed by GoA in February 2008 but the PFM Action Plan is still to be agreed. Different donors support different areas of public finance sector reform, such as state treasury management and the recently announced Corporate and Public Sector Accounting Project (CAPSAP) of WB. In this respect WB and EC together with GoA Ministry of Finance are now elaborating a proposal of Internal audit reform. The EC Sector Support Programme on Energy Reform from AP 2007 and the AP 2008 Justice sector support have as conditionality for Azerbaijan Government to agree and implement a PFM Action Plan.

2.4. Lessons learnt

Identified as a priority, this sector support programme will build on the experience, and enhance ten years of the EC Budget Support to Azerbaijan through the Food Security Programme (FSP 1996-2006). The EC FSP was based on a series of conditionalities related to the agricultural sector, public finance management, and social protection. The EC FSP evaluation 2004, the positive findings of the EC Court of Auditors and of the FSP monitoring reviews confirmed its positive influence and effects. It contributed to support the MoA, particularly, in its will to restructure and develop the veterinary structure and services, the seed sector and to create regional agricultural representations. The seed sector progressed adequately, notably with the increase of licensing to private seed farms and the establishment of the Seed Council within the MoA. The State Veterinary Services was partially streamlined and the land reform was launched in 1996. Furthermore, the EC FSP had a significant impact on public finance management and introduced a degree of budget rationalisation within the MoA. The EC FSP impact showed the sustainable character of the reforms initiated under this organisation. The MoA and the Cabinet of Ministers are accustomed to the modalities of budget support and understand the underlying mechanisms. Experience gained in the FSP has shown that the availability of a budget line allowing the beneficiaries to contract technical assistance via FWC proved to be a very useful instrument to provide technical support at short notice when and where it is needed. A similar instrument would usefully complement this budget support programme.

2.5. Complementary actions

Although there is no other direct intervention in the rural and agricultural sector, two other Budget Support Programmes in the field of Energy and Justice are about to start. These programmes will be consistent with each other in order to assist Azerbaijan to achieve better governance. Twinning projects will start in 2009, especially the one dealing with the State Statistical Office. In addition, investment projects managed by the Neighbourhood Investment Facility, EBRD, EIB, IFAD, World Bank and USAID are foreseen, as well as other bilateral or multilateral Financial Development Institutions of EU Member States.

2.6. Donor coordination

Other donors are active in the agricultural sector, rural development and regional development. The *International Fund for Agriculture Development* (IFAD) supports the government's efforts to reduce poverty substantially and improve living conditions for disadvantaged rural communities, the *Asian Development Bank* and *Japanese Aid* (machinery supply). The *World Bank* finances extra-large infrastructure for irrigation and drainage but also micro-credits. *USAID* has mainly supported GoA in

drafting policy orientation such as the State Programme on Food Supply. The GoA is willing to take the lead in donor coordination with the MoED mandated to ensure its implementation. The creation of an organised and structured "Agricultural Council" as a vehicle for donor coordination in the rural sector is considered as a tool for better transparency, information sharing, sector reform programmes and project development. It may help to avoid duplication and overlapping in donors' activities.

3. DESCRIPTION

3.1. Objectives

The objective of the proposed sector policy support programme is to promote sustainable agricultural and rural development in order to diversify the economy of Azerbaijan. Based on the "Azerbaijan State programme on Reliable Food Supply of Population", of which the implementation Action Plan consists of 12 main goals, there have been selected three specific objectives which EU would like to prioritize with this Programme:.

- Increase access to safe quality food
- Stabilise food availability and supply
- Encourage entrepreneurship in the field of agricultural and rural development by improving business environment and institutional capacity.

3.2. Expected results and main activities

The expected results regarding the above objectives are grouped in three areas

- Access to safe quality food is increased,
- Food availability and supply are stabilised through improved risk management,
- Entrepreneurship in the field of agricultural and rural development is encouraged by improved business environment and institutional capacity;

3.3. Risks and assumptions

The Programme relies on a number of assumptions such as the stability of the macro-economic situation, the continued commitment of GoA to reform the rural sector and to adopt a policy and long-term strategy in favour of agricultural sector, the involvement and coordination among the line ministries concerned such as Ministry of Agriculture, Ministry of Emergency Situations and Ministry of Economic Development. It presupposes the proper allocation of financial resources for promoting sustainable agricultural and rural development and for ensuring effective implementation of the State Programme for Poverty Reduction and Sustainable Development (SPPRSD). It assumes of the specific actions and the roll-out of reforms across the sector, such as environmental programmes.

Possible risks include some deep obstacles for the macroeconomic instability such as large oil price discrepancies and inflation. Moreover, uncoordinated interventions in the rural sphere and a lack of consistent agricultural policy could generate numbers of discrepancies between the political commitments and reality. Finally, insufficient budgetary allocations to meet the priorities of the SPPRSD are a major risk for the effective implementation.

A powerful mitigating factor would be a public commitment at the launch of the Programme backed up by the publication of the Action Plan once developed. This would allow the EC and other interested parties including the other donors and stakeholders to encourage the GoA to deliver the reforms in order to gain the respect of its citizens and the international community. Joint encouragement by all donor organisations is likely to be compelling to the GoA. Effective donor coordination by the GoA, backed up by direct contact between the EC and other donors would ensure that no reform programmes lose momentum.

3.4. Stakeholders

The Ministry of Agriculture, the Cabinet of Ministers, the State Land Committee, the State Agriculture Academy, State veterinary service, State phyto-sanitary control service, State Agency for micro-credits and the Ministry of Ecology and Natural Resources have the overall responsibility for the agriculture sector and, therefore, for the implementation of the forthcoming SBS. Nevertheless, the Ministry of Economic Development as responsible for the wider economy strategy, the Ministry of Emergency Situations being part of the Food Safety programme and the Ministry of Finance, as the

initial beneficiary of the budget resources are important stakeholders. Several other donors active in the broad agriculture sector, as ADB, EBRD, UNDP, the World Bank, IFAD, and USAID are also concerned. All of these stakeholders as well as relevant civil society organisations will be encouraged to participate in the implementation of the programme as appropriate.

3.5. Crosscutting Issues (SEE ANNEX 2 – Strategic Environment Assessment)

The programme supports good governance as it aims to improve intergovernmental consultation and coordination. It also supports diversification of the economy in order to reduce dependence on the oil sector. It tackles poverty reduction and support efforts to comply with CoE standards for phyto-sanitary control and food quality. There are no anticipated negative gender issues.

Environment issues are not considered by the EC SBS as an aim in itself but as an added value for agriculture and rural development. The environment aspects are taken into account by the proposed SBS in different ways such as: (i) improving the efficiency and effectiveness of the agriculture sector and the poverty reduction efforts by addressing environmental aspects and (ii) stepping up agricultural training and (iii) agricultural management capacity. This should mitigate risks of environmental wrongdoing by disseminating awareness and capacity building for environmental issues;

4. IMPLEMENTATION ISSUES

4.1. Method of implementation

The proposed SPSP programme will be implemented via a Sector Budget Support (SBS) with centralised management by the European Commission. The SBS will be untargeted and channelled directly into the Unified Treasury Account, after agreed conditions for payment are met. Once released funds are used, along with other government resources, in accordance with the GoA's public financial management system.

A component of the Programme (€1 million) will be devolved to Technical Assistance (TA) and will be implemented under centralised management. Following the recommendations of the Backbone Strategy in terms of ownership, the technical component will:

- Ensure objective review and evaluation of the conditionalities and criteria for budget support
- Support the coordination of the programme implementation and the monitoring of the progress in the field of agricultural and rural development
- Provide ad hoc expertise upon demand, to the GoA.
- Strengthen capacity building and education skills especially for the State Agriculture Academy in order to ensure long term sustainability of the whole programme

4.2. Procurement and grant award procedures

The European Commission will directly manage and award contracts for the accompanying TA project support component of the programme, in accordance with the procedures and standard documents laid down and published by the Commission for the implementation of external operations, in force at the time of the launch of the procedure in question.

4.3. Budget and calendar

The Agriculture sector budget support programme amounts up to €14 million, of which indicatively €13 million will be used for sector budget support (SBS) and €1 million for the accompanying project support/technical assistance (TA). The SBS is proposed to be disbursed over a three year period through a fixed tranche of €3 million and two variable annual tranches of €5 million, subject to the conditionalities agreed upon by the EC and GoA in the Financing Agreement (FA).

The tranches will be disbursed within the three GoA fiscal years, starting from the year of signature of the Financing Agreement. The value of the disbursement for each instalment being dependent on the extent of compliance with the conditions agreed with the GoA. Eligibility and general conditions for sector budget support will be valid for all payments during the programme and will be continuously reviewed.

The maximum foreseen operational period is 48 months after the signature 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

Programme implementation is the responsibility of the GoA. The overseeing of the overall programme is entrusted to a Steering Committee (SC) whose members will be representatives of ministries (MoA, MoF, MoED, MoE) and departments involved in the implementation of the present programme (State Agriculture Academy, State veterinary service, State phyto-sanitary control service) and the European Commission. The precise membership of the SC will be agreed between the GoA and the EC.

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

The disbursement from the variable tranche will be related to monitored progress towards achieving a set of benchmarks. The targets attached to the variable tranche of the programme will be carefully discussed with the Government in order to ensure ownership and to set up benchmarks that represent a significant progress towards achieving the programme objectives.

A TA provision is included in the programme to finance (a) evaluation, audit, and visibility actions (indicatively €0.20 million), (b) independent expertise to assess the fulfilment by the GoA of the conditions for disbursements (indicatively € 0.40m) and (c) capacity building to the Recipient Institutions (indicatively €0.40 million). The TA activities will be coordinated with similar activities carried out under other EC funded budget support projects. Azerbaijan own performance monitoring in general is in development. The GoA has access to certain statistics concerning the agricultural and rural sectors but the utilisation of these statistics in order to formulate objective decisions is weak. The Yearbook on “Food security in Azerbaijan”, published by the State Committee on Statistics can be utilised and built on by the programme: As the SBS will target 3 specific objectives (food access, food quality and entrepreneurship) the utilisation of statistics concerning monthly income of households per capita and specific gravity of different sectors in Gross Domestic Product will be useful to measure SBS Programme impact. It could become also source for the GoA to continue to streamline policy and governance. It must be underlined, that the criteria for disbursement should be the indicators and statistics noted in the Logical Framework Matrix.

4.5. Evaluation and audit

The programme will be subject to annual review, which will assess compliance with conditions and make recommendations on the appropriate level of disbursements. Prior to the completion of the sector budget support programme, the Commission will mandate consultants to carry out an independent final evaluation of the programme. The programme will be subject to independent reviews that will assess the level of compliance with its conditions/indicators set forth in the Financing Agreement.

4.6. Communication and visibility

Communication and visibility will be organised in conjunction with the Ministry of Agriculture and Ministry of Economic Development. A stakeholders’ network with European Commission involvement will be established within MoA. The TA project will support dissemination of results via web-pages, printed materials and other dissemination activities. All documents and events will comply with the EC visibility rules.