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ANALYTICAL PAPER ON CORRUPTION IN THE PUBLIC FINANCE SECTOR

AZERBAIJAN ANTI-CORRUPTION STRATEGY STUDY

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ANALYTICAL PAPER ON CORRUPTION IN THE PUBLIC FINANCE SECTOR

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ACRONYMS

AZM	manat – unit of currency
BSL	Budget System Law
CBC	Caspian Business Consultants
CID	Control Inspection Department
DAI	Development Alternatives, Inc.
FDI	foreign direct investment
GDP	gross domestic product
IDP	internally displaced person
IMF	International Monetary Fund
MED	Ministry of Economic Development
MOF	Ministry of Finance
MTEF	Medium Term Expenditure Framework
PIP	Public Investment Program
PIPE	Public Investment Policy and Efficiency project
SOCAR	State Oil Company of Azerbaijan
SOFAZ	State Oil Fund of Azerbaijan (also referred to as SOFAR)
SPPRED	State Program For Poverty Reduction
SCC	State Customs Committee
TIMS	Treasury Information Management System project
SOE	state-owned enterprise
USAID	United States Agency for International Development
VAT	Value-added tax

TABLE OF CONTENTS

EXECUTIVE SUMMARY	VII
1. INTRODUCTION	1
2. THE FISCAL DIMENSION	3
2.1 DOMESTIC TAX COLLECTIONS HAVE IMPROVED	4
2.2 FISCAL EVASION REMAINS PERVASIVE	5
3. ORGANIZATION OF CORRUPTION	7
3.1 GRAND, ADMINISTRATIVE, OR BUREAUCRATIC CORRUPTION	7
3.1.a Examples of Bribes in Education, Health, and Customs	8
3.1.b Bureaucratic Corruption and the Public Investment Program (PIP)	9
3.1.c Customs	10
3.2 STATE CAPTURE	10
3.2.a State-Owned Enterprises	11
3.2.b Subsidies for State Utilities	11
3.2.c Tax Ministry	12
4. PUBLIC FINANCE AND DECENTRALIZATION IN AZERBAIJAN	15
4.1 FINANCE FOLLOWS FUNCTION – LOCAL GOVERNMENT INSTITUTIONS	15
4.2 WEAK CENTRAL ABILITY TO MONITOR AND EVALUATE DECENTRALIZATION	15
4.3 INTERGOVERNMENTAL FISCAL FRAMEWORK	16
4.4 CAN DECENTRALIZATION MAKE THE STATE MORE RESPONSIVE?	16
4.5 PUBLIC INVESTMENT POLICY	17
4.6 PUBLIC FINANCIAL SYSTEM IS STARTING TO IMPROVE	18
4.7 IS THERE POLITICAL WILL FOR REFORM?	20
5. FORMULATING AN ANTI-CORRUPTION STRATEGY	21
5.1 MERITOCRACY AND PUBLIC ADMINISTRATION	21
5.2 STRENGTHENING GOVERNANCE STRUCTURES AND THE BUDGET FORMULATION PROCESS	22
5.2.a Budget Preparation and Execution	22
5.2.b Improving the Budget System Law	22
5.2.c Broaden the Medium Term Expenditure Framework (MTEF).....	23
5.2.d Public Expenditure Management	23
5.3 IMPROVING TRANSPARENCY AND ACCOUNTABILITY: FULL BUDGET COVERAGE	24
5.3.a Strengthening Linkages between Sector Plans and SPPRED.....	24

5.3.b Budgeting Foreign Grants and International Aid	24
5.3.c Treasury and Aid Management	25
5.4 ENSURE FULL BUDGET COVERAGE AND CONTROL AND IMPROVE SERVICE DELIVERY	25
5.4.a Public Investment Program.....	25
5.4.b Issues Associated with the Current Public Investment Practices	26
5.4.c Public Investment and Local Governments	27
5.4.d Public Investment Inventory.....	27
5.4.e State-Owned ENTERPRISES and Public Investments	27
5.5 IMPROVING TRANSPARENCY WITH RESPECT TO THE STATE OIL FUND	27
5.5.a Review of the State Oil Fund.....	28
5.5.b SOFAZ Off-Budget Financing	28
5.6 IMPROVING PERFORMANCE IN TAX AND CUSTOMS ADMINISTRATION	30
5.6.a Tax Administration.....	30
5.6.b Customs	31
5.7 STRENGTHENING PUBLIC PROCUREMENT	32
5.8 STRENGTHENING INTERNAL AND EXTERNAL AUDITS	33
5.8.a Internal and External Audits.....	33
5.8.b External Audit Function: Chamber of Accounts	34
5.8.c Internal Audit Function: Control Inspection Department (CID)	34
5.9 DECENTRALIZATION AND IMPROVING TRANSPARENCY	35
5.9.a Asymmetric and Poor Assignment of Responsibilities	35
5.9.a Norms and Implementing a More Transparent System of Transfers.....	35
6. IMPLEMENTING REFORM: ISSUES AND RESOURCES	37
BIBLIOGRAPHY	45
ANNEX A: AZERBAIJAN: SNAPSHOT OF ECONOMIC PERFORMANCE	A-1
ANNEX B: GOOD GOVERNANCE, ACCOUNTABILITY AND DEVELOPMENT	B-1
ANNEX C: IMF “CODE OF GOOD PRACTICES AND FISCAL TRANSPARENCY”	C-1
ANNEX D: SHAPING FISCAL EQUALIZATION TRANSFERS	D-1
ANNEX E: SUBSIDY MECHANISMS	E-1

ANNEX F: EQUALIZATION TRANSFER MECHANISMS AND LESSONS LEARNED	F-1
ANNEX G: FISCAL PLANNING AND ANALYSIS CELL (FPAC)	G-1
ANNEX H: FLOW OF FUNDS TO LOCAL GOVERNMENTS	H-1
ANNEX I: LIST OF PERSONS CONSULTED/CONTACTED	I-1

List of Tables, Figures, and Charts

Table

1	Regional Fiscal Indicators.....	5
2	Capital Expenditures (2003–2006) (in billion manats).....	9
3	Areas of Corruption Within the Public Financial Management Process.....	19
4	Potential Program Issues.....	38

Figure

1	Azerbaijan State Budget as a Percentage of GDP.....	3
2	Azerbaijan—Main Tax Revenues as a Share of Total Tax Revenues (1994–2004).....	4
3	Azerbaijan – Systemic and Endemic Corruption.....	8
4	Tax and Customs Revenues as a Percentage of Total Planned Collections (2002–2005 Forecast).....	12

Executive Summary

The phenomenon of public-sector corruption should not be viewed in isolation, but as part of the broader issue of governance and public management. The international community's recognition in the late 1990s of the corrosive effect of corruption is a logical extension of the link between governance and development created earlier in the decade. Virtually every aspect of public administration, and public finance, can be a source of corruption—large procurements and major public works projects, tax administration, debt management, customs, and ill-designed privatization of state-owned enterprises.

What can be done in an environment where the highest levels of government partake in corrupt public financial management process? Experience in Albania and other countries strongly suggests that the answer lies in taking an indirect approach to combating corruption. Shah and Schacter (2004) reveal that because corruption is itself a symptom of fundamental governance failure, the higher the incidence of corruption, the less an anti-corruption strategy should include tactics that are narrowly targeted at corrupt behavior and the more it should focus on the underlying features of the governance environment. As a result, where corruption is high (and the quality of governance is low), it makes more sense to focus on the underlying drivers of malfeasance in the public sector by building the rule of law and strengthening institutions of accountability. A nonexclusive list of interventions is provided in Section 6, Issues and Resources Required (including Table 4).

This paper reviews and assesses the effectiveness of the structural reforms in Azerbaijan with respect to the current programs and the legal and institutional framework establishing the budgetary system, and seeks to identify the remaining challenges in various public policy areas in reducing public-sector corruption. While progress has been made toward public-sector transparency and accountability and the establishment of an institutional public-sector budget framework, much remains to be done to enhance the sustainability of these reforms. Some Azerbaijani public financial management and corruption issues are as follows:

Development Policy, Sectoral Planning, and Budget Formulation and Execution

- In Azerbaijan, determining the efficiency of spending is more of a challenge than usual because the **budget process is not activity-based**; officials are seldom able to identify the total level of expenditure on specific programmatic elements by simply reviewing the budget. But even more significant than determining actual programmatic expenditures is the need for policy makers to be able to properly monitor the implementation of policy, which is formulated on a sector basis but implemented on an imperfectly aligned budget structure. It requires significant effort for sector programs (which may involve several ministries in a sector) to define a clear and consistent translation matrix between policy formulation and program implementation.
- The **Budget System Law (BSL)** is a good framework law that contains many of the necessary provisions to ensure budget accountability and transparency. Just bringing the Government of Azerbaijan's budgeting practices up to the standard(s) required by the Budget System Law would be a great leap forward toward closing the gaps in the financial reporting system process. After a more complete implementation of the BSL, there will be at least two areas of the budget formulation process where additional strengthening in the BSL would reduce the discretion of individual departments (line agencies) and bring more rule-based transparency to the budget formulation process. Possible additions to the BSL include making budgetary ceilings a binding

constraint for budget organizations, and linking the sector development programs of budget organizations to their actual budgets.

Public Investment Program

- **Government investment and recurrent budget are not seamlessly integrated** within the overall spending envelope. It is imperative that capital outlays and their respective operational expenses be integrated into the annual budget, long-term capital investment plan, and Medium Term Expenditure Framework (MTEF). However, the U.S. Agency for International Development (USAID) has recognized this gap and has introduced the Azerbaijan Public Investment Policy and Efficiency (PIPE) project, which should, over the next three to four years, increase public transparency and efficiency with respect to capital (investment) expenditure. It is recommended that PIPE be moved directly into the Ministry of Finance (MOF) in order to have a greater impact on capital investment project integration into the budget.
- **Foreign grants** must be budgeted, whether they are given as cash or in-kind grants. The use of counterpart funds from sales or granted goods must be budgeted, recorded, and accounted for within the overall budget framework.
- **External resources (including international aid)** must be integrated with overall resource utilization, and thus should be included in the consolidated budget. Generally, this suggests placing the management of counterpart funds within the Treasury.

Revenue Management

- Although domestic tax revenues and customs duties revenue growth have been significant over the past few years, **fiscal evasion remains pervasive**. Anecdotal evidence suggests that employees in the private sector often do not pay income taxes (tax avoidance/evasion). Furthermore, there appears to be no systematic approach by the local tax administration to collecting these personal income taxes.
- **Utility subsidies and offsetting tax liabilities** present a significant area for corruption and noncompliance. Offsetting mutual liabilities among the State Oil Company of Azerbaijan (SOCAR), the government budget, and Azer Energy often lead to negotiated (nontransparent) settlements.

Expenditure Management

- A brief review of government expenditures shows that there is insufficient attention paid to the **strategic allocation and efficient use of public resources**. In effect, the quality of government expenditures has deteriorated over the past five years. Further compounding the difficulties associated with enhancing, for example, healthcare budget outlays and improving health sector service delivery is the fact that local municipalities have been given responsibility for the maintenance of facilities and infrastructure located in their respective areas.
- There are a number of issues with respect to **state-owned enterprises (SOEs)** that need to be improved. For example, SOEs are effectively national government assets. However, their capital expenditures are not brought under the umbrella of the national investment planning process, creating leakages within the national investment planning system. SOE capital expenditures should be brought under a public investment policy framework.

Treasury and Financial Management

- Government financial assets consist of shares in enterprises, loans granted by the government, guarantees, and other assets. The Treasury must record and account for these assets. A **register of real property assets** should be maintained and regularly audited, either by the Treasury or by some other MOF department. Every acquisition and disposal of state property should conform to standards issued by the MOF and should be budgeted.

- Effective management of public expenditures requires robust treasury management systems. The **Treasury Information Management System (TIMS)** sponsored by USAID is the first (and most crucial) step in improving public financial management accountability. The World Bank (or any other donor agency) would be unable to undertake an effective Public Expenditure Tracking Survey without the functionality of TIMs in place. It is recommended that, in addition to the current package of treasury management systems, TIMS be expanded to include the fixed asset and human resource management modules.

Intergovernmental Fiscal Relations

- A general review suggests that there is an (over-) dependence on nontransparent central government transfers that may in fact undermine accountability and create perverse incentives for misallocation of public resources. In addition, the technical design of **intergovernmental transfers** may not have the desired impact on the general problem of government accountability. It is imperative to develop an appropriate and transparent system to implement these grants.
- There have been a number of laws enacted with respect to municipalities. However, the municipalities remain institutionally weak and there is little clarity in the distinction of the roles and responsibilities of municipalities from Local Executive Authorities. The lack of clarity in the role of various levels of government could have adverse consequences on the development of infrastructure at the local community levels. Further, when there is confusion regarding roles and responsibilities for expenditures, the potential for financial mismanagement and corruption is exacerbated. Clearly, more has to be done in terms of defining **municipal expenditure and investment responsibilities**.

Public Procurement

- The **Public Procurement Law** indicates that all public enterprises and budgetary organizations should follow the national competitive procurement procedures; however, some SOEs have apparently been able to circumvent the State Procurement Law and have engaged in sole source contracts. This not only violates the current law, but creates a precedent for substantial kickbacks within the procurement process.
- The following issues must also be addressed: 1) the staff in the procurement agency must receive more training on effective procurement procedures; 2) standard tender documents and model contract forms should be made available to the various contracting units; 3) the procurement processing organization must have access to a central computerized register of procurement transactions; and 4) there should be well-defined and widely understood procedures for the control and audit of procurement transactions, including anti-fraud and anti-corruption measures.

Internal and External Audit

- The role of the **Chamber of Accounts** is to undertake audits of all public-sector bodies and organizations, including budgetary and extra-budgetary organizations and funds, and to make public the results of such audits.
- There is still a considerable amount of capacity building work that should be introduced at the Chamber of Accounts. The immediate issues with respect to enhancing the ability of the Chamber include: 1) maintaining an appropriate legislative framework and developing an appropriate professional and institutional capacity; and 2) providing the Chamber with the necessary working tools and practices, including International Standards and Practices.
- The function of the internal audit is carried out by the MOF's Control Inspection Department (CID). In an attempt to reduce duplicative control and audit functions, a Presidential Decree abolished all public-sector internal inspection departments except the CID. As a result, there is no internal control function residing in any ministry or line agency. The enormity of the auditing task

may require devolution of some internal audit practices and strengthening of the internal audit capacities of the various ministries and other budgetary organizations.

1. Introduction

Good governance and effective public finance are the two most important vehicles for establishing a country's economic and social priorities given governmental resources. Good governance is an essential part of a framework for economic and financial management including macroeconomic stability, promotion of efficient institutions responsive to the public interest, and social and economic equity. Two simple relationships emerge from international experience: corruption is generally less frequent in richer countries, and there is a negative correlation between the rate of growth and corruption.⁵⁵ In effect, more corrupt countries tend to be poorer and to grow at a significantly lower rate than less corrupt countries.

The goal of improving government accountability and reducing inefficiency (or waste) should not be viewed in isolation but as part of the broader issue of governance and public management. The international community's recognition of the corrosive effect of lack of local government accountability is a logical extension of the link between governance and development. Weaknesses in information and control systems in local government administrations and lack of transparency and accountability within the legal and political systems may give rise to cost padding, service diversions, and a general lack of public-sector accountability. Aside from the moral and legal considerations, there is solid evidence that lack of accountability, transparency, and operational effectiveness distorts resource allocation and invariably hurts the poor the most.

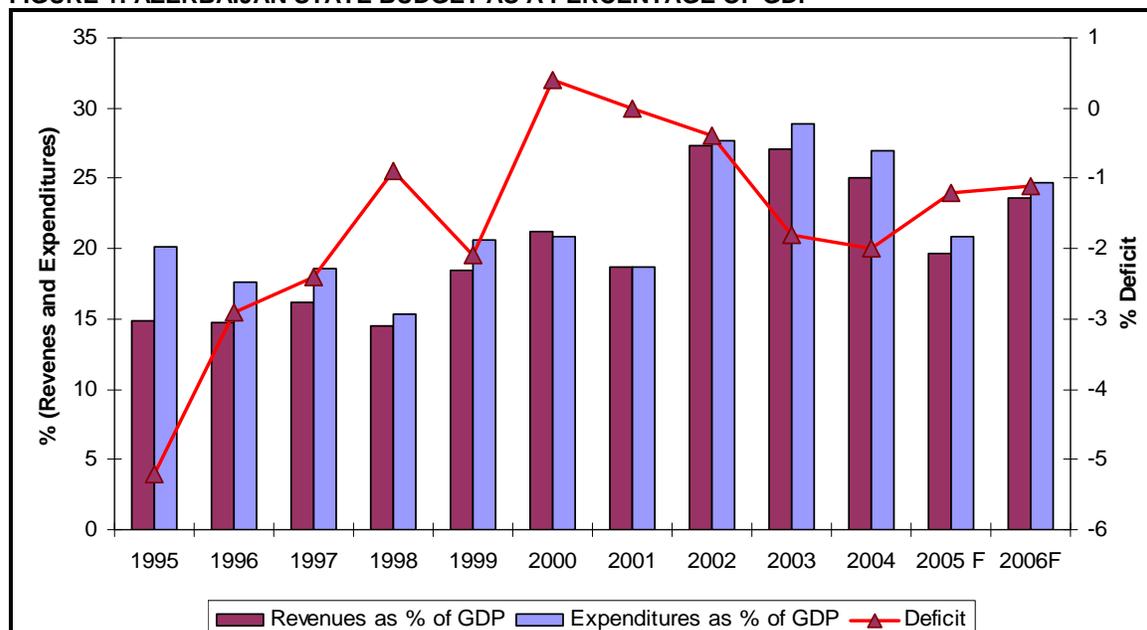
Although progress has been made in a number of areas related to improving public-sector transparency and accountability and the establishment of an institutional public-sector budget framework, much remains to be done to enhance the sustainability of these reforms. This report has two primary objectives: 1) to identify areas of major vulnerability to public finance corruption in Azerbaijan; and 2) to identify potential activities that civil society groups, institutes, and government offices can pursue to remedy these vulnerabilities. Excluding this brief introductory section, this report is divided into five sections: The Fiscal Dimension, Organization of Corruption, Public Finance and Decentralization in Azerbaijan, Recommendations for Improving Public Finances, and Issues and Resources Required to Implement Reforms.

⁵⁵ ADB, 1999, p. 2.

2. The Fiscal Dimension⁵⁶

The Government of Azerbaijan's macroeconomic policies are aimed at achieving stable economic growth, low inflation, and fiscal stability. In general, strong economic growth is expected to facilitate further fiscal consolidation with the government continuing to pursue a restrained fiscal policy based on measures to increase tax revenues and improve public expenditure management. Public revenues that are primarily derived from the faster-growing sectors of the economy (principally oil) are projected to substantially increase over the next few years. One of the major positive elements of the Azerbaijan government's fiscal consolidation efforts has been increased revenue generation. Total 2004 budget revenues and grants reached approximately 27.1 percent of gross domestic product (GDP) (see Figure 1). However, total forecast budget revenues and grants as a percentage of GDP are projected to dip to 19.7 percent and 23.6 percent in 2005 and 2006, respectively. A relatively fast rate of GDP growth and a reduction in the marginal income tax rate to 26 percent have resulted in a near-term dip in the revenue to GDP ratio.

FIGURE 1: AZERBAIJAN STATE BUDGET AS A PERCENTAGE OF GDP



Sources: World Bank, 2003c; Schaeffer, 2005; and IMF, 2005. Year 2004 figures represent estimates derived from half-year statistics.

According to World Bank (2003c) and IMF (2005) reports, Azerbaijan has shown remarkable progress in the area of revenue generation, with value-added tax (VAT) increasing significantly over the past four years. The 2004 estimated deficit of 2.0 percent of GDP is about the same as 2003 levels. According to the National Bank of Azerbaijan, while small deficits have kept national debt levels low, the limited supply of treasury bills has created difficulties in managing the country's money supply.

⁵⁶

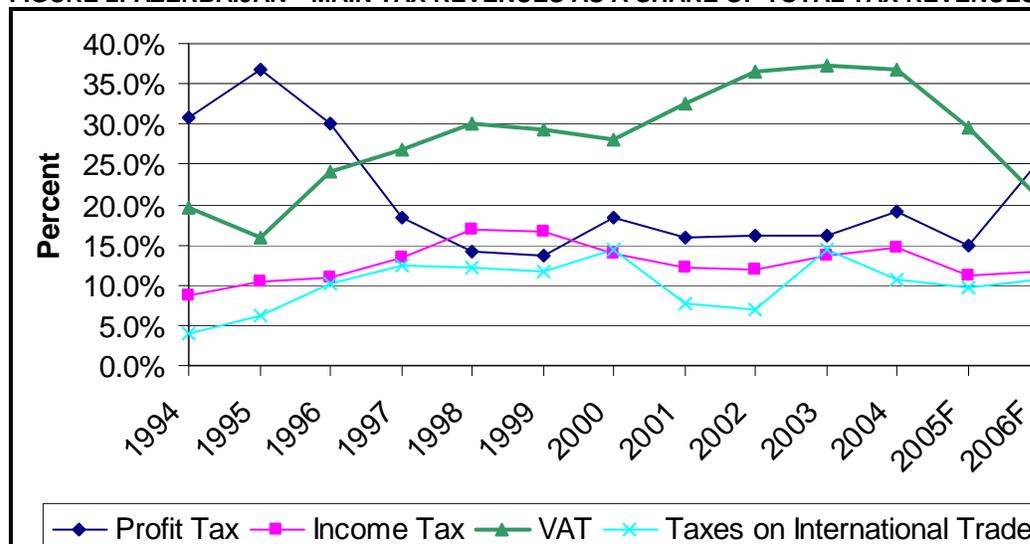
For a brief Azerbaijan economic review, please see Annex A.

In November 2004, the Parliament approved the 2005 budget, the first budget to be consistent with the government's long-term strategy on the management of oil revenues.⁵⁷ This strategy provides for annual limits on the change in the non-oil deficit to guide fiscal policy. Total government budget expenditures are forecast at US\$1 trillion, representing 20.9 percent of GDP. Recent government forecasts project 2006 government spending at US\$3.2 billion, representing a 58 percent increase over 2005 levels. The 2005 budget targets a fiscal deficit of 1.2 percent of GDP. The fiscal deficit as a percentage of GDP is expected to hover around the 1.0 percent level over the 2005–2006 period.

2.1 Domestic Tax Collections Have Improved

Figure 2 shows Azerbaijan's main tax revenues (VAT, profit tax, income tax, taxes on international trade) as a share of total tax revenues. There has been considerable change in the structure of the tax system, with a strong movement toward indirect taxes, which reflects the introduction of VAT and improvements in the trade tax region. VAT collections have expanded by more than 173 percent over the past five years. As of the end of 2004, VAT was Azerbaijan's single largest source of tax revenues. The proportion of tax revenues accounted for by profit taxes has fallen by more than half, reflecting the poor performance of the traditional non-oil sectors of the economy and significant tax arrears from large state enterprises.

FIGURE 2: AZERBAIJAN—MAIN TAX REVENUES AS A SHARE OF TOTAL TAX REVENUES (1994–2004)



Sources: World Bank, 2003c; IMF, 2005; and CBC, 2005c. Note: 2004 figures represent extrapolations from half-year actual figures obtained from the Ministry of Finance (MOF).

The prime area for changes to improve government revenues relates to increasing energy and utility sector compliance with the tax code. Potential tax collections and tax arrears remain high in the energy and utility sector, and there is little

⁵⁷ ADB, 2005a, p. 168.

transparency in these sectors with respect to their obligations to the State Budget. For example, the World Bank (2003c, p. 12) states that the State Oil Company of Azerbaijan (SOCAR) pays taxes according to a negotiated tax target that takes into account the firm's quasi-fiscal activities.⁵⁸ Apparently, negotiated tax targets for all other state corporations were eliminated in 2001/2002.

Domestic tax revenues have increased in direct proportion to the increase in the number of registered taxpayers. According to informed sources at the Ministry of Taxes, there are only 92,000 currently registered legal taxpayers in Azerbaijan. Of these, only 640 qualify under the category of large taxpayers. Obviously, much more needs to be done.

2.2 Fiscal Evasion Remains Pervasive

Compared with other Eastern European transitional economies, Azerbaijan ranks relatively high with respect to tax rates, but relatively low with respect to tax revenue collected as a percentage of GDP. Table 1 provides comparative fiscal indicators. Of the 10 countries surveyed, Azerbaijan had the lowest tax revenue as a percentage of GDP—estimated at 18 percent. Only Turkey and Moldova, with 21 percent tax revenue as percentage of GDP, come close. The table and the resulting conclusions show that the potential for higher revenue collection in Azerbaijan remains considerable.

TABLE 1: REGIONAL FISCAL INDICATORS⁵⁹

Country	Tax Revenue as Percentage of GDP	VAT Rate	Top Corporate Marginal Tax Rate	Top Personal Income Tax Rate
Azerbaijan	18 ⁶⁰	18	36, reduced to 24% January 1, 2004	36
Latvia	32	18	25	25
Estonia	36	18	26	26
Macedonia	24	19	15	35

⁵⁸ CBC, 2005c.

⁵⁹ Latvia, Estonia, Bulgaria, and Greece figures from 2002. Turkey, Slovenia, Moldova, and Macedonia figures from 2003. Azerbaijan figures estimated from 2004 data.

⁶⁰ Estimated using IMF, 2005, Statistical Annex.

⊘	Moldova	⊘ 21	⊘ 20	⊘ 32	⊘ 28
⊘	Bulgaria	⊘ 31	⊘ 22	⊘ 27	⊘ 40
⊘	Croatia	⊘ 38	⊘ 22	⊘ 35	⊘ 35
⊘	Greece	⊘ 26	⊘ 18	⊘ 40	⊘ 45
⊘	Slovenia	⊘ 39	⊘ 20	⊘ 25	⊘ 50
⊘	Turkey	⊘ 21	⊘ 15	⊘ 27	⊘ 55

Sources: PWC/IBM Consulting, 2005; IMF, 2005; and CBC, 2005c.

Although domestic tax revenues and customs duties revenue growth have been significant over the past few years, fiscal evasion remains pervasive. Anecdotal evidence suggests that employees in the private sector often do not pay income taxes (tax avoidance). Revenue losses caused by corrupt tax evasion⁶¹ or flight into the hidden economy must be compensated either by reducing infrastructural services or by additional transfer payments, higher borrowing, or increases in the level of taxation. These options usually lead to major distortions in resource allocation.

Fiscal evasion (corruption) affects not only the scope but also the structure of tax revenues.⁶² Since direct taxes are usually more susceptible to corruption than indirect taxes, this implies that as fiscal evasion increases, there will be a corresponding reduction in the progressivity of the existing tax system, with correspondingly negative effects on the distribution of income.⁶³

⁶¹ According to Johnson et al. (1999), there is evidence to support the assumption that countries with more corruption tend to have a larger shadow economy. Countries with a larger shadow economy tend to display slower growth.

⁶² Different types of taxes will respond to corruption in different ways. For example, the payment of some taxes is negotiable. In some countries, a number of taxes (including income taxes) are assessed by taxpayers themselves, while in other countries the taxes are assessed by tax assessors or inspectors. These inspectors can be influenced by opportunistic or even extortionate behavior. As a result, whenever there is the opportunity to simplify tax administration it is advisable to do so.

⁶³ Tanzi, 2000, p. 173.

3. Organization of Corruption⁶⁴

The budget is the government's key instrument for planning the scope and structure of public revenues and expenditures. It lays down the allocation of resources between the private and public sectors. The following section outlines issues that adversely impact public-sector budget formation and effective service delivery.

3.1 Grand, Administrative, or Bureaucratic Corruption

Grand corruption typically involves senior officials, major decisions or contracts, and the exchange of large sums of money. A list of illicit behavior referred to as corruption is presented below. This type of corruption may involve, but not be limited to:

- The design or selection of uneconomical projects because of opportunities for financial kickbacks and/or political patronage.
- Procurement fraud including collusion, overcharging, or the selection of contractors based on criteria other than the lowest evaluated and substantially responsible bidder.
- Illicit payments to government officials to facilitate access to goods and services or to facilitate timely delivery of goods and services.
- Payments to government officials to foster or sustain monopolistic practices.
- The embezzlement of public property and monies.
- The sale of official posts, positions, or promotions or other actions.
- Extortion and the abuse of public office such as using threat of a tax audit or legal sanctions to extract personal favors.⁶⁵

Figure 3 provides a snapshot of the underlying nature of Azerbaijan corruption activities. In brief, corruption activities can be viewed as a pyramid. The top of the pyramid includes the presidential administration and 12 to 15 major clans. Informed observers estimate that the top of this crime pyramid consists of no more than perhaps 1,000 people. Underpinning the pinnacle of the pyramid are franchises run by important members of the leading clans, whose interests span both the public and private sectors. In any given ministry, the minister is effectively the head of a long chain of corrupt payment schemes and he or she has paid the presidential administration for the privilege of holding such a powerful position.

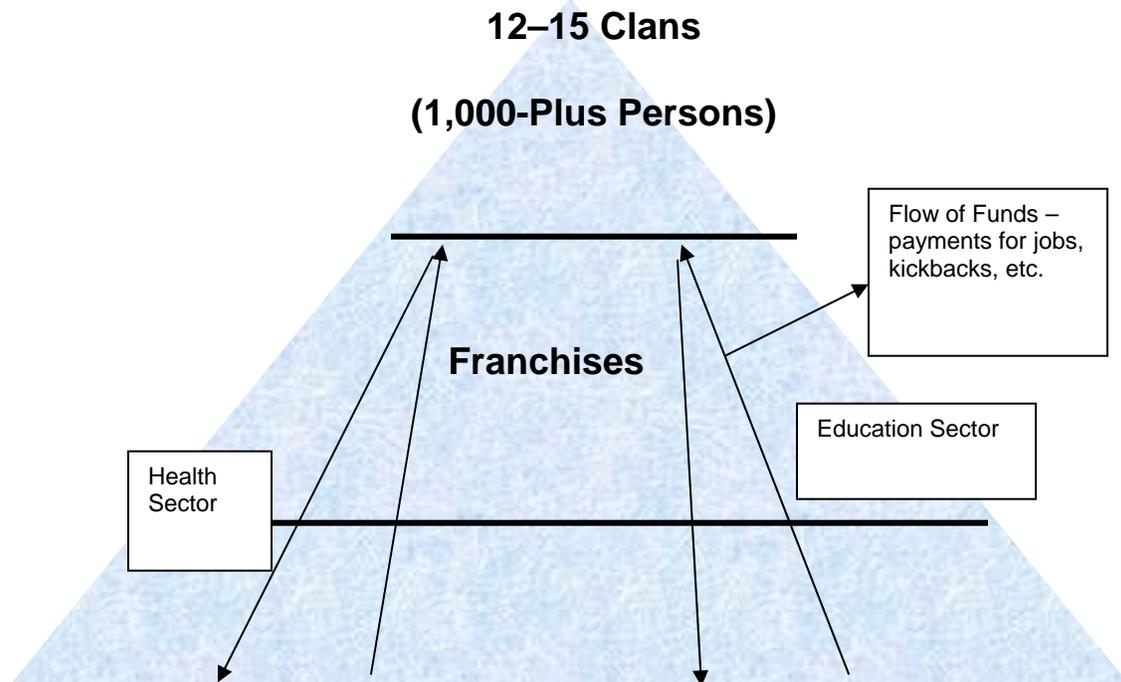
To obtain a position in any given ministry, a person must pay a pre-established fixed amount plus a pre-determined annuity. Everyone up the chain of managerial command obtains a piece of this "job fee plus annuity." In order to pay this, the newly hired official extracts a fee from those below him or her. The payment pyramid scheme is self-perpetuating. Anecdotal evidence suggests that members of the various ministries receive a percentage of every procurement contract (that is, a kickback). Furthermore, if, for example, a person wished to open a business establishment, he or she must pay a fee to the appropriate ministry. Part of the fee

⁶⁴ Please see Annexes B and C for a more thorough theoretical review of effective public financial management and the underpinning linkages of good governance.

⁶⁵ See ADB, 1998, p. 11.

would be retained as part of official ministerial fees, and part would be paid under the table as part of an entrance fee into the business sector.

FIGURE 3: AZERBAIJAN – SYSTEMIC AND ENDEMIC CORRUPTION



In assessing Azerbaijan, it is important to keep in mind these definitions and the pyramid nature of corruption and to evaluate whether these occur within other elements of the institutional public financial framework.

3.1.a Examples of Bribes in Education, Health, and Customs

According to the World Bank, informal payments exist in education, health, and customs.⁶⁶ With respect to:

- The health sector—wages are low and often unpaid, resulting in either the absence of service or an implicit fee-for-service system. One of the most disturbing implications of informal payments is that it fuels corruption and the growth of the grey economy, undermining many efforts to improve health and public sector accountability.
- The education sector—informal payments can take several different forms. Parents may have to pay teachers for additional tutoring to compensate for low teacher salaries.⁶⁷
- People seeking jobs at the State Customs Committee (SCC) bribe those in positions to offer employment. They must be loyal to the SCC and make continuing payments to hold their jobs. The flow of bribes appears to be from the bottom up.⁶⁸

⁶⁶ World Bank, 2005a, pp. 80–95; and World Bank, 2003c, pp. 18–20.

⁶⁷ World Bank, 2003c, p. 35.

⁶⁸ CBC, 2005b.

3.1.b Bureaucratic Corruption and the Public Investment Program (PIP)⁶⁹

The lack of transparency in the manner in which the budget is negotiated and agreed upon with the various line ministries often leads to an opportunity for rent seeking and other potentially corrupt practices. One form of bureaucratic corruption is when a ministry's or organization's budget request does not have sufficient justification for the resources sought (or the request in general is not well grounded) but the resources are still allocated because the request is supported by key officials. Such corruption can be classified as administrative (bureaucratic) corruption with elements of abuse of office (or kickbacks).⁷⁰

The story becomes more complicated if there is collusion among the key players in the budget process. According to various interviews:

- The process is first initiated by the spending line ministry, which initiates a plan to extort rent(s) through the budget process.
- The rents usually take the form of kickbacks obtained from related subcontractors to implement poorly justified large infrastructure projects.
- These projects are included in the budget in exchange for another kickback (quid pro quo).⁷¹

Most of these corrupt practices apparently take place with respect to capital investments in social and economic infrastructure and capital expenditure projects. Therefore, the importance of successfully implementing the Public Investment Policy and Efficiency project (PIPE)—a USAID program designed to improve the identification, preparation, and appraisal of capital investment projects for Azerbaijan's PIP—becomes paramount.

This kind of collusive practice has the combined elements of both administrative and grand corruption. The amounts can be substantial. Table 2 shows that Azerbaijan capital (investment) spending for the 2003 to 2005 period averaged AZM 1,099 billion.

TABLE 2: CAPITAL EXPENDITURES (2003– 2006) (IN BILLION MANATS)

₹	₹ 2003		₹ 2004		
	₹ Estimate	₹ Actual	₹ Forecast	₹ Actual	
₹ Capital expenditures — Including	₹ 749	₹ 793	₹ 940	₹ 953	
₹ – Procurement of fixed assets	₹ 102	₹ 114	₹ 107	₹ 108	
₹ – Capital constru	₹ 427 ₹ 425	₹ 443 ₹ 414	₹ 488 ₹ 480	₹ 498 ₹ 475	

⁶⁹ See CBC, 2005c.

⁷⁰ See CBC, 2005c.

⁷¹ See CBC, 2005c.

€	tion, of which new invest ments					
€	– Capital repair	€ 221	€ 237	€ 346	€ 347	

Sources: Annual Budget Packages (2004, 2005, and 2006); and CBC, 2005c.

3.1.c Customs⁷²

Bureaucratic corruption and bribe taking may be endemic in Azerbaijan customs. SCC officials can erect a number of “bureaucratic barriers” if they want to extract bribes from importers. For example, perishable goods importers may be asked to wait for days for the customs paperwork to clear.

To minimize the time spent at customs, many importers pay a fee (bribe) to customs officials. In addition, large demurrage charges⁷³ may be attached to imports of some goods. For example, Mars-S Company was importing finished steel products into Azerbaijan from Russia. These imports were stopped at the border, apparently until import bribes were paid.⁷⁴

This type of situation apparently happens for two reasons:

1. To stop or slow down the customs procedures (and the product imports) to such an extent that the importer is less reluctant to pay additional funds to have his/her case dealt with more swiftly.
2. To create additional expenses so that the importers’ goods will be more expensive on the domestic market, and to create more favorable conditions for local business monopolies that may be controlled by other members of the clan controlling the SCC.⁷⁵

In addition, customs may receive gratuities from Azerbaijan business monopolies to create bureaucratic customs difficulties at the border in order to protect the interests of local monopolies.⁷⁶

3.2 State Capture

State capture refers to the actions of individuals or groups in both the public and private sectors to influence the formation of laws, regulations, decrees, and judicial decisions that serve their own interests. The following section outlines some instances of state capture in Azerbaijan.

⁷² See CBC, 2005b for a more detailed overview of the Azerbaijan customs sector.

⁷³ CBC, 2005b states that customs clearance may require additional documents that take a number of days to receive. In this case, an importer may attempt to receive permission from the head of a particular customs house to unload cargo into his or her own warehouse (temporary storage) in order to avoid demurrage and penalties imposed by the state transport agencies. The importer pays the customs official a fee (bribe) to allow him/her to unload the cargo temporarily.

⁷⁴ *Echo Newspaper*, August 9, 2002.

⁷⁵ CBC, 2005b.

⁷⁶ CBC, 2005b, p. 13.

3.2.a State-Owned Enterprises

There are a number of issues with respect to state-owned enterprises (SOEs) that must be improved, including the following:

- Although the Public Procurement Law requires that all public enterprises and budgetary organizations follow the national competitive procurement procedures, some SOEs have circumvented the State Procurement Law and engaged in sole source contracts. This is not only in violation of the current law, but creates a precedent for substantial kickbacks within the procurement process.

An anonymous source with substantial understanding of the Azerbaijan electric power sector provided an example of potential (unverified) corruption within the power sector and, more specifically, a violation of the State Procurement Law. A May 2005 presidential decree required Azer Energy to install 52 mini-generation units in various areas of the country to improve ongoing electric power generation. A total of US\$450 million was to be allocated from the budget (or other sources) for the contract,⁷⁷ which Azer Energy procured under a sole source (not competitive bid) agreement, in apparent violation of the State Procurement Law. An informed source disclosed that this contract was at least US\$200 million more than it would have been if it had been procured under competitive bid. The source strongly suggested that a significant portion of this sole-source procurement went to various hidden kickback agreements.

3.2.b Subsidies for State Utilities

Utility subsidies and offsetting tax liabilities present a significant area for corruption and noncompliance with good governance. Offsetting mutual liabilities among SOCAR, the government budget, and Azer Energy often lead to negotiated (nontransparent) settlements. For example:

- Azer Energy receives oil and gas from SOCAR as inputs for the production of electric power.
- Because of low non-cost recovery tariff levels and low collection rates, the electric utility company is unable to pay for the heavy oil and gas that SOCAR supplies.
- Electrical power is a national and economic priority; the provision of power cannot be stopped merely because of non-payment of bills to another state company.
- As a result, the Government of Azerbaijan is forced to compensate the supplier (SOCAR) for the unpaid portion of the bill.
- The payment for the oil and gas to Azer Energy comes principally in the reduction of the outstanding tax liabilities that SOCAR owes the government.

Why is this important? In effect, the lack of incentives to eliminate these negotiated tax offsets (or subsidies) may contribute to the lack of fiscal transparency and accountability for both Azer Energy and SOCAR.

⁷⁷ Caspian Business Consultants (CBC) consultants were not able to confirm where these funds were obtained. If they were borrowed by Azer Energy, this would necessarily imply a state-level guarantee or backstop facility. CBC and DAI consultants could not find evidence of this. If these funds were obtained from the budget, they were not clearly shown in the 2005 budget. CBC and DAI consultants were not able to view a mid-year revised budget.

3.2.c Tax Ministry

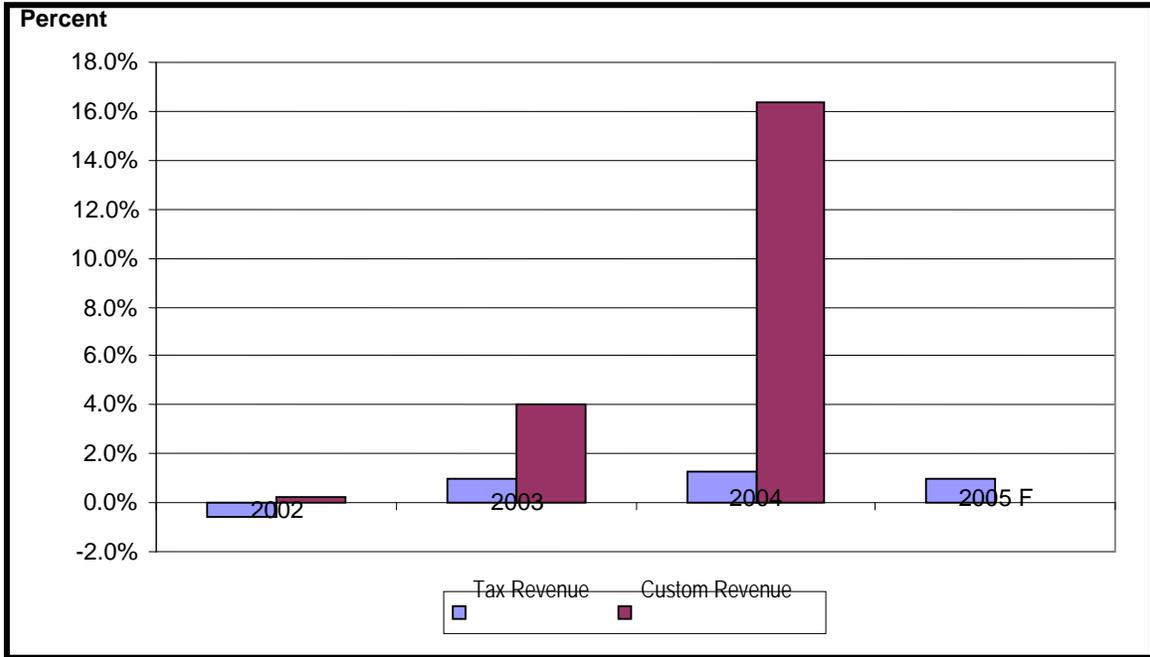
Discussions with informed observers suggest that the Azerbaijan tax administration has substantially improved over the past few years. However, the sheer complexity and the scope (and breadth) of reach of the tax administration still can be a significant contributory factor toward corruption. Anecdotal evidence indicates possible elements of state capture within Azerbaijan's Tax Ministry, including:

- Although Tax Ministry salaries have significantly increased over the past two years, many taxpayers continue to evade paying taxes (and remain part of the informal economy) by simply bribing tax collectors.
- There is little transparency (or suspicious patterns in the selection of cases for audit) in the criteria for selection of taxpayers to be audited.

The lack of checks and balances in the Tax Ministry often leads to a situation where the taxable profit of a legal entity is deliberately shown to be less than it really is due to a heavy tax burden. Such practices are widespread throughout the non-oil sector, resulting in significant underestimation of the formal sector of economy. Another consequence is that the tax base is also underestimated. In the end, it is not surprising to see more than 100 percent collection performance consistently attained by both the Ministry of Taxes and the SCC, which means that targeted or budgeted revenue plans are deliberately set below formally reported levels. Figure 4 presents actual revenue and tax collections over a multiyear period. As is evident, the rate of growth in customs revenues has substantially exceeded that of tax revenue. As of this writing, 2005 customs revenues are not available. This apparently allows the agencies to meet or exceed their collection targets, while at the same time giving them the potential to extort additional unreported revenues.⁷⁸

FIGURE 4: TAX AND CUSTOMS REVENUES AS A PERCENTAGE OF TOTAL PLANNED COLLECTIONS (2002– 2005 FORECAST)

⁷⁸ See CBC, 2005c, p. 13.



Sources: Annual Budget Packages (2004,2005,2006); and CBC, 2005c.

4. Public Finance and Decentralization in Azerbaijan

Intergovernmental fiscal relations should be thought of as a system—all pieces of the system must fit together. Implementation should begin with design of the comprehensive system and should lay out the plan for each element of the system. A phased-in approach may be the correct strategy to avoid reform shock. In general, countries that have effectively decentralized have followed a comprehensive plan and have prepared themselves to deal with transition problems during phase-in.

4.1 Finance Follows Function – Local Government Institutions⁷⁹

The correct order of decentralization reform requires the assignment of expenditure responsibilities to local governments first, followed by the assignment of revenue responsibility. This is an important rule for two reasons: 1) the central government must establish expenditure needs for each level of government before tackling the question of revenue assignment; and 2) economically efficient assignment of revenues requires knowledge of expenditure assignment.⁸⁰

A government body must settle on the assignment of expenditure responsibilities to local governments before it can choose an efficient mix of taxing. The Azerbaijan decentralization process has assigned some expenditure functions to local government units, but how many of these expenditures can be devolved, and how much these expenditures will cost local municipal governments, have not been effectively analyzed. An effective policy and administrative plan would clearly define the functions of the various institutions of the state administration and local governments, enforce standardized budgeting systems, and establish transparent safeguards and controls for municipal budget execution.

4.2 Weak Central Ability to Monitor and Evaluate Decentralization

A controlled and gradual process of fiscal decentralization requires central government leadership on matters such as the imposition of a uniform system of financial accounts, audit rules, disclosure requirements (for borrowing), and determination of when to relax spending mandates. A stated intent for a degree of administrative decentralization is enshrined in the Constitution. In addition, a division of responsibilities between different levels of government is clearly emerging. However, these responsibilities and their fiscal implications still must be more clearly defined. Technical assistance to local governments is needed in a number of areas, including accounting, treasury, and tax administration; data processing; and project evaluation.

A problem may arise in Azerbaijan because it does not appear that there is a strong ability at the MOF, or at any other national government ministry, to monitor the development of local government finances. The two ingredients that are necessary are: 1) a fiscal analysis unit (most likely located in the MOF),⁸¹ and 2) an extensive data system that will allow quantitative monitoring and evaluation.

⁷⁹ Azerbaijan is organized according to a two-tiered administrative structure: the central government and subnational governments composed of rayons, cities and municipalities, and one autonomous region.

⁸⁰ IMF, 1998.

⁸¹ See Annex G.

4.3 Intergovernmental Fiscal Framework⁸²

A review of the intergovernmental transfer framework indicates that local governments (municipalities) tend to receive negotiated (and even ad hoc) transfers from the budget. There does not appear to be any systemic intergovernmental fiscal formula or process in place for fiscal transfers. Negotiated transfers further obfuscate the budget process, creating an environment where vertical accountability is lacking. This makes it difficult for local governments to prepare budgets and to plan for future expenditure activities.

Annex D presents a more detailed review of the benefits associated with establishing more effective and transparent equalization transfer formulas. In brief, fiscal transfers to lower levels of government are generally justified:

- To equalize vertically (revenue adequacy improvement);
- To equalize horizontally (interjurisdictional redistribution);
- To correct for interjurisdictional spillovers (externalities); and
- To streamline bureaucracy and correct for major administrative weaknesses.

There does not currently appear to be an effective, transparent fiscal transfer mechanism applied to the intergovernmental transfer relationship. Most transfers are undertaken on an annual basis as a result of a negotiated process. To improve fiscal transparency, the creation of a transparent fiscal transfer mechanism is justified.⁸³ In the case of conditional grants, many countries have developed and use output-based aid. This is essentially a system of performance-based grants to be distributed on the basis of achieving well-defined performance goals.⁸⁴

A well-designed decentralization process can bring government closer to the people. This means that the people have an interest in ensuring that government works effectively. It is true that decentralization can empower local elites; however, the bulk of empirical evidence illustrates that decentralization is associated with significantly lower levels of corruption.

4.4 Can Decentralization Make the State More Responsive?

Decentralization of service delivery can, in principle, make the state more responsive to the needs of the people and to improving service delivery. However, in Azerbaijan, where the accountability and capacity of subnational (municipal) governments is weak and there are few safeguards against the manipulations of municipal assets (physical and financial) for the private gain of local officials, a very rapid decentralization process without effective controls and accountability structures in place may actually increase corruption, bias resource allocation, and adversely affect access to and quality of basic services.⁸⁵

Improving accountability at the local level for local expenditures and to the central government in cases where expenditures are only administered by the local level

⁸² Please see Annex H for additional details.

⁸³ See Annex F for more details regarding intergovernmental fiscal mechanisms.

⁸⁴ For more detail regarding output-based aid, please see Annex E.

⁸⁵ Increases in corruption due to ineffectual decentralization processes have already occurred in many parts of Central Asia and the Caucasus.

(deconcentration) is a necessary first step in the development of an effective decentralization process. Reform efforts should also strongly focus on:

- Improving (making more transparent) intergovernmental transfers; and
- Creating regional/local government capacity in financial management and auditing, before (or while) the decentralization process gets under way.

4.5 Public Investment Policy

A significant portion of Azerbaijan government funds are for investment purposes. The PIP has been elaborated and implemented with the aim of fitting resources into overall public expenditures. A good PIP is aimed at ensuring several interrelated functions:

- Improving economic management to ensure that macroeconomic sector strategies are translated into programs and projects;
- Raising investment efficiency by improving average project quality;
- Assisting public financial management by balancing commitments and resources over a multiyear framework; and
- Strengthening the project cycle by providing a framework within which project identification, preparation, appraisal, rank ordering, budgeting, implementation, and monitoring can occur.

Azerbaijan has adopted a hybrid approach to public investment planning. Typically, regulations to implement the PIP are more flexible than those for the recurrent budget. Administrative considerations are in practice more influential than economic considerations on the decision of whether a given expenditure is included in the recurrent budget or PIP. As a result, the recurrent budget usually contains miscellaneous investment expenditure, while the investment budget almost invariably has a significant component of recurrent expenditures. The hybrid nature of investment budgets creates loopholes, including the following:

- There is only limited awareness of the PIP process and, even more relevant, there appears to be at best a notional sense of the advantages of such an approach with respect to translating policy objectives into implemented programs and projects.
- Line ministries attempt to include alleged projects in the PIP to finance recurrent spending and obtain additional resources (for nonspecified spending).
- The recurrent budget structure leaves substantial room for the promotion of pet projects by clan interests.
- Ministries often circumvent the normal budgetary process, particularly the PIP, by obtaining the approved of the Cabinet of Ministers for sectoral plans and specific projects.
- Capital investments for SOEs are not brought in under the consolidated State Budget. In many instances, the President will issue a degree for SOE capital spending that is not part of the normal budgetary process, particularly the PIP. This creates a breeding ground for corrupt procurement and investment practices.

Quist (2005) describes a number of features related to the public investment process in Azerbaijan, including:

- The Ministry of Economic Development (MED) receives project proposals from sector agencies. There is limited or no prioritization of projects.
- The PIP process does not have credibility with at least some of the line ministries. There is the threat of a parallel system of public investment review and consideration based not on the PIP procedures but on Sector Strategic Plans duly approved by the Cabinet and the President.
- Projects that are approved by the Cabinet of Ministers imply that ministries are working outside of the normal budget process.
- A general rule for improving fiscal transparency is that all capital investment projects must be appraised and rank ordered in the PIP by the MED and thereafter under the umbrella of the MOF's Consolidated State Budget.

With an economic growth strategy based upon diminishing oil reserves, there is an extraordinary urgency to effectively establish and implement a reform agenda in Azerbaijan. The capital spending gaps mentioned above imply that both total budgetary and capital investment outlays are severely under reported.⁸⁶ If public sector reforms, budgetary and public investment accountability are not integrated into the fabric of public expenditure management, then the economic oil wealth will be squandered for current and future citizens of Azerbaijan. The following sections provide recommendations for improving the current system of public finances and public investments.

4.6 Public Financial System is Starting to Improve

The Government of Azerbaijan has recognized the need for an overhaul of the system of public finances.

- The government, with international donor assistance, has begun extensive fiscal and monetary reforms; the most notable has been the expected establishment of a Treasury with a single treasury account and the centralization of cash management functions.⁸⁷ However, there are holes in this system. For example, international financial institution-financed project expenditures run through various project implementation units and bank accounts, not through the Treasury. In addition, although there is a separate department in the MOF for Treasury operations, it is no more independent than any other separate department.
- With the introduction of a modern SAP-based Treasury Information Management System (TIMS) by USAID, the Azerbaijan government should in the near future be able to produce more reliable and timely information on its fiscal operations and to introduce more effective cash management and commitment controls.

⁸⁶ In a macroeconomic sense, substantial underreporting (non-budget reporting) of government spending may lead to rapid price (inflationary) pressures.

⁸⁷ The single treasury account is currently being developed and improved through USAID's TIMS program. However, TIMS is not yet operational. As a result, these improvements are still six months to one year away.

- The Budget System Law⁸⁸ (BSL) has addressed many previous deficiencies “on paper” by incorporating off-budget expenditures and improving monitoring and general reporting requirements. However, substantial gaps remain.
- The external audit framework in the form of the Chamber of Accounts is up and running as a separate legal institutional structure. However, it is not up and running as an effective external audit authority.
- The legal framework for the State Procurement Agency has been strengthened. In effect, the agency exists as a legal entity, but it is weak and ineffective compared to the expectations described under the law.

In many areas of the country’s public finance accountability framework, Azerbaijan has received and will continue to receive a considerable amount of analysis, advice, and assistance. However, there continue to be many areas of weakness with respect to budget formulation, transparency, and public-sector accountability. Table 3 provides a matrix of potential types of corruption and where they might reside within the public financial management framework. As is evident, corruption is endemic in Azerbaijan and is a symptom of failed governance at virtually very level (and, branch) of the public sector. Corruption in Azerbaijan is not manifested in one single form, but takes on three broad forms: administrative/ bureaucratic corruption, grand corruption, and state capture.

TABLE 3: AREAS OF CORRUPTION WITHIN THE PUBLIC FINANCIAL MANAGEMENT PROCESS

☐ Gaps	☐ Administrative and/or Bureaucratic Corruption	☐ Grand Corruption	☐ State Capture
☐ Capital expenditures	☐ ●	☐ ●	☐ ●
☐ Tax evasion	☐ ●	☐	☐ ●
☐ Utility subsidies	☐	☐ ●	☐
☐ Nontransparent execution	☐ ●	☐ ●	☐ ●
☐ Rigidity and vagueness of line items	☐ ●	☐	☐ ●
☐ Cash management	☐ ●	☐	☐
☐ Dotation to regions	☐ ●	☐ ●	☐ ●
☐ Weak external audit	☐ ●	☐ ●	☐
☐ Weak public procurement	☐ ●	☐ ●	☐ ●

Note: ● denotes the potential existence of corruption.

Sources: CBC, 2005c; and author.

⁸⁸ The BSL inter alia covers state extra-budgetary funds including the Oil Fund; provides for complete accounts of extra-budgetary revenues and expenditures with respect to economic and functional classifications; requires that these accounts are reported to the Parliament and should be reported to the media and the general public; and ensures that any resources drawn from the extra-budgetary funds (with the exception of the State Oil Fund’s administrative expenses) are channeled through the state Treasury. The BSL sets out rules and regulations for budget preparation, formulation, and audit.

4.7 Is There Political Will for Reform?

If corruption is about effective governance, and governance is about the exercise of state power, then efforts to combat corruption demand strong leadership and ownership if they are to be successful.⁸⁹ Is there a political will to reform in Azerbaijan? Discussions with various agencies, nongovernmental organizations (NGOs), and international donors indicate that there is little public acceptance of the notion that the role of the state is to rise above private interests to protect the broader public interest. In Azerbaijan, clientelism⁹⁰ shapes the public landscape and creates conditions ripe for corruption. However, in the case of Azerbaijan it may be more appropriate to use the word *clan* rather than *client* because the systemic structure of corruption is more clan-based. The line between what is public and what is private is blurred so that abuse of public office for private gain is a routine occurrence.

Widespread corruption in Azerbaijan will endure in the public sector so long as government authorities at all levels are either unwilling or unable to forcefully address the issue. As stated above, corruption in Azerbaijan is endemic and touches the very highest level of government. There does not appear to be any political will or desire to change the current system of accountability.

⁸⁹ Shah and Schacter, 2004, p. 41.

⁹⁰ Shah and Schacter (2004) define clientelism as public office holders focusing on serving particular client groups linked to them by ethnic, geographic, or other ties.

5. Formulating an Anti-Corruption Strategy

What can be done in an environment where the highest levels of government participate in a corrupt public financial management process? Experience in Albania and other countries strongly suggests that the answer lies in taking an indirect approach to combating corruption. Shah and Schacter (2004) reveal that because corruption is itself a symptom of fundamental governance failure, the higher the incidence of corruption, the less an anti-corruption strategy should include tactics that are narrowly targeted at corrupt behavior and the more it should focus on the underlying features of the governance environment. As a result, where corruption is high (and the quality of governance is low), it makes more sense to focus on the underlying drivers of malfeasance in the public sector by building the rule of law and strengthening institutions of accountability.⁹¹

Experience has demonstrated that there is no single model to determine how various relationships⁹² within a society should be structured to minimize the risks of corruption. A wide range of models is available from contemporary practice and historical experience. Though the methods may differ across countries, the goals are the same: enhancing state capacity and public-sector management, strengthening political accountability, and enabling civil society. The analysis presented in this report reviews the system of public financial management only. As a result, reforming public-sector management and public-sector finance generally requires:

- Instilling meritocracy and adequate pay in public administration;
- Clarifying governance structures;
- Enhancing transparency and accountability in fiscal management; and
- Policy reforms in sectoral service delivery.

The following sections present possible ways to strengthen Azerbaijan institutions over the near to medium term with respect to public-sector management and public-sector finance.

5.1 Meritocracy and Public Administration

The practice of political patronage in Azerbaijan's public administration continues to be an important source of corruption. Political patronage can be a source of accountability to the patron, but it undermines the development of strong institutional governance standards. As a result, it opens the way to conflict of interest, misprocurement, and general misuse of public funds. A first step in reforming public-sector management is to eliminate patronage by instituting (or enhancing) meritocratic systems for appointment, promotion, performance evaluation, and, where feasible, an independent civil service oversight body.⁹³ In parallel, it is essential to increase salaries, relate them to skill and responsibility, and regularize the extensive non-salary benefits that provide a broad scope for discretion and

⁹¹ Shah and Schacter, 2004, p. 42.

⁹² Relationships include internal organization of the political system, the relationship between the state and firms, and the relationship between the state and civil society.

⁹³ Poland and Latvia are currently moving down this path.

corruption.⁹⁴ However, in Azerbaijan, increasing salaries does not make sense unless there is a very strong and consistent demonstration of political will to root out corrupt officials and stop corrupt practices.

5.2 Strengthening Governance Structures and the Budget Formulation Process

Another challenge is to institute, or to strengthen, key elements of a functioning budget system that ensures accountability. Budget formulation is often flawed by ambiguity between executive and legislative roles, poor parliamentary processes, and lack of strategic policy coordination. The following section provides observations and suggestions for improving the budgetary system.

5.2.a Budget Preparation and Execution

Formulation and implementation of an effective public expenditure envelope requires an institutional framework for integrated and coordinated fiscal management. It appears that there is some interaction among key government agencies, including the Cabinet of Ministers, the Minister of Finance, the Minister of Economic Development, and the Central Bank. However, interaction between the MOF and the MED is limited, if not extremely problematic. A brief review of the various roles of these institutions indicates that:

- The Cabinet of Ministers is a relative black box that no one quite understands.
- Line ministries do end-runs around the MOF and MED to the Cabinet of Minister in order to get approval of sectoral plans that in many instances are out of step with the long-term strategy (State Program for Poverty Reduction – SPPRED) or the PIP.
- With the approval of the Cabinet of Ministers in hand, the line ministries then force the MED to put their projects in the PIP regardless of the projects' merits.

There is a need to empower key line ministries (for example, health and education) to participate more effectively in the budget preparation process. Some lack of clarity exists in the delineation of responsibilities for budget preparation between the MOF and the various line ministries.⁹⁵

5.2.b Improving the Budget System Law⁹⁶

The BSL is a good framework law that contains many of the necessary provisions to ensure budget accountability and transparency. The BSL defines the main concepts of budgeting and budget execution and is an initial step in curtailing corruption. However, until now, the Government of Azerbaijan has not fully and effectively implemented the BSL. A full, complete, and effective implementation of the Law would be a substantial milestone in the path to reducing corruption and improving public expenditure management.

In addition to successful implementation of the BSL, there are at least two places in the budget formulation process where additional strengthening in the BSL would help to reduce the discretion of individual departments (line agencies) and bring

⁹⁴ The Republic of Georgia allows for higher salaries for public servants who have successfully cleared competitive examinations.

⁹⁵ Anecdotal evidence suggests that this is particularly true with regard to state budget institutions located in the regions, or with respect to spending in local municipal governments, for which the controlling line ministries assume no direct oversight responsibility.

⁹⁶ The following section was taken in its entirety from CBC, 2005c.

more rule-based transparency to the budget formulation process. Possible additions to the BSL should include:

- Making budgetary ceilings a binding constraint for budget organization; and
- Linking the sector development programs of budget organizations to their actual budgets. Furthermore, as for improving the budget execution process, Treasury instructions and rules should be made publicly available with more frequent public reporting and public discussions of quarterly budget outputs and annual budget outcomes.

5.2.c Broaden the Medium Term Expenditure Framework (MTEF)

The purpose of a budget is to translate government policy objectives into reality by optimizing budget allocations and expenditures. The MTEF was designed to strengthen the budget process by making budget expenditure allocations more stable over the near to medium term, thereby allowing program managers to plan their resources with some degree of predictability. In reality, the evidence suggests that the presentation of the budget is relatively meaningless.

In addition, there is a need to:

- Improve the MTEF process by deepening its analysis, broadening its coverage, and integrating the government's national policy initiatives in the budget strategy;
- Link the MTEF to Azerbaijan's long-term development goals (SPPRED); and
- Strengthen institutional capacities to improve the effectiveness of the MTEF and the budgeting process in general and to ensure that the line ministries have adequate human resources for its implementation.

Poor budget formulation creates a demand for frequent virement.⁹⁷ Rules for transfers between line items (or virements) are generally stated in the financial regulations or the BSL. In general, virement weakens the ability of a budget department to address underlying strategic problems in preparing good budgets and leads to a general lack of budgetary transparency. The widespread use of virement at the central and local government levels is an indication of serious weakness in the budget development and execution process. Addressing virement is crucial to reducing the potential for corruption at central (and local) government levels and to increasing budget transparency and accountability.

Over the course of a budget year, fiscal circumstances may dictate a shift in budget priorities. However, there are inadequate budget rules and procedures for transparently shifting budgetary priorities. A fundamental program developing procedures and regulations to reduce the demand for virement, and still provide a mechanism allowing for budgetary flexibility, will be needed in order to enhance public-sector budget transparency.

5.2.d Public Expenditure Management

The search for operational approaches to improving public expenditure management in Azerbaijan rests upon three basic premises: 1) the information problem is

⁹⁷ Virement is the transfer of expenditure provision from one line item (object) to another during the budget year.

massive; 2) specific entry points must be identified⁹⁸; and 3) Azerbaijan has a limited human resource endowment. In Azerbaijan, as in other transition economies, disincentives to share information and the absence of systematic interagency communication result in fragmented policy formulation and atomized decision making. In many ways, the challenge is to improve communications and reduce the cost of information within the public sector.

The guiding operational criterion of technical assistance for sustainable public expenditure management improvement should therefore be to strengthen the linkage between the components of the overall budget formulation and expenditure execution systems, not only among central ministries but between them and local governments. The World Bank will continue to spend an enormous amount of time and financial resources in improving public financial systems.

5.3 Improving Transparency and Accountability: Full Budget Coverage

To improve transparency and accountability in fiscal management, it is crucial to ensure full budget coverage and control. The Government of Azerbaijan has historically diverted substantial resources into off-budget accounts that typically lack oversight and transparency. These off-budget accounts take different forms, from extra-budgetary funds to the lack of integration of investment planning and external financing into the budget.

5.3.a Strengthening Linkages between Sector Plans and SPPRED

Quist (2005) writes that the Azerbaijan government places significant weight upon the 10-year sector plans. These sector plans are approved by the Cabinet of Ministers and developed without any reference to resource constraints. Although there is some overlap between the objectives of the sector plans and the SPPRED, there is no concerted effort to align these policy frameworks. There is significant opportunity to integrate the sector plans with the overarching SPPRED policy framework.

The Government of Azerbaijan has attempted to strengthen the linkages between national development strategies and annual and multi-annual budget processes; however, there has not been adequate opportunity to demonstrate the effectiveness of such linkages. There is still a substantial amount of work to be done in defining functional linkages, program frameworks, and institutional arrangements that support functional linkages.

5.3.b Budgeting Foreign Grants and International Aid

According to the BSL, all extra-budgetary financial operations of budget organizations must be implemented through Treasury, thereby bringing a greater degree of transparency to all financial flows. Loans and grants obtained from international financial institutions, however, do not go through the Treasury and are disbursed through the commercial banking system or the Investment Bank of Azerbaijan.

Multilateral organizations have insisted that their disbursements flow in this manner because of the lack of transparency and financial management accountability exercised by the Azerbaijan Treasury. For example, the Family Planning Center

⁹⁸ Simultaneous across-the-board budget system reform is not realistic. However, total inaction with respect to institutional reform will lead to progressive deterioration in budget functions. Therefore, one effective approach is to pick specific entry targets and start the reform from these targets.

receives grant funds from the United Nations Population Fund through the Investment Bank. With the introduction of the TIMS, it may be advisable to bring these financial flows under the Treasury system. In addition,

- Foreign grants must be budgeted, whether they are given as grants or in-kind. The use of counterpart funds from sales or granted goods needs to be budgeted, recorded, and accounted for within the overall budget framework.
- External resources (including international aid) must be integrated with overall resource utilization, and thus should be included in the consolidated budget. Generally, this suggests placing the management of counterpart funds within the Treasury.

5.3.c Treasury and Aid Management

The MED should play a key role in recording foreign grants and related transactions as needed. Institutional arrangements generally vary according to the country or donor, but the minimum requirements for good management of grants should be the following:

- Expenditures financed by grants must be subject to the same scrutiny and prioritization as other expenditures, regardless of the organization for aid coordination;
- Transactions relating to grants must be accounted for and data collected and recorded at the central (that is, Treasury) level;
- Accounts for counterpart funds should be controlled and audited along the same lines as other government accounts; and
- External resources (including international aid) must be integrated with overall resource utilization, and thus should be included in the consolidated budget.

Generally, this suggests placing the management of counterpart funds within the Treasury. However, this is not the case in Azerbaijan. The central registration of grants should be performed either by the Treasury or by the MED (planning).

5.4 Ensure Full Budget Coverage and Control and Improve Service Delivery

To improve transparency and accountability in fiscal management, it is crucial to ensure full budget coverage and control. Azerbaijan has historically diverted substantial resources into off-budget accounts, and failed to integrate capital investment planning into the budget. The following sections present observations with respect to the current situation in Azerbaijan and suggest ways for enhancing, and integrating, the public investment planning process.

5.4.a Public Investment Program

The issue of government property and asset management in transition countries has often been disregarded in discussions of the legal and fiscal impacts of decentralization.⁹⁹ The balance sheet issues that are raised by this situation are critical to understanding the state of government finances. For example, given the relative inflexibility of tax and revenue sources, the greatest degree of freedom that a government enjoys is the manner in which it manages its assets to generate a social or financial return. This section briefly describes issues surrounding the government's public investment management practices.

⁹⁹ For a thorough discussion of municipal asset management issues, see Kaganova and Nayyar-Stone (2000); Kaganova (1999); Kaganova et al. (1999); and Peterson (1999).

5.4.b Issues Associated with the Current Public Investment Practices¹⁰⁰

Issues associated with government long-term capital investment practices include:

- Government investment projects are currently not reviewed as a total financial/economic package with capital outlays and future recurrent operating expenditures, amortization, and depreciation. The coordination of recurrent and capital expenditures must be strengthened. When a project is reviewed in light of the medium-term investment framework, future recurrent costs should also be taken into consideration and budgeted.
- The lack of project preparation skills (project identification, financial, and economic feasibility studies) is being addressed by the USAID PIPE project both in the MED for project appraisal for the PIP and in selected line ministries for project identification and preparation. Vast amounts of human resources are dedicated to controlling small expenditures. Public investments are in many instances decided with little or no consideration of their economic and financial feasibility, especially when line ministries circumvent PIP procedures by obtaining Cabinet of Ministers approval of their sectoral plans and specific capital projects.
- Greater credence is placed upon the 10-year sector plans, which are directly approved by the Cabinet of Ministers and developed without any reference to resource constraints. While there is some overlap between the objectives of the sector plans and the SPPRED, there is no concerted attempt to align these policy frameworks or to update them in a synchronous fashion.
- There is substantial opportunity to better integrate the sector plans with the overarching SPPRED policy framework, but there is also a risk of evolving two competing policy frameworks—one by the MED and the other by the various sector ministries.¹⁰¹
- Capital projects in the PIP and recurrent budgets that relate to these investments are not integrated within the overall spending envelope. Capital outlays and their respective operational expenses should be integrated into the annual budget, long-term PIP, and medium-term economic framework. USAID has recognized this major gap and has introduced PIPE, which could, over the next two years, increase public transparency and efficiency with respect to capital (investment) expenditure.
- The importance of developing a sound PIP derives from its importance in providing a framework for policy formulation, public investment planning, project implementation management, and monitoring.¹⁰² But its success requires attention to a number of other related areas, including but not limited to:
 - Coordinating sectoral plans;
 - Integrating the PIP into an effective budget planning, preparation, and execution process; and
 - Enhancing the legal and regulatory framework.

The PIPE project, which is expected to run through the end of calendar year 2007, has a substantial work agenda that is expected to integrate a number of capacity-

¹⁰⁰ USAID's Public Investment Policy and Efficiency project started in March 2005 and is expected to run until the end of 2007. The primary task of this project is to improve the efficiency of capital investment spending programs in Azerbaijan. The consultant is aware of the goals of PIPE but has itemized a few of the issues that PIPE must resolve in enhancing budget transparency and improving capital investment service delivery.

¹⁰¹ See Ronald Quist, 2005, p. 10

¹⁰² See Quist, 2005 for a very good diagnostic review of "Public investment Policy and Efficiency in the Infrastructure Sector" in Azerbaijan.

building elements. The 2.5-year timeframe for the successful completion of such an enormous undertaking may be inadequate and should be revisited by USAID.

5.4.c Public Investment and Local Governments

The ability of the Azerbaijan government to deliver services and support development and poverty alleviation at the local level is dependent upon the level of fiscal decentralization achieved. Fiscal decentralization in Azerbaijan is underpinned by the Constitution. The roles, responsibilities and authorities are set out in the Law of the Azerbaijan Republic “On Status of Municipalities.”¹⁰³ There are 2,650 municipalities registered in Azerbaijan.

The legal and regulatory framework defines the scope and structure of Azerbaijan’s decentralization, and specifies the powers, functions, roles, and responsibilities of the various structures within the decentralized structure of government. However, there is substantial overlap in the roles and responsibilities of the State Local Authorities and the municipalities with significant consequences on the scope of the PIP and the structure and presentation of its framework. Quist (2005) states that since the Local Executive Authorities fall under the Office of the President, with a separate Budget Head (Local Executive Powers 1251), and are responsible for significant infrastructure development projects, any PIP framework that focuses solely on sector ministries and agencies and excludes the municipalities may miss significant opportunities for addressing poverty alleviation public investment policy.

5.4.d Public Investment Inventory

The Government of Azerbaijan has no fixed asset investment inventory. A fixed asset accounting system is a scheme for policies, procedures, and methods for recording and reporting monetary amounts associated with fixed (infrastructure, investment) asset transactions. A fixed asset management system is the synchronization of methods, policies, and procedures that address the acquisition, use, control, protection, maintenance, and disposal of assets. In order to develop more effective capital investment strategies, it is essentially to develop a detailed inventory of what is already there, including the condition of those assets. USAID’s PIPE project can make a start and work could be accelerated through USAID’s TIMS project if the system is expanded to include a fixed asset component.

5.4.e State-Owned ENTERPRISES and Public Investments

Although SOEs are effectively national government assets, their capital expenditures are not brought under the umbrella of the national investment planning process. Given the high percentage of Azerbaijan government public ownership of enterprises and, more significantly, the number of enterprises that are (cross) subsidized, narrowly defining PIP to include only sector ministries and subvented agencies just because this is the standard practice excludes from policy dialogue and consideration a majority of the most crucial investment and development issues. This creates leakages within the national investment planning system. SOEs’ capital expenditures should be subject to the discipline of the PIP.

5.5 Improving Transparency with Respect to the State Oil Fund

Review of governance and functional structures in ministries should also be a high priority in reforming Azerbaijan’s public financial administration. As presented below,

¹⁰³ Since 2001, Azerbaijan has been party to the Charter on Local Governance of the Council of Europe.

Azerbaijan has blurred the lines of policy direction and accountability with respect to the State Oil Fund (SOFAZ) providing funding for housing internally displaced persons (IDPs). While no one can dispute the necessity for such funding, these funds should have been directed through the state's normal budgetary process.¹⁰⁴

5.5.a Review of the State Oil Fund¹⁰⁵

The Government of Azerbaijan has adopted a measured approach to the development of the country's oil and gas reserves. According to World Bank estimates, the revenues accumulated in SOFAZ are expected to reach US\$100 billion over the next 20 years—10 times more than the current GDP of the Azeri economy. As a result, effectively managing the funds in SOFAZ is an enormous challenge. The establishment of SOFAZ provides a financial mechanism for separating commercial decisions on oil extraction from public finance spending decisions and helps to sterilize the macro-monetary effects of capital inflows. Current oil fund¹⁰⁶ regulations require that:

- Only interest revenues earned on SOFAZ's off-shore investments can be used for public expenditures.¹⁰⁷
- Nonoperational expenditures are strictly limited to funding projects within the Consolidated State Budget, including capital investments in the PIP, and in conformity with the MTEF.
- The oil fund was established by presidential decree.
- Per the BSL, all expenditures in the Consolidated State Budget must be channeled through the Treasury.
- The oil fund is subject to high standards with regard to accountability and good governance essential for fiscal discipline and avoiding the hurriedly and ill-conceived expenditure projects.
- The oil fund is subject to proper assessment of risk and uncertainty, especially with regard to volatile oil prices.

5.5.b SOFAZ Off-Budget Financing

According to the Chief of the Department of Economic and Financial Credit Policy (Azerbaijan Cabinet of Ministers) and the World Bank, the oil fund relaxed its original charter by engaging in direct poverty reducing measures to alleviate the plight of IDPs.¹⁰⁸ The oil fund allocated about US\$36 million in funding in 2003, followed by a second allocation of US\$40 million in 2004 for the construction of housing for IDPs. The allocation of funds to IDPs fits within Azerbaijan's poverty reduction strategy. However, according to the Law of Azerbaijan Republic on Amendments to the Law on Budget System, these two capital investment allocations did not flow through the Treasury system or Consolidated State Budget. According to the amended Budget System Law:

¹⁰⁴ In addition, off-budget agency funding contributes to budget fragmentation and lack of transparency. Off-budget funding should be reduced or eliminated.

¹⁰⁵ See Decree of the President of the Azerbaijan Republic "On the Approval of 'The Long-Term Strategy on the Management of Oil and Gas Revenues,'" September 2004.

¹⁰⁶ See World Bank, 2003c, p. xiii.

¹⁰⁷ World Bank, 2003c, p. xiii.

¹⁰⁸ World Bank, 2003a, p. 14.

- “All state budget revenues and expenditures, extra-budgetary payments (contributions), extra-budgetary state funds, (excluding revenues of the State Oil Fund of Azerbaijan Republic, accumulation of state funds at the international financial markets or institutions in kind of portfolio investments or transactions costs), transactions with credits borrowed under the state guarantees in order to cover budget deficits, and other state financial transactions, following the legislation should be carried out within the State treasury system of Azerbaijan Republic.” (Article 19.2)
- “All expenditures of the extra-budgetary funds (excluding reserves of the State Oil Fund of Azerbaijan Republic, which are accumulated at the international financial markets or institutions in kind of portfolio investments or transactions costs) should be included into the consolidated budget. All the capital expenditures should be directed to finance projects of the State Investment Program.” (Article 27.2)

It is not clear why domestic oil fund capital investments (such as housing for IDPs) should be excluded from the PIP. In addition, the fund’s resources have not been used within the framework of the long-term strategy. SOFAZ’s resources have been used to finance the current fiscal needs of the government. For example, transfers from SOFAZ to the government budget have become a source for financing social needs (such as increasing salaries and pensions). The nature of such expenditures does not contribute to the overall development of the country and can lead to significant macroeconomic imbalances. Over the past two years, sharp increases in domestic inflation can be directly linked to increased domestic demand pressures aggravated by imbalanced and expansive domestic fiscal expenditure policies of the Azerbaijan government.¹⁰⁹

Some interviewed persons have argued that SOFAZ is much more transparent and is subject to audits by international accounting firms; therefore, SOFAZ should be allowed to engage in domestic capital investments without integrating these expenditures into the consolidated budget or via the single treasury mechanism. In brief:

- Bringing all state capital investment spending under the scrutiny of a single treasury system and consolidated budget system would in fact increase budget transparency.
- The State Oil Fund should be established and its charter elaborated by law rather than presidential decree. Establishing SOFAZ under an overarching law with coordinating corporate charter and governance structures would allow it to be maintained as a more transparent, permanent institution.

In addition, a law should be passed that strengthens the status of SOFAZ, thereby removing it from the discretionary nature of presidential decrees. The law should:

- Delineate clearly the sterilization and development objectives of the SOFAZ;
- Strengthen SOFAZ’s status in society—an appropriate law on SOFAZ would ensure that not only profit oil but also all oil taxes paid by contractors are transferred to the SOFAZ;
- Formulate the financial framework and flow of funds transferred from SOFAZ to the government budget and subordinate any transfers to the long-term management strategy of the oil revenues; and

¹⁰⁹ See CBC, 2005c.

- Increase the transparency and accountability of SOFAZ and increase opportunities for parliamentary and public supervision of the fund's activities. Currently, SOFAZ is not accountable to the Parliament of Azerbaijan Republic.¹¹⁰

5.6 Improving Performance in Tax and Customs Administration

Corruption in tax and customs administration lowers state revenues and creates a distorted private-sector environment. Reforms to simplify tax policy and standardization of forms and procedures in tax administration generally help. In addition, implementing transparent systems at the border, such as the use of computerized risk analysis, should help to minimize some customs-related corruption. It is important to eliminate one-on-one contact between taxpayers and officials and ensure that operating and management systems are efficient and easily monitored. The following sections provide some suggestions with respect to improving tax and customs administration.

5.6.a Tax Administration

Many interviewed persons indicated that the Azerbaijan system of tax administration has significantly improved over the past few years with the introduction of the new tax code and improvements in internal tax administration. According to various sources:

- Audits have become more predictable;
- Tax officials' knowledge has increased significantly due to extensive training programs;
- A Code of Ethics has been established, which all tax officials must sign annually; and
- The strengthening of the large taxpayer unit and increased reliance on no-contact filing have improved services for large corporate taxpayers.

Yet many issues remain. The U.S. Resident Treasury Advisor indicates that there are 92,000 active taxpayers (legal entities) in Azerbaijan. Of those, 640 are considered to be large corporate taxpayers. However, fiscal evasion remains a pervasive problem. In other words, a substantial portion of the economic activity remains outside the system.

World Bank (2003a) and Tax Administration advisors estimate that the Azerbaijan informal economy is huge, estimated at about 50 percent of total economic activity. Lowering the highest marginal tax rate to 24 percent, as recently stipulated by the government (see Table 1, above), could create an incentive to bring those in the informal economy into the formal sector. As a result, total personal and corporate income tax collections may be expected to increase over the near term.

Much still needs to be done with respect to improving the efficiency of the Azerbaijan Tax Administration, including:

- Improving the capacity/capability of the audit and collections department.
- Establishing individual tax filing requirements to reduce tax evasion. Currently, there is no individual tax filing requirement; employees pay taxes as an automated function at the firm (or source of employment).

¹¹⁰ CBC, 2005c.

- Establishing a more effective Tax Administration Internal Control/Investigation Function to report malfeasance. This is not currently available.
- Introducing a centralized tax processing database. At present, citizens must go back to their places of residency permit and pay taxes at the local bank and obtain a receipt from the bank to validate tax payment. A centralized tax processing database would improve tax payment efficiency.
- Removing the Azerbaijan Tax Administration from the political process. There is no “firewall” between the presidential administration and the tax authorities. An example of this concerns the potential abuse of the Tax Administration authority in the case of Barmek Llc (Turkish Electric Power Distribution Company). When there was a dispute between Barmek Llc and Azer Energy (the State Electric Company) the Tax Administration was called in to audit Barmek on a number of occasions (raiding their offices).¹¹¹
- Resolving issues related to the Income and Asset Disclosure statement. In January 2006, all public officials are required by law to file an Income and Asset Disclosure statement. It is unclear who will receive these statements, how these statements will be used, or whether the Tax Administration will review these statements against the tax registry.
- Overseeing tax officers. Many interviewed persons maintained that, despite the recent reforms in Tax Administration, tax officers still use a great amount of individual discretion in applying the Tax Code.
- Establishing a Taxpayer Ombudsman. Many interviewed persons indicated that tax procedures are often nontransparent and inconsistent. In the case of adjudicating differences of interpretation regarding the Tax Code, tax payment, filing and payment procedures, or taxpayer registration, it is essential that the Tax Administration establish a Taxpayer Ombudsmen.

5.6.b Customs¹¹²

The most problematic area in the day-to-day operation of firms in Azerbaijan is import/export. Broad procedures for the import of goods include the following:

- The customs documents (certificate of origin, description of goods, volume and value of the goods) are examined by the customs inspector.
- The goods are reviewed to ensure they meet or pass a special standardized control for health or safety.
- The official might take samples of the imported goods according to the customs code and/or weigh the truck.
- Once the papers have been successfully examined, a clearance document is then issued and the truck is sealed and driven to the closest checkpoint. At this point, the importer takes the various customs documents to the regional customs administration to get them cleared and pay customs duties.
- Once the goods are cleared by customs, the truck can be unsealed and shipped and goods can be freely unloaded. The whole customs clearance procedure should normally take between one and two days.

Informal payments are a prominent feature of the customs system. Importers were unaware that many shipments that passed through customs could avoid extra

¹¹¹ Further, police were used to ticket and harass Barmek Llc vehicles and business officials.

¹¹² This section paraphrases elements from CBC, 2005b.

payments.¹¹³ One side effect of these informal payments is the administrative nightmare that it causes importers.¹¹⁴ In addition, customs officials operate to protect monopolies operated by their clan members.¹¹⁵

Other issues regarding customs include:

- Because of the absence of risk analysis systems, customs offices' inspection and monitoring strategies are either deficient or nonexistent.
- Customs clearance procedures appear to be poorly designed and are cumbersome.
- Anecdotal evidence suggests that there is a lack of access to reference prices, which gives customs officials broad discretionary scope when valuing goods and assessing duties and charges.

Additional signs of corruption include the following nonexclusive list of indicators:

- Large numbers of arbitrary exemptions and other special provisions;
- Excessive use of nontariff barriers;
- Special agreements with individual industrial enterprises (monopolies) instead of with the entire sector;
- Declarations with respect to the value of goods that are in some cases incorrect or too low;
- Goods stored in customs warehouses that are released without payment of duties and charges; and
- Fees demanded by some customs officials for swift issuance of customs clearance certificates.

Areas where reform can take place include:

- Better data collection and control through the adoption and refinement of an automated data capture system.
- The use of international standards for import-good valuations.
- A shift toward an audit-based system for import/export goods movement control.
- A broader use of an automated process for customs documentation for importers. This includes much more effective use of a licensed customs broker program, the creation of specialized units that perform audits (and customs valuations), and the implementation of a system targeting the selectivity of transactions and consignments.

5.7 Strengthening Public Procurement

Azerbaijan has made considerable progress developing the legal framework for public procurement. The Public Procurement Law developed by the State Procurement Agency and based on the United Nations Commission for Internal Trade was put into place in 2002.¹¹⁶ In the context of public procurement, corruption can be generally encouraged by factors such as:

- Excessive use of restricted forms of tendering and single source procurement;
- Changing orders and variations in tender specification; and

¹¹³ CBC (2005b) writes that, in effect, a shadow (additional) tariff is created.

¹¹⁴ CBC, 2005b. Importers must document these informal payments for their headquarters to generate bookkeeping records or receipts.

¹¹⁵ Anecdotal evidence suggests that bribe taking is pervasive with respect to customs administration.

¹¹⁶ World Bank, 2003b.

- Inadequate provisions for internal control, review of procurement complaints, and external audit of procurement procedures.

CBC and DAI consultants, after reviewing the public procurement environment in Azerbaijan, recommended that the procurement review department be enhanced and given more independence from other departments within the State Procurement Agency. The following issues should be systematically addressed:

- There is an ineffective system of recruitment and staff development in place. The staff in the procurement agency needs to receive more training on effective procurement procedures.
- Standard tender documents and model contract forms should be made available to the various contracting units.
- Sample forms of standard contract conditions, contracts, and other documents should be included in the tender documentation.
- The procurement processing organization must have access to a central computerized register of procurement transactions. The dissemination of information to contracting entities and the private sector should be substantially improved.

In addition, there should be well-defined and widely understood procedures for the control and audit of procurement transactions, including anti-fraud and anti-corruption measures.

5.8 Strengthening Internal and External Audits

In general, the effectiveness of internal and external audits varies greatly across countries and across entities. In some countries, such as Kazakhstan, the external audit entity is constitutionally dominated by the executive, thus limiting its independence and credibility. To be effective in reducing corruption, external audits must be independent and equipped with strong auditing and diagnostic skills, moving beyond the individual fault to target systemic weaknesses. In addition to improving parliamentary and public oversight, the internal audit function must be strengthened. The following sections briefly present some suggestions for improving internal and external audit functions.

5.8.a Internal and External Audits

Auditing, combined with internal controls and evaluation, consists of mechanisms that are designed to ensure that planning, budget, and use of public resources conform to the Budget System Law and the objectives pursued by the government. Without these mechanisms, there is considerable risk that policy decisions will be based on false information, that resources will be mismanaged, and that policy decisions will be ignored by the relevant operating organizations. Audit in the public sector also has the important function of giving decision makers and citizens regular assurance of the quality of reports of how taxpayers' money has been spent and the management of assets and liabilities under public control.

There is an important and fundamental distinction between external and internal audits, basically related to the degree of independence the auditor responsible for the audit has in relation to the audited entity and to whom the results of the audit are addressed. In order for the external audit process to function effectively and be trusted as an objective mechanism, it should be fully independent of the auditee and its reports should be addressed to entities that are separate from the bodies being

audited. However, this does not preclude close links facilitating the practical work between the two types of audit organizations.

5.8.b External Audit Function: Chamber of Accounts¹¹⁷

The Chamber of Accounts was formed in 1994 by Parliament. However, actual implementing legislation was not passed until the Law on the Chamber of Accounts was ratified in 1999, and the Chamber of Accounts did not start operations until June 2001. Together with the enactment of the BSL, the Chamber of Accounts is vested with the authority to:

- Undertake audits of all public-sector bodies and organizations, including budgetary and extra-budgetary organizations and funds; and
- Make public the results of the various audits.

Although established as a permanent audit institution under the Parliament, the Chamber of Audits¹¹⁸ should technically be independent to produce the following:

- An annual report on the activities of the Chamber of Accounts;
- Executive reports on the execution of the State Budget (quarterly/annual); and
- Other analytical reviews.

There is still a considerable amount of capacity-building work needed by the Chamber of Accounts. The immediate challenges are:

- The Chamber must maintain an appropriate legislative framework and develop an appropriate professional and institutional capacity.
- The Chamber should be provided with the necessary working tools and practices, including International Standards and Practices.
- The auditors of the Chamber of Audits should be required to pass the professional accounting and auditing examinations.¹¹⁹

A major weakness in the area of public scrutiny with respect to public investments relates to SOEs. Over the last year, the Chamber of Accounts wanted to review (audit) the state-owned Caspian Shipping Company (CASPAR),¹²⁰ but its auditors were not allowed to enter the premises. By law, the Chamber of Accounts has the right to audit and inspect SOEs. In this case, the Government of Azerbaijan and the Chamber of Accounts are simply not operating according to the law.

5.8.c Internal Audit Function: Control Inspection Department (CID)¹²¹

The function of the internal audit is carried out by the MOF's Control Inspection Department. In an attempt to reduce duplicative control and audit functions, a 1999 Presidential Decree abolished all public-sector internal inspection departments with the exception of the CID. As a result, there is no internal control function in any ministry or line agency. In effect, there is no internal inspection function at any of the

¹¹⁷ This section draws upon elements from CBC, 2005b.

¹¹⁸ The Chamber of Audits is somewhat similar to perhaps the U.S. General Accountability Office.

¹¹⁹ See CBC, 2005c.

¹²⁰ CBC, 2005c.

¹²¹ CBC, 2005c.

individual ministries that could examine and monitor the effectiveness of accounting and internal control systems. All internal audit control ability rests with the CID at the MOF. This task may be so large that it may be necessary to devolve some internal audit practices and to strengthen the internal audit capacities of the various ministries and other budgetary organizations.

5.9 Decentralization and Improving Transparency

Rapid decentralization without installation of a priori accountability safeguards and improvement of the capacity of local financial management may actually increase the level of corruption. The following sections provide suggestions for improving the level of public-sector accountability within a decentralization policy framework.

5.9.a Asymmetric and Poor Assignment of Responsibilities

This review indicates that, in general, adjustments in the final delivery of government services are negotiated between the national, rayon, and local governments. In effect, there are no basic regulated (clear and transparent) criteria for the allocation of responsibilities and financial resources between the rayon(s) and local self-governments. The consequences are duplication or underprovision of public services and proliferation of unfunded mandates (or delegated functions).

The net result is that responsibilities with respect to the delivery of local government services has become defuse, with limited or no accountability. One way that the proposed fiscal policy unit¹²² can assist with respect to clarifying the assignment of decentralized responsibilities is to serve as a forum for overseeing, clarifying, and implementing the decentralization agenda. In addition, the fiscal policy unit can assist the MOF in determining an appropriate fixed state tax share that will be directed to local municipal governments. A transparent fixed state tax share directed at local municipal governments should improve local government revenue predictability and eliminate the need for negotiated annual transfers.

5.9.a Norms and Implementing a More Transparent System of Transfers

Traditionally, funding in Azerbaijan is allocated on the basis of normatives (“norms”) for inputs. Norms are used for virtually all sectors. For example, jurisdictions with the most school buildings (and teachers) or the most hospitals (and hospital beds) received the most funds.

However, it is almost universally accepted that “finance follows function” (or, restated, the amount of funds follows students, or the amount of funds follows the number of patients). This simply means that funding for health or education is a function of the number of patients or the number of students. Such funding systems are said to be based on capitation, or unit cost, or average cost. In other words, program (performance) budgeting is almost the most universally accepted means of developing effective programs and budgeting processes.

5.9.a.1 Adjusting the Funding Formula

The funding formula per patient (or per student) can be adjusted for factors that result in differences in costs, such as population density.¹²³ The formula must be

¹²² See Annex F.

¹²³ Rural schools (or hospitals) are usually more expensive per capita than urban schools (hospitals) because fixed costs are distributed across a smaller number of students (or patients).

simple and transparent with only a limited number of adjustment factors.¹²⁴ In capitation, or demand-side financing schemes, public funds are allocated as “block” or “lump sum” grants according to a formula. The formula can also be designed to reward service delivery improvement or the efficiency with which the institution uses inputs. Institutions then would have the flexibility to reallocate resources as they see fit.

5.9.a.2 Equalization Grants¹²⁵

The Azerbaijan example suggests that overdependence on nontransparent central government transfers may in fact undermine accountability and may create perverse incentives for misallocation of public resources. Further, the technical design of intergovernmental transfers may not have the desired impact on the general problem of government accountability, and larger political/economic solutions may be needed to explore better service delivery by local governments. In particular, policy interventions that address local information asymmetries are likely to be critical to empower citizens to hold their local government representatives accountable. Not all local governments or local service enterprises have the same capacity to raise revenues. The cost of providing the same service varies by locality. It is appropriate to address these differences in local fiscal capacity and spending through transfers. Because the objective is to normalize the differences in local conditions, these are often called equalization grants. It is imperative to develop an appropriate and transparent system to implement these grants.

¹²⁴ It is suggested that fewer than six adjustment factors be introduced.

¹²⁵ See Annex E.

6. implementing reform: Issues and Resources

Table 4 identifies potential ways to improve public-sector transparency and expenditure management. Many of these recommended steps can only be undertaken within the scope of donor-financed projects, and some of these public-sector weaknesses are currently being addressed by programs established by donor agencies. These deficiencies are listed because during this brief DAI assessment, they were seen as a continuing obstacle to effective public-sector service delivery.

TABLE 4: POTENTIAL PROGRAM ISSUES

☐ Objective	☐ Task	☐ Implementation
☐ Identify and Formalize Budget Resource Envelopes	<ul style="list-style-type: none"> ▪ The Budget System Law intends for the government/MOF to begin with a clear identification of a resource envelope. ▪ It is also clear that the resource envelope is not being effectively set. ▪ It is essential to generate an effective medium-term resource envelope. 	☐ MOF, fiscal policy unit (fiscal policy and analysis cell [FPAC] if it is created), MED.
☐ Develop Effective (Strategic) Plan (Budget)	<ul style="list-style-type: none"> ▪ Develop an effective (strategic) expenditure framework and set national priorities. ▪ Encourage line ministries to develop budgets based on strategies—including increasing service delivery—and efficiencies rather than using normatives. ▪ Improve costing, prioritization, and goal orientation of programs. 	☐ Line ministries, MOF, MED, and FPAC (if it is created). Strategy should be updated annually.
☐ Strengthen Strategic Focus of Budget Formulation	<ul style="list-style-type: none"> ▪ Improve analysis of public expenditure policy dealing with efficiency of resource use and accessibility of public services. 	☐ MED
☐ Improve Domestic Revenues and Administration Capacities	<ul style="list-style-type: none"> ▪ Improve coordination between tax, customs, and, other line agencies responsible. 	☐ MOF, Tax Ministry, SCC
	<ul style="list-style-type: none"> ▪ Strengthen internal audit capacity 	☐ MOF, CID, line agencies.
	<ul style="list-style-type: none"> ▪ Continue strengthening customs administration. 	☐ MOF, SDC.
☐ Budget Decision Making	<ul style="list-style-type: none"> ▪ Establish formal procedures for bottom-up/top-down budget development . 	☐ MOF, ministries.
☐ Budget Coverage	<ul style="list-style-type: none"> ▪ Assess, disclose, and review policy decisions with an immediate or future impact. ▪ Classify expenditure by activity and program to define the right performance indicators at an appropriate level of activity. ▪ Government of Azerbaijan should publish full budget every year and post on internet. ▪ Publish annual budget including macroeconomic projections, budget envelope, government priorities and objectives, and aggregate budget ceilings. 	☐ MOF and MED
	<ul style="list-style-type: none"> ▪ Develop expenditure classification system that fits the needs of both policy analysis and management, and covers all government expenditures. 	☐ Preferably fiscal policy unit within MOF can establish this and develop effective performance indicators.

☐ Objective	☐ Task	☐ Implementation
	<ul style="list-style-type: none"> ▪ Classify expenditure by activity and program to define the right performance indicator at the appropriate level. 	<p>☐ MOF and World Bank. This task has been recommended by the World Bank but progress has been limited. Performance indicators have been established but have not been widely disseminated. Civil society, NGOs, and general public should be involved in the discussion. However, there does not appear to be a mechanism that would enable greater public participation and broad dissemination of performance indicators.</p>
☐ Budget Execution	☐	☐
☐ Hard Budget Ceilings	<ul style="list-style-type: none"> ▪ Introduce hard budget ceilings at the functional and organizational level. 	<p>☐ MOF and MED should require hard budget ceilings by April of every budget year. A hard budget ceiling implies that the MOF must have some ability to enforce these ceilings.</p>
☐ Ensuring Basic Expenditure Control	<ul style="list-style-type: none"> ▪ Ensure expenditure control and budget execution within budget polices. ▪ Develop annual and quarterly cash and procurement plans across government. ▪ Introduce internal auditing and monitoring on the basis of goals determined in the budget. 	<p>☐ MOF. Reporting of budget versus actual should be completed on a regular basis and analyzed. Donors and NGOs should assist in analysis, dissemination, and discussion of data.</p>
	<ul style="list-style-type: none"> ▪ Establish effective controls at each stage of expenditure. 	<p>☐ Over the last few years there has been a penchant for budget virement (transfer of funds between accounts). This has created an environment of less budget accountability and transparency. Tighter controls at the MOF and Treasury are currently being adopted. USAID's TIMS advisor stated that TIMS is currently adopting monthly departmental (cash) budget ceilings. However, monthly budget ceilings may prove too onerous to maintain. It may prove more viable to install quarterly budget ceilings and review. Effectiveness of reducing budget volatility should be reviewed/analyzed on a quarterly basis.</p>
	<ul style="list-style-type: none"> ▪ Hold each line ministry accountable for developing, installing, and maintaining an internal audit control framework. ▪ Establish internal audit departments at each line agency. 	<p>☐ Chamber of Audits</p>

☐ Objective	☐ Task	☐ Implementation
	<ul style="list-style-type: none"> ▪ Provide adequate monitoring at each stage of the expenditure cycle (commitment, verification, and payment). 	<ul style="list-style-type: none"> ☐ MOF/Treasury. MOF should report results of its monitoring program. Indicators and performance benchmarks should be established. Information should be reported on a quarterly basis (internally and to general public).

☐ Objective	☐ Task	☐ Implementation
☐ Improving the Efficiency of The System	<ul style="list-style-type: none"> ▪ Progressively decentralize controls. 	☐ MOF, Treasury.
☐ Intergovernmental Fiscal Transfers	<ul style="list-style-type: none"> ▪ Review current system of transfers (conditional, unconditional, and equalization). ▪ Develop a transparent fiscal equalization mechanism where possible. 	☐ MOF, World Bank, USAID.
	<ul style="list-style-type: none"> ▪ In the case of conditional grants, an effective approach used in numerous countries is the development and use of output-based aid, a system of performance based grants—to be distributed on the basis of achieving well-defined performance goals. 	☐ MOF, World Bank, USAID.
	<ul style="list-style-type: none"> ▪ Establish Intergovernmental Fiscal Policy working group (or FPAC) to work on intergovernmental transfers and fiscal decentralization. If a virtual group exists, this group should be formalized. 	☐ MOF.
☐ Budget Monitoring and Evaluation	<ul style="list-style-type: none"> ▪ Develop training programs to improve staff skills in budget analysis and evaluation. 	☐ Establish FPAC in Budget Department (or other suitable department) of MOF. Develop capacity of fiscal policy unit to analyze budget policy decisions.
☐ Financial Management Systems	<ul style="list-style-type: none"> ▪ Develop training programs to improve staff skills. ▪ Strengthen treasury and tax departments' audit capabilities. ▪ Make audit results and analysis public. 	☐ MOF, Treasury, Tax Ministry.
☐ Public Investment Programming	<ul style="list-style-type: none"> ▪ Raise investment efficiency by improving project quality. ▪ Require better analysis of projects at all levels of government. ▪ Increase capability for economic appraisal of projects. 	☐ This gap is being addressed through USAID's PIPE project. However, PIPE needs a new component to address local government capacity building on a large scale—or another donor could take this responsibility.
	<ul style="list-style-type: none"> ▪ Provide physical monitoring of project implementation and completion of projects. ▪ Establish formal and systematic project completion review procedures. 	☐ MED.
	<ul style="list-style-type: none"> ▪ Establish procedures for early decision on whether the investment allocation corresponds to aggregate and sectoral policies. ▪ Ensure preliminary definition of the sectoral expenditure envelope. 	☐ MED and MOF.

☐ Objective	☐ Task	☐ Implementation
	<ul style="list-style-type: none"> ▪ Re-locate PIPE—currently physically separated from both the MOF and MED—within the MOF and MED, possibly with a secretariat in the Cabinet of Ministers to ensure more day-to-day interaction and effectiveness in integrating the public investment program into the budget practice. 	<ul style="list-style-type: none"> ☐ USAID Country Coordinator, U.S. Ambassador, Ministers of Finance and Economic Development,.
<ul style="list-style-type: none"> ☐ Performance Orientation 	<ul style="list-style-type: none"> ▪ Develop and include more effective performance monitoring indicators at national/subnational level. 	<ul style="list-style-type: none"> ☐ Currently, MOF has a number of fiscal and sectoral performance indicators but they are not widely known or understood. These indicators should be discussed, publicized, and widely disseminated. Performance indicators should be developed for monitoring all levels and departments of government.
	<ul style="list-style-type: none"> ▪ Build in provisions for the systematic assessment of the performance monitoring system itself. ▪ Review and update the performance monitoring system on a regular basis. 	<ul style="list-style-type: none"> ☐ MOF, MED. ☐
<ul style="list-style-type: none"> ☐ Performance Expenditure Tracking Survey 	<ul style="list-style-type: none"> ▪ Pay sufficient attention to the strategic allocation and efficient use of public resources. 	<ul style="list-style-type: none"> ☐ Any interested donor—World Bank, USAID, or others. ☐ NGOs publish results.
	<ul style="list-style-type: none"> ▪ Develop survey tracking public expenditure from national to subnational government to department and institution level—for education and health sectors—to reveal public service provider behavior and translate public spending into effective public-sector services. 	<ul style="list-style-type: none"> ☐
	<ul style="list-style-type: none"> ▪ Process of introducing performance indicators can consist of picking one or two government departments (health and education) that provide services directly to the public, introducing simple performance measures at an acceptable cost (including transaction costs), monitoring the function and impact of the measures, debugging and adjusting these performance measures, and gradually expanding these performance measures to other institutions. 	<ul style="list-style-type: none"> ☐
<ul style="list-style-type: none"> ☐ Effective Revenue Administration 	<ul style="list-style-type: none"> ▪ Establish performance standards and standardized procedures. 	<ul style="list-style-type: none"> ☐ Tax Ministry.
	<ul style="list-style-type: none"> ▪ Create Tax Ombudsman with independent jurisdiction over tax matters. 	<ul style="list-style-type: none"> ☐ Tax Ministry.

☐ Objective	☐ Task	☐ Implementation
	<ul style="list-style-type: none"> ▪ Publish results of studies conducted within the scope of anti-corruption measures. 	☐ Tax Ministry.
☐ Customs	<ul style="list-style-type: none"> ▪ Create more transparent (if possible) licensing procedures for importers and exporters. ▪ Simplify import and export regulations. ▪ Define and publish standards of service. ▪ Decrease or eliminate cash transactions for customs payments. 	☐ MOF, SCC.
	<ul style="list-style-type: none"> ▪ Introduce risk analysis. ▪ Identify points in the customs system conducive to incorrect or other payments. 	☐ MOF, Chamber of Accounts, SCC, and—if it is established— the FPAC.
	<ul style="list-style-type: none"> ▪ It is not clear whether a code of ethics has been integrated into the customs services training program. If not, a code of ethics program should be integrated into the curriculum and refresher courses for all officials should be provided. 	☐ SCC.
	<ul style="list-style-type: none"> ▪ Consider creating external organization to monitor and protect the integrity of the SCC and its operational system. 	☐ Unclear.
☐ Chamber of Accounts	<ul style="list-style-type: none"> ▪ Maintain an appropriate legislative framework and develop an appropriate professional and institutional capacity. 	☐ Chamber of Accounts, Government Accounting Standards Board (GASB).
☐ Control Inspection Department	<ul style="list-style-type: none"> ▪ Develop internal audit capacity within each individual ministry and coordinate with CID in MOF. 	☐ MOF, Chamber of Accounts, ministries (various).

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Annex A: Azerbaijan: Snapshot of Economic Performance

Table A-1 provides a brief economic portrait of Azerbaijan. Azerbaijan's gross domestic product (GDP) has grown by an average of 10.7 percent over the 2000–2004 period. According to the Economist Intelligence Unit (October 2005), Azerbaijan economic growth is forecast at 20 percent in 2005. Over this same 2000–2004 period, per capita GDP increased by 56 percent to an estimated AZM 1,041 from a lowly AZM 665 in 2000.

Official unemployment remained low in 2004 at 1.5 percent, but this figure includes only individuals registered for unemployment insurance.¹²⁶ The State Statistical committee carried out a labor force survey in 2003 showing unemployment at 10.7 percent, with the urban rate double that of rural (14 versus 7 percent, respectively).¹²⁷

TABLE A-1: AZERBAIJAN MACROECONOMIC INDICATORS AND FORECAST (2000-2005 F)

☺ Indicators	☺ Units	☺ 2000	☺ 2001	☺ 2002	☺ 2005 F
☺ Growth in GDP	☺ percent	☺ 11.1	☺ 9.9	☺ 10.6	☺ 20.0
☺ Per Capita GDP	☺ AZM	☺ 665	☺ 714.3	☺ 774.5	☺ 1,041
☺ CPI	☺ percent	☺ 1.8	☺ 1.7	☺ 2.8	☺ 2.8
☺ Nominal Exchange Rate	☺ AZM / \$	☺ 4474	☺ 4656	☺ 4860.8	☺ 4860.8

Source: World Bank, 2005b; 2005 F is a forecast from the Economist Intelligence Unit (October 2005).

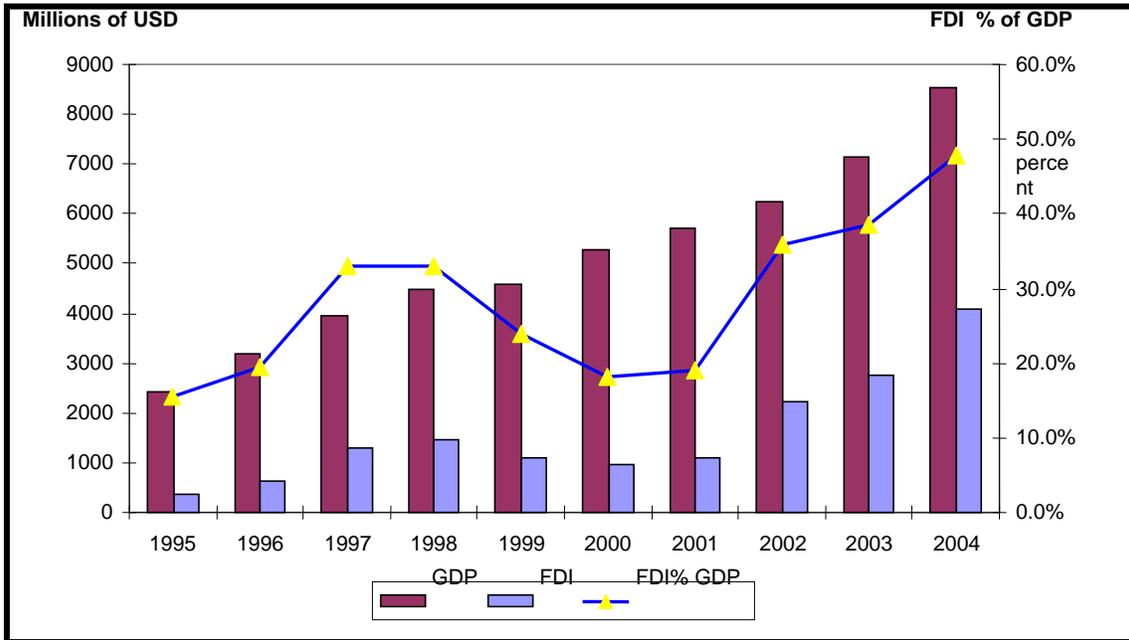
As illustrated in Figure A-1, Azerbaijan's GDP over the 1995–2004 period has more than tripled. Indeed, economic growth was spurred by substantial growth in foreign direct investment (FDI), principally in the oil and gas sectors. FDI is estimated at 47.9 percent of GDP.

Driven by the rapidly growing oil and gas sector, the overall near-term macroeconomic outlook for Azerbaijan looks favorable. However, non-oil GDP will in all likelihood expand at a more modest pace. Because of expected profit repatriation outflows of foreign oil companies, there is bound to be a divergence between the double-digit GDP growth rates experienced over the past five years and the resources available for domestic absorption. This may translate into more modest growth rates in per capita consumption. As a result, future macroeconomic stabilization policy and fiscal management issues become more pressing. Further, it is incumbent upon the Azerbaijan government to manage public resources more effectively.

¹²⁶ Economist Intelligence Unit, 2005.

¹²⁷ World Bank, 2003c, p. 87.

FIGURE A-1: AZERBAIJAN GDP AND FOREIGN DOMESTIC INVESTMENT INFLOWS (1995– 2004)



Source: Azerbaijan Republic Ministry of Economic Development, 2005; World Bank, 2003a; IMF, 2005.

Annex B: Good Governance, Accountability, and Development¹²⁸

There is a general consensus that good governance rests on four pillars: accountability, transparency, predictability, and participation.¹²⁹ Accountability means the capacity to hold public officials responsible for their actions. Transparency implies that relevant information is easily and cheaply accessible. Predictability results primarily from laws and regulations that are clear, known in advance, and uniformly and effectively enforced.¹³⁰ Most importantly, public participation is needed to supply reliable information and to provide a reality check for local government action. None of these four components can stand by itself. All four together are instrumental in achieving sound government public management. How are the four pillars of good local governance, especially accountability, linked to effective local government financial management?

- A lack of government financial resource **predictability** generally serves to undermine strategic prioritization, and makes it hard for government officials to plan for the provision of services.
- **Transparency** of government financial information is essential for public officers to be adequately informed about public-sector performance. It is essential that information not only be provided but that it is relevant and understandable.¹³¹
- Appropriate **participation** of local citizens, NGOs, public officials and employees, and other stakeholders is necessary for the sound formulation of expenditure programs and for the monitoring of government operational efficiency.
- **Accountability** is needed for the use of government funds and for the results of spending it.¹³²

Although all four pillars of governance are interrelated, accountability rests at the center of good government practices. Through overuse, the term accountability has acquired a number of different qualities and definitions. Effective accountability has two fundamental components:¹³³

1. **Answerability**—is the requirement for public officials to respond periodically to questions concerning how they use their authority, where the resources went, and what was achieved with them. Or more simply stated, public officials are held responsible for the effective spending and performance of public funds.¹³⁴

¹²⁸ This section is in large part obtained from Schaeffer, 2005.

¹²⁹ ADB, 2001, p. 10.

¹³⁰ ADB, 2001, p.10.

¹³¹ In 1998, the IMF assembled a “Code of Good Practices on Fiscal Transparency” (see Annex C) that underlines the importance of clear fiscal roles and responsibilities, public availability of information, and open processes of budget preparation, execution, and reporting. While not all the specifics of the Code are applicable to all local governments in developing countries, the Code serves as an excellent guideline for effective local government fiscal transparency practices.

¹³² ADB, 1999, p. 12.

¹³³ ADB, 2001, p. 11.

¹³⁴ In other words, internal administrative accountability must be mirrored by external accountability through feedback from service users and citizens.

2. **Consequences**—there is a need for meaningful consequences because government must account both for the use of public funds and for achieving effective results.

Strengthening government accountability is necessary in the context of enhancing initiatives for greater decentralization and for local government managerial autonomy. New checks and balances may be required to assure that access to government services and the quality of public services is not compromised, especially for the poorer segments of the population.

Accountability Linkages

In a well functioning government structure, a government accountable to its citizens, public agencies (or institutions), and other levels of governments. These kinds of accountability are referred to as:

- **Bottom up**—by the subnational government to local citizens;
- **Horizontal**—by the local government to various public institutions of accountability¹³⁵; and
- **Vertical**—by the local government to higher-level governments.

As Figure B-1 illustrates, bottom-up accountability may include citizens acting through the electoral process or indirectly through civic organizations (such as NGOs and civil society) or the news media. Horizontal accountability covers the range of public entities in order to check central (and local) government abuses and inefficiencies. These agencies may include but are not limited to electoral commissions, the court system, ombudsman or public complaints agencies, or various auditing agencies.

Local governments are also held accountable to higher-level (central) governments. Higher-level governments nearly always provide a portion of their financial resources to local governments through fiscal transfers. Thus, there is always some level of reporting and accountability by local governments to higher governmental authorities.

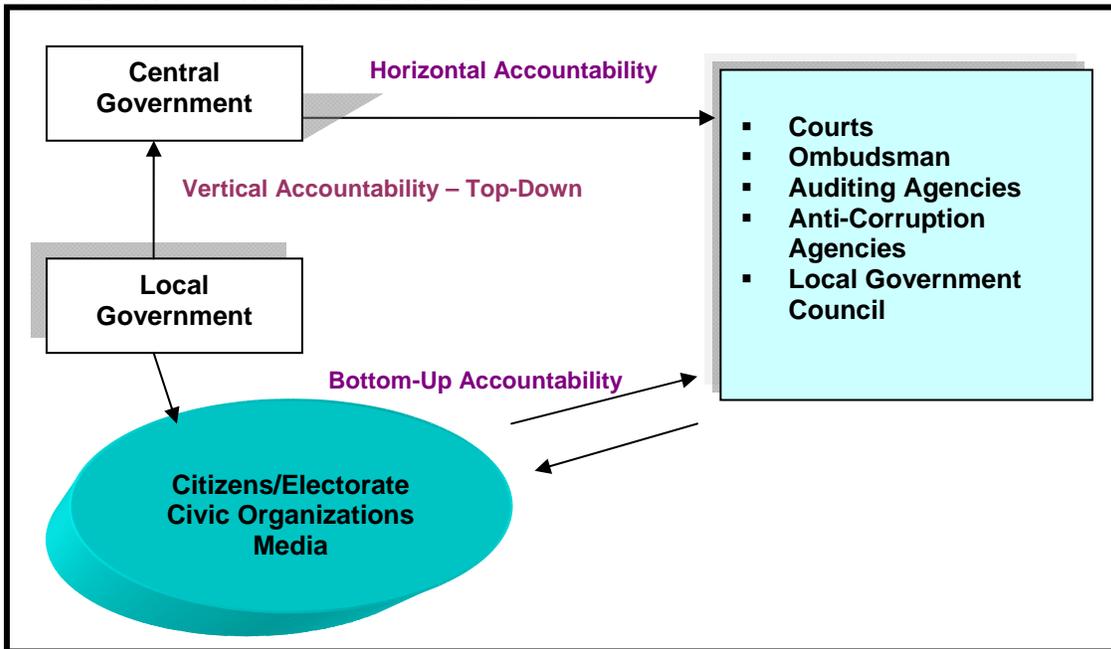
Due to factors including poor salaries, weak morale, weak oversight institutions and laws, and ineffective government public-sector management practices, governmental accountability is frequently weak in many developing countries. Institutional weaknesses in governmental organizations such as audit bodies and courts create an environment where horizontal and vertical accountability frequently fall short. Bottom-up accountability may similarly fall short if elections are dominated by political elites,¹³⁶ or if the electorate has few other ways to register its views on the quality of governance, or lacks the capacity to organize itself effectively.¹³⁷

¹³⁵ O'Donnell, 1999.

¹³⁶ Mair and Katz, 1997.

¹³⁷ Mungui-Ppidi, 2003.

FIGURE B-1: ACCOUNTABILITY LINKAGES



The Budget and Public-Sector Accountability

Performance information is primarily a management, transparency, and financial accountability tool rather than a mere budgetary instrument. Effective and efficient service delivery and local sector accountability requires performance management.¹³⁸ In performance management, the local government establishes service objectives and monitors performance toward attaining those objectives. Characteristics of an effective budget that enhances performance are shown in Table B-1.

Some of these characteristics for an effective budget relate primarily to the process of budget prioritization (comprehensiveness, perception). Other characteristics are related almost exclusively to operational efficiency (cooperation, timeliness). These standards often overlap.

¹³⁸ Performance management implies the planning, monitoring, and measuring of service performance

TABLE B-1: CHARACTERISTICS OF AN EFFECTIVE BUDGET¹³⁹

∃ Terms	∃ Characteristics
∃ Accountability	▪ Detailed controls should be established to ensure that policy directives are carried out by managers, contractors, and all concerned parties.
∃ Comprehensiveness	▪ Includes all uses of government financial resources.
∃ Constraint	▪ Limits the amount of money that need be acquired by government.
∃ Cooperation	▪ Budgeting should exist in harmony with other decision processes and should not be dominant.
∃ Honesty ∃	▪ Based on unbiased projections.
∃ Judgment	▪ Encourages participants to seek the most effect at the least cost.
∃ Legitimacy	▪ The budget process should reserve important decisions to legally appropriate authorities.
∃ Perception	▪ Considers both near and long term.
∃ Responsiveness	▪ The budget must adopt policies that match public preferences.
∃ Timeliness	▪ A budget process should complete regular tasks when expected.
∃ Transparency	▪ The budget and budget procedures should be understood by participants and outside stakeholders.

¹³⁹

See Meyers, 1996.

Annex C: IMF “Code of Good Practices and Fiscal Transparency”

In the context of the architecture of the international financial system, the IMF in 1998 developed a Code of Good Practices on Fiscal Transparency aimed at increasing transparency in fiscal policy. The IMF Code contains principles that could be followed by countries to increase fiscal transparency. Applying these principles would make fiscal policy more transparent and enhance public-sector governance. Among the principles are the following:¹⁴⁰

1. The government sector should be clearly distinguished from the rest of the economy, and policy and management roles within government should be well defined.
2. There should be a clear legal and administrative framework for fiscal management.
3. The public should be provided with full information on the past, current, and projected activity of government.
4. A public commitment should be made regarding the timely publication of fiscal information.
5. Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.
6. Budget data should be classified and presented in a way that facilitates policy analysis and promotes accountability.
7. Procedures for executing and monitoring approved expenditures should be clearly specified.
8. The integrity of fiscal information should be subject to public and independent scrutiny.

¹⁴⁰ IMF, 1998.

Annex D: Shaping Fiscal Equalization Transfers

Fiscal transfers to lower levels of government are generally justified:

- To equalize vertically (improve revenue adequacy);
- To equalize horizontally (interjurisdictional redistribution);
- To correct for interjurisdictional spillovers (externalities); and
- To streamline bureaucracy and to correct for major administrative weaknesses.

This section will briefly discuss the major factors that should be considered in determining an efficient equalization transfer.

Both central and local governments are expected to provide public services, but it is common to find that the own-source revenue-raising powers of subnational governments are not sufficient to meet the costs of services they have been assigned. The resulting gap can be filled by vertical equalization—increasing local revenue-raising powers or transferring resources from higher levels. Increasing local own-source resources can often be difficult. Allowing subnational governments to have substantial revenue-raising powers reduces central control over the total size of the public sector and raises concerns about macroeconomic stabilization. In addition, appropriate local revenue bases may be weak or too administratively complex for subnational governments to handle.

Horizontal equalization is also important because there are generally wide differences in the ability of subnational governments to mobilize resources independently. If only subnational government own-source revenues were available to finance assigned services, there would be substantial interjurisdictional differences in the quantity and quality of public services, based largely on differences in regional resource endowments. Intergovernmental transfers can be a powerful mechanism to help equalize these differences in subnational fiscal capacity.

A third rationale for transfers is that some local government services generate interjurisdictional spillovers, which are benefits (or costs) that extend beyond the borders of the locality. For example, health services provided in one jurisdiction may improve the health situation in neighboring communities. Local governments may be unwilling to provide an efficient level of services if they believe that people who reside outside of their locality will obtain some of the benefits. To ensure that the locality provides more of those services, the central government may transfer resources to local governments with the condition that such resources be spent on services that generate spillover.

Finally, administrative efficiency can often be improved by centralizing the management of certain taxes. A few taxes, such as property taxes and fees, can be adequately collected locally. However, in some cases local governments levy taxes generally reserved to central governments, such as personal or corporate income tax. Such taxes are likely to be administered more effectively through a central administration.

The preceding discussion of objectives provides the basic rationale for the use of intergovernmental transfers. Equally important is a related set of desirable features that can be considered criteria for evaluating transfer mechanisms. These criteria

include revenue adequacy and growth, predictability, simplicity and transparency, allocative efficiency, equity (in terms of redistribution), and incentives for sound fiscal management and subnational resources mobilization:

- **Revenue adequacy and growth.** A transfer system meets these criteria when it is designed to ensure that a subnational government has enough resources to cover its unmet revenue need(s), and when the transferred resources grow appropriately over time.
- **Predictability, transparency, and simplicity are inherently intertwined.** Fiscal planning requires a reasonable degree of certainty in the flow and timing of resources from the center. It is desirable for subnational governments to have a general idea of how much money they are likely to receive from their various sources of revenue as they begin their planning and budgeting. National/subnational governments should also be able to ascertain how their share of a particular transfer is determined. Even if subnational governments are not satisfied by the level of transferred funds, at least they will understand the rationale. A simple but explicit transfer formula usually facilitates such an understanding. Using a formula effectively, however, requires that appropriate data are available and that governments should not be able to manipulate the values of the factors included in the formula.
- **Allocative efficiency includes two sub-objectives.** First, allocative efficiency requires that public services be provided at the lowest possible cost.¹⁴¹ Thus, transfers should encourage local governments to spend their limited resources carefully and in the most productive way possible. Second, allocative efficiency means that resources should be allocated to services identified subnationally as the highest priority. Unless spillovers exist, grants¹⁴² should not be allowed to distort how subnational governments allocate resources.
- **The equity criterion** relates directly to the issue of horizontal equalization discussed in the main text and above. The criterion is complex and commonly entails a combination of not easily measured factors. Even if complete equalization of access to resources was possible and desirable, equal expenditures on the same service in two different communities does not guarantee that equal levels of services would be provided. Equalization transfer systems should ideally be resources distributed across localities in a manner that accounts for differences in both expenditure needs and fiscal capacity.
- **Equalization transfers can affect local financial management.** Where grants are viewed as an entitlement with no strings attached, subnational governments may neglect to use funds wisely, particularly if they are not adequately accountable to local constituents. Grants can also adversely affect the willingness of local governments to maintain infrastructure if they expect grant levels to be determined on the basis of its condition. In such cases, local officials may prefer to allow capital facilities to deteriorate in expectation of a new flow of grant funds.

Unfortunately, the objectives briefly discussed here often conflict with each other, so that constructing a transfer system requires careful consideration of trade-offs among the various goals that the government seeks.

Any mechanism intended to transfer funds from one government to a set of others will entail three policy choices:

- How to determine the total amount of resources to be distributed;
- How to allocate that resource pool across all eligible subgovernments; and,

¹⁴¹ This means that for a particular level of spending, the highest amount (quality) of service is produced.

¹⁴² Grants and transfers are used interchangeably in this section.

- How to restrict the ways that transfer funds can be used?

Appropriate design should consider each of these design features systematically. In brief:

- **The transfer pool can be determined in three basic ways.** First, pools based on a predefined portion of national revenues in the current or recent fiscal year can provide an increased degree of certainty to subnational governments that they will receive their transfers. The potential downside is that by inflexibly dedicating a proportion of national revenues to subnational governments, the central government will lose some control over macroeconomic fiscal policy. Second, aggregate transfer allocations may be linked, depending on the spending plans of subnational governments. In other words, the overall level of grant financing for approved projects can be determined on the basis of the size of those projects planned by the subnational government. These transfer pools can be either closed- or open- ended. Closed-ended pools set aside a maximum amount of funds available for distribution (not all the funds need to be distributed if an insufficient number of approved plans are submitted). Open-ended pools are determined on the basis of approved spending and can potentially be unlimited. Such a design feature can be risky if the central government is trying to keep its overall spending under control. Third, a common way of determining a transfer pool is through annual budget decisions. This approach gives the central government maximum flexibility to respond to national fiscal conditions, but can create uncertainty for subnational governments.
- **Allocation of funds among governments.** A number of approaches are used to allocate the transfer pool across jurisdictions. First, tax-sharing transfers return to a particular subnational government all or some portion of a central government tax collected within its geographical jurisdiction. Such transfers can be elastic in terms of their growth if the tax being shared has significant growth potential. However, these types of transfers are usually counter-equalizing since subnational governments with larger tax bases will derive greater amounts of transfer funds. These types of funds are based on subnational fiscal capacity and are not good for redistribution. Second, transfers allocated on the basis of an objectively defined formula are increasingly popular because they meet many of the key evaluative criteria outlined above. Specifically, they are transparent and can give the government considerable latitude in determining which of the main objectives should be emphasized. One limitation of formula-based transfers commonly faced in developing countries is the lack of timely and adequate data required to implement the allocation formula. In addition, sometimes there is a tendency to meet too many objectives with a single transfer formula so that its overall effects are not clear. Third, cost-sharing transfers reimburse subnational governments for expenditures on particular priority activities deemed worthy of subsidization. Such grants can be either total or partial cost sharing (or matching grants). The former reimburses the subnational government for the full costs; the latter requires the jurisdiction to contribute some minimum portion of total costs from its own resources—effectively subsidizing the price of the activity. If such subsidization is not clearly justified (for example, to correct for interjurisdictional spillover or to meet some equity goal) the budget(s) of recipient governments can be distorted.
- **Degree of subnational spending autonomy and the transfer instrument.** A final policy choice in equalization transfer design concerns the degree of autonomy by recipient subnational governments in using the funds from a transfer. Greater subnational autonomy means that the central government has less control over how the funds are spent. A number of mechanisms are commonly used, including:
 1. General-purpose allocations give a subnational government full autonomy over the use of transferred funds. Such transfers are closest to the spirit of full devolution of spending powers.

2. Sectorally limited block allocations permit the recipient government to choose how funds are to be used, but only within a particular sector. These funds are particularly relevant where the government determines that significant benefits external to spending locally are associated with particular activities.
3. Specific purpose transfers can be highly restrictive in how the funds are spent. Restrictions may apply to choices between labor and non-labor inputs and for particular spending plans.

The discussion presented in this section suggests a theoretical total of more than 36 different combinations of transfer programs. Since transfer programs commonly consist of several different types of grants, the full combination of equalization transfer grants is effectively limitless. However, only a small number of transfer and grant programs is generally used.¹⁴³

¹⁴³ General purpose, block, and specific-purpose equalization grant programs are the most commonly used form of intergovernmental transfers.

Annex E: Subsidy Mechanisms

Recent approaches to improve the targeting of subsidies for enhancing the poor's access to services have been developed and used in various developing countries. Pro-poor subsidy mechanisms that may be suitable in Azerbaijan include:

- **Access Subsidies**—financial supports (or grants) that enable households or local communities to have general access to a basic level of services. For example, using access subsidy (grants) to increase health services, hygiene awareness, and education.
- **Incentive Linked Output-Based Aid (OBA)**—OBA is a strategy for supporting the delivery of basic services (such as health) where policy concerns justify using public funding to complement or replace user fees.

With respect to Azerbaijan's health sector, there is a need to focus on community-level approaches that create wider benefits, thereby providing the necessary environment for household benefits. With respect to OBA, the primary issue for government authorities is to design appropriate incentives for operators to improve local service delivery performance, and quality and coverage of service. The OBA subsidy should:

- Clearly identify the target population;
- Clearly define the management of the scheme;
- Manage expectations; and
- Supervise implementation according to a binding timeline.¹⁴⁴

The introduction of an output-based subsidy scheme can provide a powerful solution to the challenge of effective sanitation service provision. For example, OBA could be used to improve the professional capacity, coverage, and performance of infrastructure service delivery (providing direct subsidies to identified low-income groups).

Targeted Subsidies

Evidence from Azerbaijan's health (and other) programs suggests that subsidies are poured into various communities and hospitals without adequate transparency, accountability, or demand for improvement. Subsidies must be fixed transparently, in proportion to the overall magnitude of the lower-income population of the community, and should be linked to acceptable minimum standards, as well as availability of total funds to reach the target population within a defined timeframe.

OBA Schemes

In many developing countries, the low rates of return on investments have often prevented private investors developing sustainable infrastructure or becoming involved in the provision of various services. Often, developing country utilities, for example, fail to recover their basic operating costs. Due to limited investment capacity, much of the local population may remain underserved. Attracting private capital requires moving local tariffs to cost-recovery levels.¹⁴⁵ In many instances, this transition implies upward tariff adjustments. Upward rebalancing of tariffs may lead

¹⁴⁴ See Martin, 2002.

¹⁴⁵ Cost-recovery tariffs should include the cost of investments (debt and equity).

to significant household affordability issues, and less of the local service population may be able to afford health or other services.

To mitigate the risk of adverse tariff increases, governments have often relied on instruments such as subsidy schemes that allow low-income users to access various services. In brief, OBA involves a subsidy payment through external assistance sources to ensure that specified outputs from a private service provider are obtained against payments from government and donors (public sources).¹⁴⁶ This is in contrast to traditional international financial institution lending which provides for construction finance rather than being disbursed against pre-agreed outputs. OBA has emerged as a relatively attractive way to manage directed subsidies to offset the effects of private-sector participation in expanding service delivery to the underserved. OBA supports the delivery of basic services where policy concerns would justify using public funding to complement or replace user fees. Any output-based subsidy scheme must create incentives for operators to improve local service delivery performance, quality, and coverage of service. An OBA subsidy scheme should support the transition to cost-recovery pricing for users who cannot currently afford the tariff.

The Azerbaijan government may be somewhat reluctant to implement subsidy schemes due to other financial commitments.¹⁴⁷ However, output-based subsidy schemes can provide powerful solutions to the challenges of effective health (sanitation, water) finance strategies. For example, OBA:

- Reduces the pressure for cross-subsidy arrangements;
- Better targets intended beneficiaries by tying disbursement of public funding to specified services (or outputs),¹⁴⁸ and
- Allows governments to introduce public funding into, for example, a concession contract while keeping performance risks with the operator.¹⁴⁹

While the transition to any cost-recovery level of services must be gradual, any well designed OBA scheme can help governments achieve a richer form of private-sector participation. Operators will have recourse both to user fees and output based payments, which may encourage active, broad, and transparent participation in service provision.

¹⁴⁶ Baietti and Raymond, 2005.

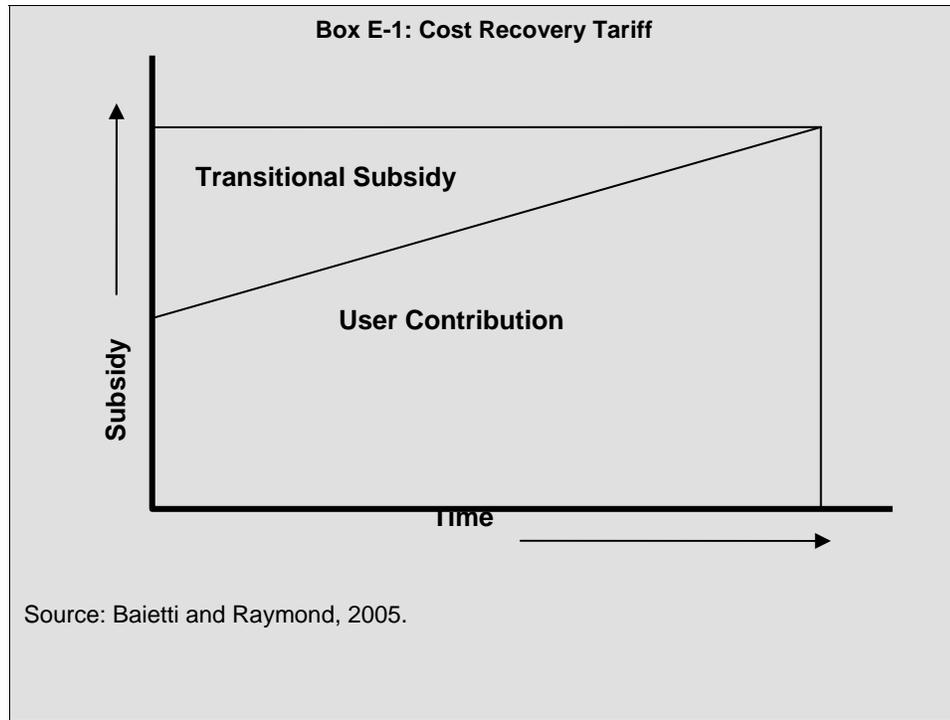
¹⁴⁷ Thanks to the ability to apply different user charges to different customers, cross-subsidies may be a viable alternative subsidy scheme in overcoming fiscal constraints.

¹⁴⁸ Baietti and Raymond, 2005, p. 9.

¹⁴⁹ Baietti and Raymond, 2005. p. 9.

OBA Transitional and Long-Term Subsidies¹⁵⁰

OBA schemes can support either transitional or long-term subsidies. Cost-recovery tariffs need to be phased in gradually. During the transitional period, a hospital, for example, would be required to introduce services to a level that corresponds to efficient service provision. Payments for this transitional period could be financed for a period of five or more years from an international financial institution credit or other donor financing scheme (see Box E-1). At the end of this period, the subsidy would



be financed directly by the government.

¹⁵⁰ For greater detail on credit-enhancing OBA, see The Global Partnership on Output-Based Aid, 2004.

Annex F: Equalization Transfer Mechanisms and Lessons Learned¹⁵¹

There is no single correct policy regarding equalization grants. The practice varies greatly from country to country. But a number of principles provide useful guidance in designing policy.

Measurable objective

The policy should define the equalization objective in measurable terms. In this way it is possible to quantify the existing differences that the grants seek to remedy. It also is possible to determine to what extent the grants succeed in reducing those differences.

- Practices to consider—In **Poland** the straightforward equalization grant system is easily understood.

Existing conditions, not performance

The equalization grants should seek to address problems that are outside the scope of management control of local governments. That is, the grants should compensate for differences in fiscal capacity, not performance. Poorer communities, with a lower tax base, should qualify, not those that do a poor job collecting taxes.

- Practices to consider—**Poland** adjusts local revenues on a per capita basis to 90 percent of the national average.
- Practices to avoid—in the **Czech Republic** and **Romania**, revenue sharing by origin exacerbates existing differences in local fiscal capacity.

In the same way, the grants should compensate for service needs, not actual expenditures. Assist those whose needs are higher, not necessarily those who are spending more. Otherwise the equalization grant becomes an incentive not to collect taxes and not to control costs.

- Practices to consider—**Czech Republic, Denmark, France,** and the **Netherlands** rely on sector grants outside the equalization process to address severe cost differentials or special needs of certain local governments.
- Practices to avoid—In **England** and **Hungary** the high share of earmarked transfers reduces economic efficiency and local autonomy.

Transparency

It should be clear who will approve the size of the pool and the method of allocating the funds and when.

- Practices to consider—**Australia** and **Sweden** use an independent commission to develop the grant distribution methodology.
- Practices to avoid—in **England, Hungary,** and **Romania**, the size of the pool, the method of allocating the funds, or both vary each year as part of the national budget process
- Practices to avoid—in **Romania**, an intermediate subnational level of government distributes the equalization grants without reference to published or formal criteria.

¹⁵¹ This section is taken in its entirety from Conway (2002).

Whatever the policy, its implementation should be through criteria and methodologies that are easy to understand for all those involved. Formulas should use only data that is readily available to everyone. There are practical limits on the amount of information reflecting each local area that can be incorporated in the equalization formula. Simple formulas are better than complicated ones. Local governments should be able to use the formula on their own to estimate in advance and subsequently to verify the size of the grant to which they are entitled.

- Practices to consider—**Albania** and **Poland** use a simple formula based on data that is published and easily accessible to all those involved.
- Practices to avoid—in **England** and **Hungary**, the formulas have grown so complex that they are obscure and difficult to understand or apply.

If there is a need to modify the state budget up or down in mid-year, the same formula should be applied to the larger or smaller pool of funds available to recalculate the grant amounts. Everyone should get the same share of the pool of grant funds in any given fiscal year, whatever its total size.

Predictability

Local governments should be able to anticipate the amount of the equalization grant they will receive (if any) in the current and subsequent fiscal years, within reasonable bounds. One way to achieve this predictability is to adopt the formula used to allocate grants one budget year in advance.

- Practices to consider—**Australia, France, Germany, and Sweden** all have explicit mechanisms to increase stability of local revenues year to year.
- Practices to consider—**Denmark, France, the Netherlands, and Sweden** have mechanisms that either guarantee appropriate additional funding for new responsibilities or tie the size of the grant pool to the state of the national economy.
- Practices to avoid—**England, Hungary, and Romania** tend to adjust or modify either the size of the pool or the allocation methodology or both from year to year.

Annex G: Fiscal Planning and Analysis Cell

Azerbaijan does not have a cell within the MOF (or apparently in the Ministry of Economic Development) dedicated to fiscal planning and fiscal impact analysis and local government finance issues. Yet there appears to be a need for better fiscal planning. Among the substantive areas that call out for hard policy analysis are the operations and maintenance costs of increased capital spending, inadequate fiscal effort, decentralization strategies, and the expected future costs of debt servicing. These are only a few examples of big fiscal issues that will face Azerbaijan in the immediate future. Not only must Azerbaijan have a better facility for policy analysis and forecasting in order to better manage its development, but the donors and the central government will require it to ensure compliance with loan agreements and with central government mandates.

What is a Fiscal Analysis Unit?

A fiscal policy and analysis cell (FPAC) within the MOF can serve as the principal policy analysis agent of the national government on matters related to the budget. Properly constituted, it would:

- Have expertise in fiscal and local government financial analysis;
- Develop and maintain databases that support hard fiscal and local government analysis;
- Focus on fiscal and local government financial impacts and projections;
- Be a permanent body, so it could have “memory” and continuously build on its policy research base;
- Be relied on by the national and subnational governments; and
- Perform regular duties as well as special assignments.

Objectives

The ultimate goal of setting up an FPAC is to assist the government in making more informed and transparent fiscal and government policy decisions. The FPAC would achieve its goal in two ways:

First, it would make fiscal analysis related to local government finances more transparent by carrying out special analyses of major issues. It would remove some of the guesswork from fiscal choices, and the consequences of fiscal policy choices could be more clearly identified. Politicians, government officials, and civil society could gain a better understanding of the hard costs and benefits of various fiscal options.

Second, it could institutionalize a more forward-looking approach to fiscal planning. Instead of taking only an annual budget planning view, the FPAC could also draw attention to the longer-term consequences of any action by factoring this calculation directly into the analysis and projections.

Another objective of the FPAC is to upgrade the policy analysis capacity of the national government’s MOF. A demonstration of the utility of policy analysis might ratchet up enthusiasm for analytical work and open new opportunities and demands for training.

Activities of the FPAC

The FPAC will not be successful if it is no more than an adjunct to the MOF. It must have a set of regular and important responsibilities so it can be an integral part of the planning and policy-making process. The full range of responsibilities would have to be worked out with the MOF so as to fit in with the present organizational structure and responsibilities, but the following list of responsibilities is illustrative of what a successful FPAC might do.

Preparation of Fiscal Notes

A fiscal note is an analysis or brief relating to a particular proposal. For example, a new capital project may involve new debt service and new operations and maintenance costs, and the short- and long-run fiscal impact of these would have to be estimated. The FPAC could be responsible for preparing fiscal notes, at the request of the Minister, on all major decisions with significant fiscal impact. This would not replace the work of the budget analysts, but it would give responsibility for the larger and more complicated issues to the FPAC.

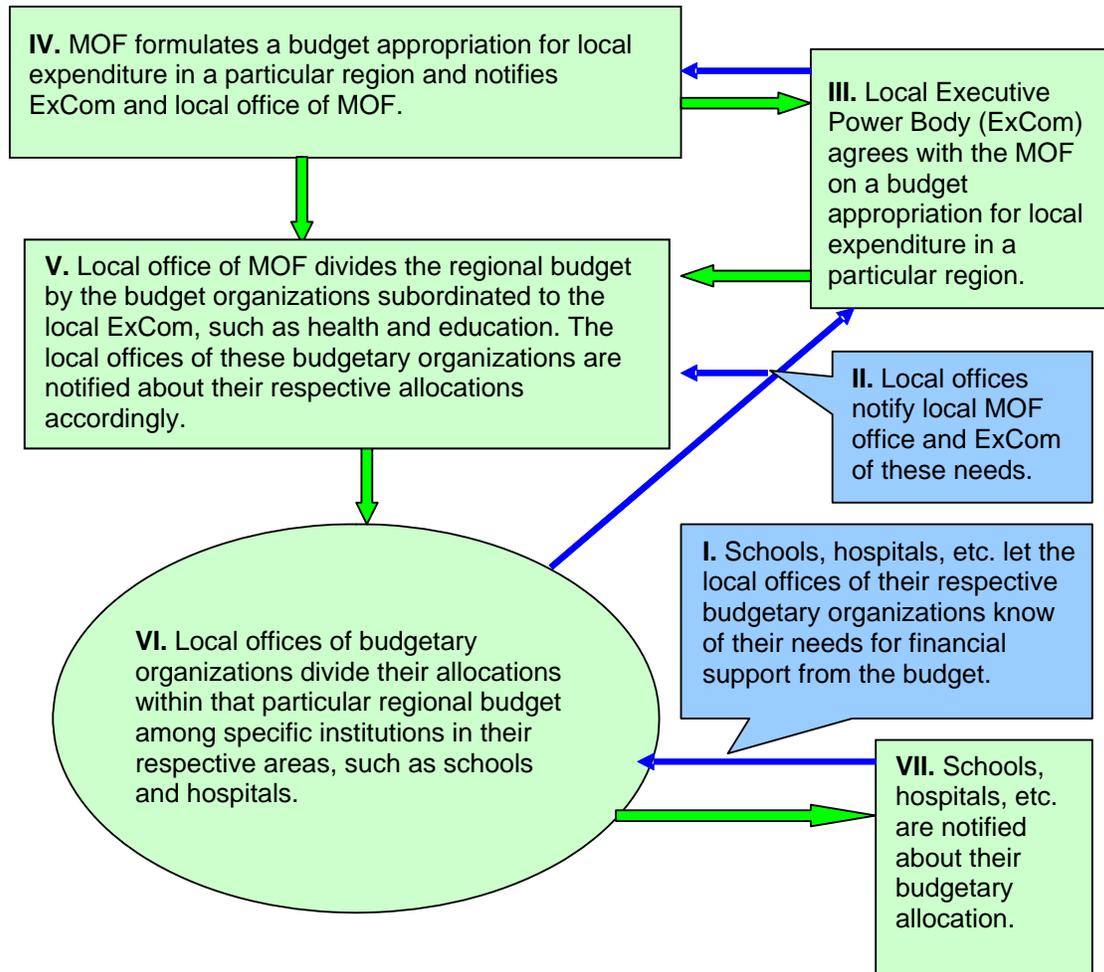
Special Studies of Fiscal Impact

There are many areas where issues related to fiscal impact are complicated and the policy choices are not easily determined. In such cases—the impact of loan guarantees, the determinations of whether a federal proposal will actually reduce the demand for loan guarantees, the revenue implications of a new user charge or a change in VAT administration, for instance—a special study is required. At the request of the MOF, the FPAC would carry out the study.

Annex H: Flow of Funds to Local Governments¹⁵²

Figure H-1 describes how the local expenditures of central government are formulated and executed in Azerbaijan.

FIGURE H-1: LOCAL EXPENDITURES OF CENTRAL GOVERNMENT: FORMULATION AND EXECUTION



Source: CBS, 2005c.

Budget executions take place as follows:

- I. Local ExCom and MOF officers present to the various local government offices of budgetary organizations (LOBOs) their respective budgets, including functional classification by paragraph, detailed economic classification, and quarterly expenditure ceilings;
- II. LOBOs prepare distribution (smetas) of education budget among the specific service delivery institutions—schools, kindergartens, hospitals, and so on. They present smetas to the school director and to the head of budget division at the local MOF office;

¹⁵² This section paraphrases from CBC, 2005c, pp. 6–7.

- III. LOBOs present monthly financing needs to local MOF office by paragraph and economic classification. The budget division at the local MOF office verifies compliance with approved budget and passes to treasury division at the same office. The latter initiates treasury financing by registering/entering transaction in treasury books;
- IV. LOBOs receive on a quarterly basis commitments from the treasury for provision of financing for agreed expenditure items;
- V. In line with commitments agreed by the treasury, LOBOs present all procurement-related documents to the treasury division of the local MOF office, which checks against the commitments and financing available and approves disbursement, then stamps and returns it to the LOBOs;
- VI. Actual cash execution starts. LOBOs present payment order to local MOF office/treasury division, where it is verified for compliance with financing available, commitments made, and procurements approved.

There is no concrete and firmly established formula for division of appropriations (stages V and VI) because the budget process is not based on well elaborated requests from service delivery institutions. Various service delivery institutions (stage I) have neither the capacity nor any incentive to formulate good budget requests. Distribution of funds takes place based on the initial requests for financial assistance submitted by these service delivery units, which are evaluated on a discretionary basis.

For example, a school director requests financial assistance from the local office of the Ministry of Education, which in turn makes sure that a budgetary allocation is provided for, without any substantiated evaluation of the school director's project proposal. The result is a budgetary process that lacks transparency and openness.

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