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IMPROVING PROGRAM DESIGN AND MANAGEMENT TO ENHANCE ANTI- CORRUPTION IMPACT IN THE USAID AZERBAIJAN PORTFOLIO

AZERBAIJAN ANTI-CORRUPTION STRATEGY STUDY

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for

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The study, in several parts, is the work of individual authors who are solely responsible for the substantive content. The study may not reflect the views of, nor has it been endorsed by, USAID/Caucasus-Azerbaijan, or Development Alternatives, Inc.

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ACRONYMS

AAD	Activity Approval Document (USAID project paper approval)
ABA-CEELI Initiative	American Bar Association/Central European and Eurasian Law Initiative
ABAD	Azerbaijan Business Assistance and Development project
ACQUIRE	Azerbaijan Access, Quality and Use in Reproductive Health project
ADB	Asian Development Bank
ADR	alternative dispute resolution
AHAP	Azerbaijan Humanitarian Assistance Program
BDS	business development services
BTC	Baku-Tbilisi-Cheyhan oil pipeline
CA	cooperative agreement
CBC	Caspian Business Consultants
CCM	Country Coordinating Mechanism (Global Fund)
CDO	community development organization
CDP	Community Development Project
CHF	Community Habitat Foundation
CIS	Commonwealth of Independent States
CM	Cabinet of Ministers
DAI	Development Alternatives, Inc.
DCA	Development Credit Authority
EBRD	European Bank for Reconstruction and Development
EU	European Union
EUR/ACE	Office of the Coordinator of U.S. Assistance to Europe and Eurasia
ExComm	Executive Committee
FAR	Federal Acquisition Regulation
FDI	foreign direct investment
GDP	Gross Domestic Product
GF	Global Fund
GTZ	German Technical Cooperation Agency
IBA	International Bank of Azerbaijan
IDP	internally displaced person
IFC	International Finance Corporation
IFES	International Foundation for Election Systems
IMC	International Medical Corps
IMF	International Monetary Fund
IRC	International Rescue Committee
IREX	International Research and Exchanges Board
IRI	International Republic Institute
JETF	Joint Economic Task Force
JTC	Judicial Training Center
MED	Ministry of Economic Development
MFI	microfinance institutions
MOF	Ministry of Finance
MOH	Ministry of Health

MOJ	Ministry of Justice
MTBF	Medium-Term Budget Framework
MTEF	Medium-Term Expenditure Framework
MTFF	Medium-Term Fiscal Framework
NBA	National Bank of Azerbaijan
NBFI	nonbank financial institutions
NDI	National Democratic Institute
NGO	nongovernmental organization
NRHO	National Reproductive Health Office
PIP	Public Investment Program
PIPE	Public Investment Policy and Efficiency project
PVO	private voluntary organization
RECP	Rural Enterprise Competitiveness Project
RFA	Request for Applications
RFP	Request for Proposals
RMG	Revenue Management Group
SACS	Strengthening Azerbaijan Civil Society project
SCC	State Customs Committee
SCP	Baku-Erzurum South Caucasus gas pipeline
SME	Small and Medium-Sized Enterprise
SME-FSD	SME Support Through Financial Sector Development
SO	Strategic Objective
SOCAR	State Oil Company of Azerbaijan
SOFAR	State Oil Fund of Azerbaijan Republic
SPA	State Procurement Agency
SPPRED	State Program for Poverty Reduction and Economic Development
SSC	State Statistics Committee
TIMS	Treasury Management Information System
USAID	United States Agency for International Development

FOREWORD

USAID Azerbaijan's Fiscal Year 2004 Annual Report lays out some of the specifics of—and explains much of the urgency for—this anti-corruption study. In particular, the report states:

Corruption is endemic in the government and throughout society. If the Government does not address corruption immediately in a serious manner, Azerbaijan's opportunity to utilize its energy resources to develop a viable democracy and market economy that will bring prosperity to the majority of its citizens will be lost.

The report further highlights the fact that corruption impedes economic growth within every sector and that a free market economy cannot properly function under a system rife with corruption and monopolies.¹⁵³

USAID's design of the anti-corruption strategy called for several separate analyses: first, an inventory of donor activities that relate, directly or indirectly, to fighting corruption; second, an inventory of U.S. Government projects and activities that relate to fighting corruption; third, a more detailed analysis of the USAID portfolio with a view to identifying projects that might be linked within Strategic Objective (SO) teams or across them, or where there are important new opportunities in an anti-corruption strategy; and fourth, a set of more detailed studies of sectors that were identified by USAID, i.e. the health sector, the judicial sector and public finance. Subsequently, USAID decided that the third study would be divided into two parts: *Recommendations for a USAID Azerbaijan Anti-Corruption Strategy*, which would address strategy exclusively; and the present study, *Improving Program Design and Management to Enhance Anti-Corruption Impact in the USAID Azerbaijan Portfolio*, for USAID Azerbaijan's internal use.

¹⁵³ USAID Azerbaijan, Annual Report FY 2005 (including "Azerbaijan: the Development Challenge"), April 2004.

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I. Perspectives on Corruption in Azerbaijan¹⁵⁴

In this introductory section, the Azerbaijan context is described and compared in a limited way with neighboring states or countries in the same corruption cohort. The context is further elaborated with a short essay on why anti-corruption must be an overarching goal in Azerbaijan. Based upon the separate sectoral studies and work carried out for this volume for USAID strategy, the study presents a hypothesis about the main organizational features of corruption. Finally, this section identifies priority areas for donor interventions that would make corruption more difficult.

A. Azerbaijan in Context

Transparency International (TI) ranked 159 countries out of 200 sovereign nations in its 2005 Corruption Perceptions Index (CPI), up from 146 countries in 2004. In 2005, Azerbaijan's CPI was 2.2 (out of 10, with confidence limits of 1.9 to 2.5), as compared to 1.9 in 2004 (with confidence limits of 1.8 to 2.0). According to TI, year-to-year changes in the perceptions "snapshot" are not significant; but being stuck far below the threshold of 3.0—which marks the lower limit for a severe corruption problem—is important. Azerbaijan now shares the same CPI with Cameroon, Ethiopia, Indonesia, Iraq, Liberia, and Uzbekistan. Only Tajikistan and Turkmenistan among members of the Commonwealth of Independent States (CIS) score worse on the composite index.¹⁵⁵ However, among the CIS countries, Azerbaijan ranks the worst on indices for state capture (measured by the percentage of firms engaging in corrupt practices) and administrative corruption (measured by bribes as percentage of annual revenue). The situation in Azerbaijan is urgent as well as daunting because corruption in Azerbaijan explains much of the poor growth in the non-oil sector, the high incidence of poverty, the widening disparity of income, the huge size of the informal economy, weak institutions, weak civil liberties, poor governance, and the absence of the rule of law. Pervasive corruption in Azerbaijan also serves a barrier for the country to become eligible for the Millennium Challenge Account, while neighboring Georgia and Armenia have already achieved eligibility, much to Azerbaijan's chagrin. The key difference is Azerbaijan's failure on the corruption criterion. Interestingly, when compared to their neighbors, the citizens of Azerbaijan are relatively more sanguine about the integrity of their governmental institutions, as compared to their neighbors, as shown in Table 1.

¹⁵⁴ Section I is drawn verbatim from Johnson, Charles W., Recommendations for an USAID Azerbaijan Anti-Corruption Strategy, January 2006.

¹⁵⁵ Transparency International, Corruption Perceptions Index 2004, October 20, 2004 ; Corruption Perceptions Index 2005, October 18, 2005.

TABLE 1: TRUST IN GOVERNMENT INSTITUTIONS

Fully or Rather Trust (in % of respondents)			
	Armenia	Azerbaijan	Georgia
President	30.2	83.4	86.5
Parliament	9.9	29.4	49.1
Justice System	15.8	30.9	34.2
Prime Minister and Ministries	14.5	37.4	41.1
Army	44.3	67.3	40.7
Political Parties	9.2	15.0	27.2
Media	38.1	57.0	54.3
Police	21.1	43.4	31.9
Education System	52.1	42.3	39.9
Health System	44.4	36.9	36.1

Source: The Eurasia Foundation, Caucasus Research Resource Center (CRCC)-Azerbaijan, Data Initiative Survey: Presentation of Initial Results, September 2004.

While Azerbaijan's per capita gross domestic product (GDP) is lower than its two Caucasus neighbors', the country's economic growth potential is significantly greater, especially over the next 15 to 25 years. Yet, the Azeri public's outlook does not reflect this potential, as shown in Table 2.

TABLE 2: PERCEPTION OF THE ECONOMIC SITUATION

	Armenia	Azerbaijan	Georgia
Household economic situation is poor or very poor	43.4%	36.6%	46.6%
Worsened household situation over past 3 years	37.6%	30.3%	27.4%
Monthly family income (mean)	\$134.5	\$133.2	\$121.0
Monthly family income (median)	\$100.0	\$110.0	\$78.0
Unemployed (both looking and not looking for work)	31.5%	39.1%	37.5%
Money is the most important factor for getting a job	29.2%	59.5%	29.1%

Source: The Eurasia Foundation, Caucasus Research Resource Center (CRCC)-Azerbaijan, Data Initiative Survey: Presentation of Initial Results, September 2004.

According to TI, Azerbaijan's survey work, citizens believe that the most serious problems facing the country are economic (economic problems in general, unemployment and social protection at 66.4 percent combined), followed by resolving Nagorno-Karabakh (22.3 percent), and then combating corruption (11 percent). The survey indicates that almost 75 percent of respondents regard corruption only as a bribe, whereas abuse of office, and embezzling state property or resources are not. However, the overwhelming majority (86.9 percent) understands that corruption is high or very high and that 92.1 percent denounce it to some degree. However, paying bribes is recognized as an interaction between citizens and officials: 48.6 percent of respondents relate it to direct extortion by public officials while 37.3 percent relate bribes to paying for services or resolving problems. When asked about the causes of corruption, responses included a number of possibilities: corrupt top officials (8.4 percent); lack of accountability of officials (6.7 percent); poor laws (6.6 percent); judicial system subservient to the executive (6.1 percent); weak media (6 percent); moral degradation of the society (5.8 percent); low salaries for civil servants (5.8 percent); weak private sector (4.8 percent); and Soviet heritage (4.5 percent). More people thought that the corruption had spread more at the top of government (23.1 percent) than among low-level civil servants (18 percent). The fact that petty corruption thrives may be evidence that the top level of government is implicated or indifferent. In this regard, the majority of respondents (53.9 percent) believe that corruption has increased over the past 10 years. Equally so, a large majority believe that the fight to curb it will not begin for another 3 to 5 years (29.6 percent), in the faraway future (18.4 percent), or never (23 percent).¹⁵⁶ Healthcare ranked the worst (86.5 percent) in terms of services for which extortion or bribes are in play, but international private voluntary organizations (PVOs) and local nongovernmental organizations (NGOs) were not exempt, with 17.9 percent reported. When asked whether it is possible to obtain services in these two different fields without paying a bribe, 78.4 percent and 14.6 percent, respectively, said no. Of those surveyed, 58.9 percent said they had encountered extortion and 55.9 percent admitted to paying a bribe.¹⁵⁷ The very high percentage of people who admit to paying a bribe is a strong indicator of how pervasive, indeed commonplace, is corruption.

B. Why Fighting Corruption is the Overarching Goal

Corruption is clearly a severe problem in Azerbaijan, meriting effective and sustained government attention, with public urging and support. In time, this corruption challenge will become even more severe because of Azerbaijan's wealth of natural resources. The nature of this challenge stems from the counterintuitive fact that countries with important oil resources have grown, on average, at a significantly slower rate than other developing economies over the last four decades and have experienced greater economic volatility. There are three reasons for this phenomenon: 1) rampant corruption—booming revenues lead to a struggle about how to use them, often taking the form of ill-conceived welfare schemes and “pork barrel” projects, coupled with widespread corruption; 2) the volatility of world prices,

¹⁵⁶ Transparency International Azerbaijan, Country Corruption Assessment: Public Opinion Survey in Azerbaijan, Baku 2004.

¹⁵⁷ Ibid.

especially for oil, leads to large, destabilizing swings in the balance of payments, fiscal revenues, and deficits; and 3) the “Dutch disease,” which refers to the effect of foreign exchange inflows from oil and gas sales on the exchange rate such that the national currency appreciates and inflation takes off to levels that make the non-oil economy less competitive. These tendencies explain the extremely poor performance of some oil rich countries, such as Nigeria. However, countries can overcome the challenge of managing a surfeit of riches as demonstrated by successful experiences of Botswana, Malaysia, Norway, and the United Arab Emirates. The Netherlands and Mexico are countries that have gone through difficult periods learning how to manage resources and promoting their non-oil sectors. During the early period (2002 through 2005) of Azerbaijan’s oil boom, huge amounts of foreign direct investment (FDI) flowed into the country for the oil and gas sectors, including the Baku-Tbilisi-Ceyhan (BTC) pipeline and for the development of the Shah-Deniz gas field and pipeline. Once oil and gas are flowing, the Capital Account turns negative as foreign companies begin to repatriate their investment costs and profits. The Current Account mirrors these trends in the opposite way, with heavy deficits during the investment years (because of imported material for oil and gas development) and large surpluses when the oil flows.¹⁵⁸

Beginning now, Azerbaijan will experience an intensified, but relatively short-lived, oil and gas-related revenue windfall. The BTC oil pipeline was completed in 2005, and will begin transporting one million barrels per day from Baku to the Turkish port of Ceyhan in 2006. The Baku-Erzurum South Caucasus gas pipeline (SCP) will deliver 8 billion cubic meters of gas per year to Georgia and Turkey beginning in 2006.¹⁵⁹ In 2004, the Government of Azerbaijan assumed a world price of oil at \$18 per barrel for medium-term economic planning purposes. In late 2005, and with world prices hovering around \$60 per barrel, the Government of Azerbaijan has changed its planning assumption to \$40 per barrel. Oil production is expected to peak around 2011, then plateau for a few years, and then decline to about one quarter of the peak level by 2024—all assuming no new reserves are discovered. The challenge will be to recycle some \$250 billion in oil revenues over the next 15 years into improving quality of life for the great majority of citizens.¹⁶⁰

Azerbaijan’s oil wealth will be recycled in four ways: a) repatriation of capital and profits by the oil consortia per the terms of the Production Sharing Agreements; b) public spending (capital investments in infrastructure and recurrent expenditures for government salaries and expendable supplies and social benefits); c) through the banking system for private consumption and investment; or d) sterilized by the State Oil Fund of the Azerbaijan Republic (SOFAR) in offshore investments, of which a small fraction of earnings will reflow to the Consolidated State Budget each year. Government revenues from oil and gas exploitation will follow the cycle of investment, exploitation, and decline. Since the oil boom will be relatively short, the public policy challenge is to utilize the flow of wealth from the sale of nonreplaceable resources in a way that will improve the lives of Azerbaijan’s citizens and ensure their future. Any misstep will be costly because there is no way to recapture these

¹⁵⁸ World Bank, *Azerbaijan Public Expenditure Review*, report no. 25233-AZ, April 3, 2003, pp. 33-34.

¹⁵⁹ U.S. Mission to Azerbaijan, *Mission Performance Plan FY 2006*, undated, p.3.

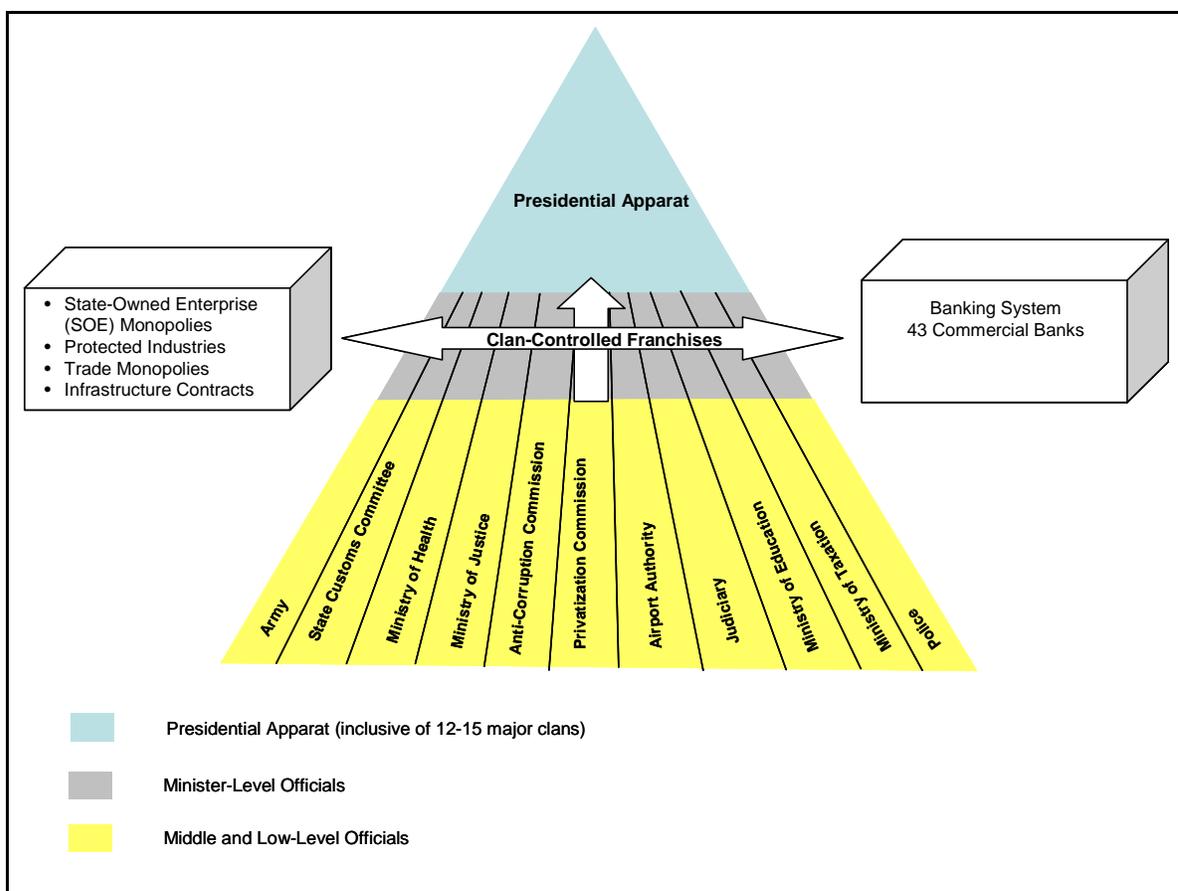
¹⁶⁰ 1 million bbl/day, at \$45 per bbl., yields \$16 billion in gross revenues per annum.

natural resources. It is, therefore, imperative that the Government of Azerbaijan create the legal structure and develop the institutional capacity to transform the country's wealth into productive investments to ensure the its future. Whether the government and people of Azerbaijan can arrest and reverse the trend of rising corruption will be determinate, making the difference between a polity that invests wisely for its future and the wellbeing of its citizens or one that falls victim to the "resource curse" or, worse, becomes a failed state.

C. Hypothesized Organization of Corruption

Corruption in Azerbaijan takes many forms and morphs frequently from one to another in response to the risk of discovery or new opportunities. Expert observers opine that corruption is systemic and pervasive—an idea that is borne out by public opinion surveys as well as many indices of corruption. A distinctive feature is that it is vertically integrated from the most common point of contact between citizen and civil servant, through entire Ministry and Agency structures, to the Presidential Administration (Presidential "Apparat"). Figure 1 characterizes how this vertically integrated system can be organized like a pyramid. The top of the pyramid includes the Presidential Apparat, wherein 12 to 15 major clan families encompassing perhaps 1,000 people are represented. Among Azeri and foreign observers, there was widespread disbelief and disappointment that the President named the head of the Presidential Apparat as the Chairman of the Anti-Corruption Commission. Ostensibly, the appointment ensures that the President's resolve to fight corruption is executed throughout the government structure. On the other hand, pessimists say that the appointment guarantees the pervasive nature of corruption will continue unabated and with less risk.

FIGURE 1: ILLUSTRATIVE LIST OF CLAN-CONTROLLED CORRUPTION FRANCHISES



Major clans have purchased one or more “franchises” (or some experts say “claims,” as in land claims) from the top of the Presidential Apparatus. These franchises are major corruption profit centers. The franchises are synonymous with ministries or major agencies. Government ministries in Azerbaijan have often been described as fiefdoms and are notorious for their lack of horizontal cooperation with other ministries, although they are exceedingly responsive to the Cabinet of Ministers above and the Presidential Apparatus. This franchise structure, dominated by clans that are strongly oriented to the profits of corruption, may provide a partial explanation of the fiefdom phenomenon. Clan interests are horizontal, spanning the public and private sectors in addition to the banking system. Typically, the head of the clan or a high level member of the clan will be the Minister or head of agency for the corruption franchise. Variations on this vertically integrated model were described separately in the reports on the health sector, judiciary, and public finance.¹⁶¹ Some highly lucrative profit centers are the Army (for payoffs by families who want a draft deferral for sons), the road police, the Tax Ministry, the State Customs Committee, and the airport authority. To take the health sector as an example, some experts estimate that the former Minister of Health amassed a

¹⁶¹ Azerbaijan Anti-Corruption Strategy Study components: 1) Vian, Taryn with Dilara Valikhanova, Analytical Paper on Corruption in the Health Sector, 2005; 2) Pepys, Mary Noel, Analytical Paper on Corruption in the Judicial Sector, 2005; and 3) Schaeffer, Michael, Analytical Paper on Corruption in the Public Finance Sector, 2006.

personal fortune of more than \$ 1 billion through his franchise. He controlled the licensing of pharmacy establishments as well as the import licenses for all pharmaceutical products, plus the staff and administration of 70 hospitals. He also had private interests in pharmaceuticals, clinics, and pharmacies. The Ministry of Health (MOH) is substantially overstaffed. The head of such a franchise can be expected to resist all efforts to downsize the Ministry because each job generates a continuing stream of revenues upward to the top of the pyramid. Clan interests are horizontal—spanning the public and private sectors in addition to the banking system—and control the most important ministries and agencies, with the Minister being at the head of a chain of corrupt payment schemes in his

Azerbaijan's Banking System

One explanation of the small capital structure of the Azerbaijan banking system (43 commercial banks with only \$1.6 billion in assets) is that each clan owns 2 to 3 commercial banks that are principally occupied with the financing needs of that clan's private interests and perhaps money laundering. Anecdotal evidence suggests a significant number of cash transactions routinely take place from "black" side (off-balance) bank ledgers. A few experts also assert that many of these small banks engage in sophisticated money laundering operations using international payments systems, which are beyond discovery by audit or National Bank of Azerbaijan (NBA) supervision. Viewing the Azerbaijan banking system from this perspective, one expert estimates that "black" financial operations may be somewhere between four and 10 times larger than "white" (or legitimate) operations. In this model, it is important for each clan family to have a representative in the NBA to monitor threatening developments. If some or many commercial banks are preoccupied with money laundering, then NBA efforts to raise the capital requirement would require these banks to increase legitimate lending. Legitimate lending is not their principal interest. In this grim picture, experts opine that commercial banks that do not rise to NBA prudential norms can purchase their bank ratings by paying bribes to officials in the NBA and, conversely, those banks that refuse to pay bribes will not be awarded the proper bank rating even if fully justified. These practices strongly suggest that the banking system is significantly weaker than commonly believed.

franchise.

In this model, job seekers pay a fixed "upfront" cash payment to obtain a position in a Ministry. In addition, the jobholder must provide his or her immediate superior with a periodic annuity payment. Loyalty to clan or to the administration is sometimes taken into account as an offset to monetary bribes because loyalty can be transformed into other benefits for those holding a franchise or a piece of it. To pay for this 'job fee plus annuity,' the civil servant must find ways to extort payments from employees below him or from citizens seeking public services. In some cases, after having paid for a position, salary supplements may flow from the top of the franchise to lower levels in recognition of loyal service such as collusive acts in connection with a large-scale privatization or major contracts. The public was offered a rare glimpse of the possible scale of corruption in the case of Viktor Kozeny, who was indicted in the United States for stealing \$182 million from U.S. investors in a scheme to collude with Azeri officials to capture the State Oil Company of Azerbaijan (SOCAR) through privatization of SOEs following the Soviet collapse.¹⁶²

¹⁶² See Louis Uchitelle, "Three Indicted for Bribery in Oil Scheme in Azerbaijan", New York Times, October 7, 2005 and Mark Turner, "US Indicts Investors on Azeri Bribe Charges—Oil Company Privatisation", Financial Times, October 7, 2005.

With flexibility in corrupt systems only limited by human imagination and reinforced by widespread public acceptance or apathy, virtually any government service (such as employment, contract, license, permit or permission of any kind, and justice) has a market value that will be exploited.

D. Priorities for Donors

Table 3 presents the most well recognized factors that enable (but do not cause) corruption, along with the suggested fixes, all of which require political will at the top to make the fixes work.

TABLE 3: INSTITUTIONAL WEAKNESSES AND CURES FOR CORRUPTION

Institutional and Social Weaknesses	Cures or Responses
Wide Authority (e.g. the ubiquitous executive)	Limit or Narrow authority: privatize SOEs; substitute open but blind competition, based upon merit, for public employment; competitive procurement; parliamentary and judiciary independence from the executive.
Opaque Governance and Limited Accountability	<p>Transparency: freedom of information law, financial disclosure, code of ethics, open budget preparation process, empowered ombudsman, transparent financial systems.</p> <p>Oversight: independent inspectors general in government departments, empowered anti-corruption agency and dedicated prosecutorial staff, parliamentary role in budget preparation and oversight of budget execution, hot lines and whistle blower protection.</p> <p>Sanctions: electoral, administrative, and criminal sanctions administered by independent judiciary.</p>
Perverse Incentives	Realign Incentives: program or performance-based budgeting, adequate salaries, codes of conduct, eliminating employment feather-bedding.
Apathy in Civil Society	Public Education: the individual moral cost of corruption and the long-run costs to the polity as a whole, through public opinion polling, media campaigns, investigative journalism, building the watchdog function in civil society, and advocacy.

Source: adapted from USAID Center for Democracy and Governance, *A Handbook on Fighting Corruption*, Washington D.C., February 1999.

In the theory and practice of anti-corruption, there is a strong emphasis on building the legal framework so that the rule of law may prevail if the political will is present to make it happen. In a related fashion, emphasis is also placed upon creating high standards of integrity in government, transparency in government operations, being accountable to civil society, and prosecuting wrongdoers through an independent and honest judicial system. All such efforts are important and on target for Azerbaijan. However, because of Azerbaijan’s natural resource wealth, three areas require emergency attention: public finance, the banking system, and—related to both—resuming and completing the privatization of SOEs.

Addressing public finance first, the table below provides a matrix of potential types of corruption and where they might reside within a public finance framework. As is plainly 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—involving low-level officials, the provision of routine services, and small sums of money;

- Grand corruption—involving senior officials, major decisions and contracts, and large sums of money; and
- State capture—involving a syndicate of interests in the private sector that influences laws, regulations, administrative and judicial decision making to advance private interests; or senior government officials establishing monopoly positions in the private sector and using state power to advance and protect those interests.¹⁶³

TABLE 4: AREAS OF CORRUPTION IN THE PUBLIC FINANCE SECTOR

	Administrative Corruption	Grand Corruption	State Capture
Capital expenditures	+	+	+
Tax evasion	+		+
Utility subsidies		+	
Non-transparent execution	+	+	+
Rigidity/vagueness of line items	+		+
Cash management	+		
Dotation to regions	+	+	+
Weak external audit	+	+	
Weak public procurement	+	+	+

Note: + denotes the potential existence of corruption.

Source: Adapted from Schaeffer, Michael, *Analytical Paper on Corruption in Public Finance in Azerbaijan*, Development Alternatives Inc., January 2006.

The whole system of planning, budgeting, and budget execution must be radically transformed quickly to stem the flow of leaks of public funds into poorly planned investments, ruinous welfare plans, corrupt schemes, and theft. USAID Azerbaijan anticipated this finding and for this reason public finance is addressed in a separate report. USAID and the U.S. Embassy are already strategically placed in this area with the Public Investment Policy and Efficiency (PIPE) project in the Ministry of Economic Development (MED), the Treasury Management Information Systems (TIMS) project in the Ministry of Finance, and the U.S. Treasury Advisor in the Budget Department of the MOF. The World Bank and the Asian Development Bank have projects as well. While each of these current or near-term prospective efforts must be tightly coordinated, much more needs to be done—on a wider scale, and faster—to make the needed improvements soon. This is addressed in section III. The financial sector generally and the banking system in particular are vitally important for recycling oil and gas revenues through the private sector, both for investment and consumption. Neither the commercial banking system nor the NBA is prepared for the tidal wave of money that must be recycled. The banking system is weak, compared to neighboring countries like Georgia and Kazakhstan, with only

¹⁶³ See also Asian Development Bank, *Our Framework Policies and Strategies-Anticorruption*, Manila, 1998.

about \$1.6 billion in assets, up from about \$1 billion in 2004. Even if, as predicted, commercial bank assets grow by 50 percent per year, total assets would only be around \$12 billion by 2010 (as compared to gross oil revenues alone in excess of \$80 billion over the same period). Not only would this weak banking system be unable to handle the onslaught of oil wealth, but also individual banks do not have the staff, experience, or inclination to devise and introduce the whole range of financial services—from taking deposits to credit and debit cards to introducing many kinds of consumer, investment, and mortgage products—required by the now underserved non-oil sector. Rapid investment in the non-oil sector must take place to secure Azerbaijan’s financial future. The NBA cannot adequately supervise the commercial banks according to Basel core principles and the banks themselves do not operate according to international norms. Any significant bank failure—the probability of which will increase as the system struggles to recycle oil revenues—could be ruinous for the financial sector as a whole, leading to large-scale capital flight, again depriving the non-oil sector of the resources it needs to grow. USAID is an important provider of technical services to central banks in the CIS, and Azerbaijan is no exception. The challenge is to build upon USAID’s current work with the NBA to improve the rigor of banking practices in Azerbaijan quickly, while expanding services to the non-oil sector. This is also addressed in Section III. There is a relationship between public finance and the banking system because the Government of Azerbaijan spending has been increasing 40 to 50 percent per annum and will soon rise to around 70 percent or even higher in 2006. While this explosive growth in spending poses a grave threat to macroeconomic stability, the forecasts are greatly understated. A large fraction of public spending flows outside of the budget system in the form of SOE financial activities. Thus, actual public spending is much larger than commonly understood. Year-to-year spending increases in the magnitude of 70 to 100 percent are certain to accelerate inflation and the appreciation of the manat. The ability of the NBA to intervene is limited because it has few policy tools at its disposal. As oil wealth circulates in the monetary system, the NBA will not be able to auction a sufficient volume of Treasury bills to sop up excess liquidity without also driving interest rates unacceptably high. Moving into an era of strong inflation and manat appreciation will crush the non-oil sector and the livelihoods of the majority of the population who live in rural Azerbaijan. The non-oil sector is not competitive in any commodity sector and will only be worse off with the acceleration of the Dutch disease. Achieving maximum impact in the public finance arena and the banking sector will depend in large measure upon energizing the Government to complete its program of privatizing SOEs as rapidly as possible. Although SOEs are very dominant in their spheres, particularly in energy and transportation, and are national government assets, their capital expenditures are not brought under the control of the budget process, the Public Investment Program (PIP). As a result, there are huge gaps and many leaks. The donor community emphasized this point until recently, but donor fatigue seems to have set in. In 2004, privatizing the International Bank of Azerbaijan (IBA) was near the top of the International Monetary Fund’s (IMF’s) and European Bank for Reconstruction and Development’s (EBRD’s) conditionality lists, but no longer. Since the Government of Azerbaijan does not intend to borrow from

the IMF any longer, privatizing the IBA is not as topical as it once was. Privatizing the IBA may be the single most important action for rationalizing the banking sector because foreign-owned banks are unlikely to make significant investments in Azerbaijan before this happens. Without foreign banks and their modern management methods, it is difficult to imagine how the banking system can mature fast enough to deal with the challenges ahead in accordance with international prudential norms. The same is true on the public finance side with SOCAR and its subsidiaries investing in capital projects on a scale greatly larger than the Government of Azerbaijan itself, but with no discipline or scrutiny, and, apparently, outside the purview of the Public Procurement Law. SOCAR and its subsidiaries are a threat to macroeconomic and fiscal stability because the Government of Azerbaijan cannot control public spending while these SOEs remain outside the budget.

II. Analysis of the USAID Portfolio

This section analyzes USAID's portfolio, examining each SO and each significant project or activity from the perspective of their relevance to an overarching goal of fighting corruption. Many other considerations that influence the content and quality of a country program are put aside. Such influences might include the size of the program budget, the claims of other entities on that budget (for example, the Office of the Coordinator of U.S. Assistance to Europe and Eurasia [EUR/ACE] and the Embassy), funds earmarked by the U.S. Congress for specific purposes, specific legal prohibitions (such as section 907 of the Freedom Support Act), earlier USAID projects that did not meet their objectives (such as grants to PVOs to develop microfinance), the number and qualifications of the staff, and the kind and quality of technical support from the regional Mission in Tbilisi and USAID Washington. Since the objective of the study is, in some sense, to optimize investments to fight corruption, any area that does not appear to meet usual USAID programming standards or recognized best practices is the subject of attention. This section of the study was undertaken in cooperation with all SO Teams, which provided activity description documents, program descriptions, cooperative agreements, workplans, and quarterly reports.

A. Reviewing the Strategic Objective 1.3 Portfolio—Growth and Development of Competitive Private Enterprises Accelerated

- Intermediate Result (IR) 1.3.1 – Legal, Policy and Regulatory Reform Improved
- IR 1.3.2 – Non-Oil Economy Diversified

Azerbaijan Business Assistance and Development Program (ABAD)¹⁶⁴

This is a large, poorly designed project with ample funding and an extended life span. If resources were needed elsewhere to advance the fight against corruption, redesigning this project offers the possibility of reprogramming funds to a higher order purpose. More specifically:

- It is rare to see a business development services (BDS) project awarded as a Cooperative Agreement, especially to a provider that has weak organizational credentials in BDS. Unless the project was solicited under an RFP, and International Rescue Committee (IRC) won in full and open competition, it is unlikely USAID has acquired the services of the most capable technical assistance provider.
- The idea of using project funds to establish and operate marketing centers is 25 years old and has been discredited for at least 10 years because there are few if any known success stories beyond the end of donor assistance. This failing is a matter of project design deviating from recognized best practices.¹⁶⁵
- The project apparently aims to make grants both to marketing centers and to clients for equipment, machinery, and infrastructure. One example: a grant sufficient to cover 45 percent of a cold storage facility is troubling because it should have been referred to the banking system. In

¹⁶⁴ International Rescue Committee, Azerbaijan Business Assistance and Development (ABAD) Work Plan: Year 2, August 5, 2005 through August 4, 2006.

¹⁶⁵ For a compendium of best practices, see Snodgrass and Winkler (2004).

another example, ABAD is making a grant to farmer for a power line to his mill.¹⁶⁶ Best practices in business development exclude such approaches because they do not lead to enterprise profitability without also distorting financial markets. They may also create the appearance of favoritism or, worse yet, corruption. ABAD should be directing entrepreneurs and the marketing centers to microfinance institutions (MFIs), nonbank financial institutions (NBFIs), or commercial banks searching for new “downmarket” customers.

- ABAD is also concerned with developing the leasing industry, but no grant funds should be made available for either the lessor or lessee. Using USAID funds to establish a Rural Leasing Guarantee Fund could be problematic, if there is an appearance of favoritism, and better left to the banking system and to the financial viability of the entrepreneurs’ proposals.
- The activity on women and entrepreneurship appears empty of content.
- The activity on community support for marketing centers is better left to soft projects like the Community Development project—or abandoned all together.
- The activity on marketing center monitoring and evaluation is an effort to create management information system (MIS) capacity that will not likely survive the end of USAID funding.
- There is no mention of anti-corruption in the workplan. In the semi-annual report there is perfunctory mention of other related USAID projects—namely the Rural Enterprise Competitiveness Program (RECP), American Bar Association/Central European and Eurasian Law Initiative (ABA-CEELI), and Community Development—but no evidence of coordination.

Rural Enterprise Competitiveness Program¹⁶⁷

The RECP design is curious, as far as can be discerned from a rather thin workplan. RECP emphasizes building value chains for particular commodity groups, a well known concept in “competitiveness” circles. However, it appears that USAID designed RECP to work on the supply side of commodity value chains, while ABAD is designed to work from processing to marketing. This division of labor does not make sense in competitiveness theory and practice.¹⁶⁸ Normally, agribusiness projects are designed to cover the whole value chain, an approach that typically yields the best results. In this case the workplan mistakenly identifies “transportation, warehousing and logistics” as “peripheral services” when they are actually integral to value chain and cluster development. In addition:

- The original USAID solicitation foresaw that the contractor would make grants to individual farmers and entrepreneurs. But making grants for “bankable” investments—for example, offsetting costs of equipment purchases for individual farmers or entrepreneurs—is not a good practice and undermines the customer universe for MFIs and NBFIs.
- Under client outreach, the project provides BDS with no fee, a practice that should be stopped because it stifles business growth and professionalism in BDS. Other donors, or even other USAID projects, may complain if they have to compete with free BDS services while they are trying to develop profitable businesses.

¹⁶⁶ International Rescue Committee, Azerbaijan Business Assistance and Development (ABAD), Semi Annual Report, February 5-August 4, 2005.

¹⁶⁷ Pragma Corporation (October 2004).

¹⁶⁸ See, for example, Fairbanks, Michael and Stace Lindsay, *Plowing the Sea*, or Michael Porter’s seminal *The Competitive Advantage of Nations*.

- The workplan is explicit that RECP will help clients interact with investors and financial organizations, presumably MFIs, NBFIs, and commercial banks, rather than provide grants; this is a distinct difference from, and improvement over, ABAD.

Azerbaijan Energy Assistance Project¹⁶⁹

The well written workplan clearly links subtasks A, B, C, involving legal reform, restructuring the energy SOEs, and mobilizing investment in the same SOEs. Subtasks D and E seem more obscure—developing the domestic energy market and energy efficiency measures. Overall, the project could be very important if, for example, USAID or the donors would seriously press the Government of Azerbaijan to resume privatization, starting with the state-owned energy companies. Privatizing them would send powerful signals to encourage more FDI as well as disciplining fiscal spending, both in terms of the quantity and quality of investments. The project could have important linkages to the Public Investment Policy and Efficiency (PIPE) and Treasury Information Management Systems (TIMS) projects if privatization is taken up. There is no mention of anti-corruption in the workplan or quarterly report, although for the public finance system the hole created by SOEs is huge and creates many opportunities for grand-scale corruption.

Treasury Information Management Systems (TIMS)¹⁷⁰

Neither the original proposal nor the workplan was available for review; however, a two-page quarterly report and Power Point presentation on TIMS were reviewed. However, as discussed elsewhere in this report, TIMS is arguably the single most important USAID project—possibly the single most important donor-financed project—in the public finance arena. The Government of Azerbaijan agreed to create a treasury system as a result of International Monetary Fund (IMF) conditionality over several years. TIMS will make it a reality for the central Treasury and three regional treasuries in early 2006 and expand to the 86 regional treasuries thereafter. As designed, TIMS will control and record all government expenditures to budget organizations according to whatever is defined as the chart of accounts. Unfortunately, the chart of accounts falls short of fully revealing government expenditures at the project and transaction levels, thereby making it virtually impossible to match financial expenditure reporting, physical work progress reports, and independent monitoring by citizen groups. TIMS has powerful corruption-fighting potential and the contractor should be required to spell it out in subsequent workplans or project amendments. Curiously, the former SO Team Leader apparently did not require fully developed workplans and relieved the contractor from submitting quarterly reports, two instructions that were immediately reversed by the newly arrived USAID Economic Advisor in June 2005. (See also the discussion of the Oil Fund, the Budget System Law, and the Budget Calendar under USAID's SO 2.1 and the Strengthening Azerbaijan Civil Society [SACS] project, below.)

¹⁶⁹ PA Government Services, Inc., Azerbaijan Energy Assistance Project Work Plans (Year Two), 22 February 2005 and PA Government Services, Inc., Azerbaijan Energy Assistance Project Quarterly Report, 2nd Quarter 2005, 10 July 2005.

¹⁷⁰ Carana Corporation, Treasury Information Management System (TIMS) power point presentation; Carana Corporation, TIMS 1June- 30 September 2005 Quarterly Report.

Banking Supervision¹⁷¹

The workplan is clear and concise about the state of the banking sector and what the project is doing to ensure that the NBA is capable of regulating the sector in compliance with Basel Core Principles. The NBA is generally regarded as the strongest public institution in Azerbaijan in terms of regulating a sector, yet comparatively speaking it is not as strong as institutions in neighboring countries facing similar challenges and opportunities (for example, Kazakhstan) and still has far to go with respect to regulating the banking sector. USAID is the only donor to the NBA. The Chief of Party has an excellent working relationship with the NBA Chairman, who values the Chief of Party's advice and has so stated to USAID. USAID's planned withdrawal from the financial sector generally, except for NBFIs and MFIs, appears to reflect a lack of appreciation of the importance of the sector to Azerbaijan's future. Without a continuously strengthening NBA, tools for fighting inflation—a danger if the Government of Azerbaijan continues on a path of irresponsible spending—will be fewer and weaker. The consequences for the non-oil economy will be devastating. Given that the work of strengthening the NBA is only just beginning, and the need for stronger supervision of the banking sector will only become more evident as oil revenues must be recycled, this project sits astride the vital banking system. Finally, anti-corruption is not discussed in the workplan, yet corruption in the banking sector is widespread and persists within the NBA itself (for example, commercial banks purchase NBA ratings).

Public Investment Policy and Efficiency (PIPE)¹⁷²

The life-of-project workplan is well written, complete, and detailed. A free-standing document like this is a good model for other contractors and grantees. However, the breadth of the project is daunting. For example:

- Component A: long-term national and sector planning and investment policy, including subcomponents for central agencies—Ministry of Economic Development (MED), Ministry of Finance (MOF), Parliament, and the NBA—line ministries, district and local governments, and civil society;
- Component B: developing and strengthening capital budget formulation policies with a subcomponent for the cabinet of ministers, MED, MOF; another for line ministries and district and municipal governments; and a third subcomponent for civil society;
- Component C: improving capital project identification, preparation, appraisal, and monitoring (of execution) with separate components for MED and MOF and line ministries and agencies; and
- Component D: training.

PIPE is the budget planning and preparation side of the public finance system and strongly oriented to capital budgeting in the Public Investment Program (PIP). However, to have the greatest impact, capital budgeting must be integrated with recurrent cost budgeting in both the State Budget and the Consolidated Budget.

¹⁷¹ Bankworld, Inc., Technical Assistance to the National Bank of Azerbaijan in Banking Supervision, Work Plan for year 2005, January 2005.

¹⁷² Development Alternatives, Inc., Public Investment Policy and Efficiency Project: Work Plan July 2005-End 2007, June 2005.

PIPE should also be integrated with TIMS in the MOF, since it controls public expenditures for the entire budget, under the Budget System Law. PIPE's planned duration—judged against the scope and difficulty of its interventions—is too short. Specifically, PIPE started too late in 2005 to have any significant impact on the 2006 budget. PIPE will have some capital spending impact on the 2007 budget with the MED but likely not much on the Consolidated Budget, which is built in MOF because PIPE is not established there. The preparation, defense, and approval of the 2008 budget would be the first where PIPE could hope to have full impact, but 2007 is also the planned year of termination. Also—the funds committed to PIPE, and therefore the scale of efforts that can realistically be made, is seriously inadequate. As PIPE is implemented, the contractor and USAID should re-examine whether the number and breadth of the components is realistic and, if not, what adjustments should be made. USAID Azerbaijan's internal documentation indicates the Mission proposed a four-year project—still insufficient in duration—but project life was shortened by the regional Mission in Tbilisi for reasons that remain unexplained. At the very least, the management of the regional Mission should have explained its rationale to the Baku office. (See also the discussion of the Oil Fund, the Budget System Law, and the Budget Calendar under USAID's SO 2.1 SACS, below.)

SME Support through Financial Sector Development (SME-FSD)¹⁷³ USAID's Activity Approval Document (AAD) for the new project candidly discusses the Mission's decision to largely terminate its direct assistance to MFIs that were earlier recipients of direct USAID grants or indirect grants via another intermediary and, implicitly, USAID's decision to narrow its interests in developing the financial sector. But the confusion of goals persists and is revealed in the project title. Is the project meant to address small and medium-sized enterprise (SME) development or building NBFIs, largely to serve enterprise development in the non-oil sector? Whether directed to SMEs or MFIs and NBFIs, neither side of the project design is guided by commonly accepted best practices. SME development specialists are unlikely to agree, for example, that lack of finance is the principal constraint facing micro and small entrepreneurs. If the informal economy accounts for 50 percent of non-oil GDP, the indirect evidence would suggest that the barriers to growth lay elsewhere—namely, in the high cost of business registration, licensing, permitting, and importing inputs—not to mention the smothering effect of public corruption. On the other hand, MFI and NBFIs experts are unlikely to agree that capacity building (via the Azerbaijan Bank Training Center), or building the MFI Association, or introducing the Development Credit Authority (DCA) are the top priorities for MFI or NBFIs development. They would say that many other things are more important, such as bringing MFIs and NBFIs under the supervision of the NBA; building financial sector infrastructure such as credit reference bureaus would be another.¹⁷⁴ Driving NBFIs to become deposit takers and then becoming licensed as commercial banks

¹⁷³ USAID/Caucasus-Azerbaijan, Cooperative Agreement 112-A-00-05-00059-40, SME Support through Financial Sector Development, undated; and USAID/Caucasus-Azerbaijan, Activity Approval Document: SME Support through Financial Sector Development, undated.

¹⁷⁴ Guides to best practices in microfinance can be found at CGAP.org (Consultative Group to Assist the Poor, a World Bank affiliate) or in Johnson, Charles W. and Jeremy M. Black (2005).

could be a suitable and achievable goal in keeping with best practices. Underwriting MFIs' and NBFIs' continued existence in their current form—largely restricted to lending—is not in keeping with best practices. Taking the commercial banks downmarket to serve micro borrowers and savers with a variety of financial products would have greater impact, would merit USAID support, and would be in keeping with best practices.¹⁷⁵ Nevertheless, even with these important conceptual defects, the AAD is better written and clearer than the program description in the Cooperative Agreement (CA), raising a question whether the grantee was fully responsive to the RFA. Finally, neither the AAD nor the CA's program description address anti-corruption, even though this is a new project, conceived and procured well after the USAID's draft country strategy was prepared.

B. Reviewing the Strategic Objective 2.1 Portfolio—More Representative, Participatory, and Better Functioning Democracy

- IR 2.1.1—Capacity and Demand of Citizens to Engage in Policy and Decision Making Increased.
- IR 2.1.2—Institutions and Opportunities for Citizen Participation in Policy and Decision Making Strengthened.

International Republican Institute (IRI)—Azerbaijan Pre-Election¹⁷⁶

Both the workplan and quarterly report are vague with respect to objectives, tasks, and the approach taken to achieve objectives. The activities reported seem rather meager in the context of the funding provided by USAID.

National Democratic Institute (NDI)—Azerbaijan Political Party Programming, Election Assistance and Civic Programming¹⁷⁷

The workplan adequately describes the objectives of the various components of the project—that is, political party building, promoting policy dialogue and development, and election monitoring and electoral reform—but is short on details at the activity level.

IFES—Free and Fair Elections & Increased Political Advocacy for Azerbaijan¹⁷⁸

The International Foundation for Election Systems (IFES) workplan presents its program components and activities clearly and concisely with adequate detail linking objectives by USAID IR to major tasks or activities with timelines and results. Anti-corruption is not specifically addressed, although much of what IFES does relates to strengthening electoral processes and improving transparency and accountability.

ABA-CEELI—Azerbaijan Rule-of-Law Program¹⁷⁹

ABA-CEELI's Rule-of-Law program is the engine for anti-corruption work in the SO 2.1 portfolio and is highly regarded by other donors and informed officials in the

¹⁷⁵ See for example the experience in the Philippines documented in Johnson, Charles W. and Jeremy M. Black (2005).

¹⁷⁶ International Republican Institute, Azerbaijan Pre-Election Work Plan, April 2005-November 2005, undated, and Quarterly Report: April-June 2005, undated.

¹⁷⁷ National Democratic Institute, Work Plan: June 10, 2004 to September 10, 2005, undated, and NDI Quarterly Report: April 1 to June 30, 2005.

¹⁷⁸ IFES, Year Two Work Plan, July 11, 2004 – July 10, 2005, and IFES, Quarterly Report: April 1, 2005 – June 30, 2005.

¹⁷⁹ ABA-CEELI, Azerbaijan Rule-of-Law Program Quarterly Report, April 2005-June 2005.

Government of Azerbaijan. The workplan is a comprehensive statement of objectives, activities, and results in the five main components: legal education, legal profession development, public awareness, anti-corruption, and elections. The several components of the program are clearly linked to USAID's IRs. It is the only program in the USAID portfolio with an explicit anti-corruption component and a full-time resident advisor with substantial corruption-fighting experience in the United States. ABA-CEELI is setting up Anti-Corruption Legal Advocacy Centers, actively assists the Legislative Working Group (of the Government of Azerbaijan's Anti-Corruption Commission), and provides training and seminars on best practices, particularly on ethics and codes of conduct.

Azerbaijan Legal Database Project¹⁸⁰

The National Center for State Courts' quarterly report provides a comprehensive description of the legal database project, including all major activities and progress to date. While the anti-corruption element is not specifically discussed, the purpose of creating a database of Azerbaijan's framework legal documents is clear and an important step in creating transparency in law and in promoting uniform and fair treatment of citizens.

Working to Heighten Awareness through the Media (WHAM)¹⁸¹

The International Research & Exchanges Board (IREX) workplan and quarterly reports fully describe the background, purpose, and content of WHAM and explicitly identify anti-corruption elements, particularly in journalism. Corruption among journalists is especially discouraging for those who hope to deploy the media—broadcast and print—to improve public awareness about public policy issues and to expose and fight corruption. Therefore, upgrading the private media by improving professionalism in accordance with international norms and codes of conduct is of great importance to a more comprehensive anti-corruption strategy. IREX works across the media sector with other organizations that share the same objectives, such as Article 19, the Organization for Security and Co-operation in Europe (OSCE), the Open Society Institute, Eurasia Foundation, Internews, and the Council of Europe.

Community Development Project (CDP)¹⁸²

This project merits special attention because given its size—\$ 11.5 million over five years—if it is not effectively implemented, it could squeeze out other USAID priorities such as anti-corruption, the Agency's pre-eminent crosscutting issue. Therefore, anti-corruption should be reflected in both the design (that is, the program description) and the objectives, strategy, and activities proposed by the cooperative agreement (CA) recipient, Community Habitat Foundation (CHF). USAID failed to provide background on the nature and breadth of corruption in Azerbaijan and its

¹⁸⁰ National Center for State Courts, Azerbaijan Legal Database Project Fourth Quarterly Report, April – June 2005, July 15, 2005.

¹⁸¹ IREX, Working to Heighten Awareness through the Media in Azerbaijan, Work Plan: September 1, 2004 – August 31, 2005, October 11, 2004 and IREX, Quarterly Report, April-June 2005.

¹⁸² USAID/Caucasus-Azerbaijan, Program Description: Community Development Project, July 5, 2005, and USAID/Caucasus-Azerbaijan, Cooperative Agreement 112-A-00058-00, Community Development Activity in Azerbaijan, undated.

special characteristics or to highlight the anti-corruption issue in the program description (page 22), except as follows:

The successful applicant will be expected to play a role in USAID's anti-corruption efforts by carefully assessing the Community Development Organizations (CDO) for vulnerabilities, structuring implementation and monitoring procedures to minimize the potential for waste, fraud and corruption and training staff (sic), especially local staff, local partners and other program participants, in both ethics and the implementation of preventive procedures. In addition, the successful Recipient(s) will encourage the implementation of activities that can help to combat corruption while achieving the goals of the activity. For example, in the context of community reintegration, the strengthening of NGOs and CBOs to monitor the work of legal institutions and local government organizations also will contribute to the fight against corruption.

CHF's response in the CA (page 22) does not meet the test of the minimal guidance contained in the RFA program description. Oddly, since CHF has had a resident presence for many years, the proposal does not discuss the nature, scope, or breadth of corruption. Rather, CHF provides only a superficial description of what it will do in the procurement integrity realm.

The program description presents a set of components whose relationships to each other are not intuitively obvious, nor are the reasons why USAID dictated them. The components are: 1) increased citizen participation, 2) increased intercommunity cooperation, 3) improved social and economic infrastructure, 4) increased incomes, and 5) improved environmental conditions and practices. While any one component might have been selected as the core objective, the rationale for the mix is not clear. Specifically while 1 and 2 might be the guts of a classic community development project, 3 might be better reflected in efforts to influence government to undertake infrastructure projects of any kind, and 4 might be better left to projects directly related to growth, such as RECP. Component 5 should not be undertaken except in the context of serious project design and engineering.

Under the rubric of "illustrative areas of program delivery", the program description (pp. 12-13) confuses the concepts of public and private goods. The infrastructure projects offer a classic list of public goods (road grading, drainage, culverts) and these are what municipalities and district governments do. There is no rationale for mounting a project to implement these mini-projects independently of the government when the same or smaller amount of resources might be used to influence or lobby the government to do the same activities, but properly, through state budget and according to the Budget System Law. The program description also contains a long list of "economic revitalization" projects (such as canning facilities), most of which are private goods. This is a very tricky area if the grantee gets into the business of making subgrants to organizations or companies where only a few people will benefit. The risk of creating the appearance of corruption can be very high. As stated above for both ABAD and RECP, making grants to individuals for capital improvements is definitely not "best practices."

The program description declares that the recipient will operate independently of, but in coordination with, other USAID activities such as SACS, the Primary Health Care

Strengthening project, SME-FSD, and ABAD, as well as the Government of Azerbaijan and other donors. But no explanation is provided. The program description also recognizes the importance of district governments (ExComms) and that the CDP will serve as a connection between government and communities. Yet, since the program description does not describe how the Government of Azerbaijan plans, budgets, and implements community projects, USAID may have unintentionally created the impression that it is trying to finance community organizations in competition with local government.

Notwithstanding USAID's design flaws, the recipient's response in the CA is disappointing, if only because CHF has had a long presence in Azerbaijan. The application itself relies excessively on boilerplate, parrots the USAID program description, and declares that CHF will do numerous things—such as making community development organizations (CDOs) sustainable—without describing how. As an example, on page 23 CHF seems to confound the meaning of the word sustainability by implying that it can be achieved by teaching CDOs to attract grant money. Surely that is not what USAID expects. Contractors or grant recipients should always be challenged by USAID to back up their claims of sustainability. There is such back-up in evidence in this project. Equally, the claims about “leveraging resources” (page 20) and cost sharing are empty. CHF claims that it will gain government support through industry stakeholders such as BP, and that “the Oil Development Trust Fund” will also be leveraged. The latter claim is preposterous and, unfortunately, indicative of the proposal's poor quality.

At the very least, given the scale of the project, CHF should have challenged USAID's most egregious design errors. Absent such a challenge, CHF carries forward some of the design's worst features—for example, apparently intending to provide grant funds to business associations and to individual entrepreneurs (page 13), a discredited practice in SME development. On the other hand, CHF does recognize that working with local government, municipalities, and district governments is important in the long run and pledges to do that—a clear improvement over the USAID design. CHF also proposes antidemocratic practices such as imposing quotas for women, youth, and vulnerable groups in the elections to community development councils (page 16), perhaps in response to what it thinks USAID wants.¹⁸³ CHF's proposal to create “cluster level councils” is interesting but should be better described, including a rationale—along with financial feasibility—in its defense. Otherwise, it looks like USAID is running the risk of creating layers of councils and subgrantees who will be disappointed when the welfare transfers end. To succeed, this project should have a formal relationship such as a project agreement or SO Agreement with the Government of Azerbaijan. But USAID did not take that step for the project. It was understandable that USAID did not take that step for the Azerbaijan Humanitarian Assistance Program (AHAP) after the President waived Section 907 in 2002 for AHAP, but it is curious that such a step was not taken for CDP. The CDP could give the Government of Azerbaijan some cause for discomfort since USAID has not engaged the Government and acted transparently. By forcing the grantee to do this work at the local level, with many

¹⁸³ USAID/Caucasus-Azerbaijan has decided to instruct CHF to abandon quotas, per Livia Mimica, “SO 2.1 Comments” on the Draft Recommendations for a USAID Anti-Corruption Strategy”, December 2, 2005.

different local government units, USAID is shifting its work responsibilities to the grantee and compounding the work load on it.

Strengthening Azerbaijan Civil Society (SACS)¹⁸⁴

The program description does not reveal how USAID determined either the size or duration of the project, some \$15.5 million over five years, nor how USAID settled on a small grants program of approximately \$6 million. The CA suggests that more than 300 subgrants may be awarded but the rationale for this large number is unknown. Given USAID's new "branding" regulations that prescribe the marking of all activities funded by the USAID, these grants increase the risk of USAID being perceived as a source of corruption or favoritism, in the event that grant advertising, selection procedures, and norms are not perfectly clear and transparent. The volume and value of grants may associate USAID with the creation of "winners" and "losers" and foster as much bitterness as good will.

Like CPD, this project absorbs a significant part of each year's operating budget and, if not effectively used, squeezes out other USAID priorities, namely anti-corruption. Therefore, anti-corruption should be reflected in both the design (program description) and the objectives, strategy, and activities proposed by the CA recipient, Counterpart International.

In the program description, USAID failed to provide background material on the nature and breadth of corruption in Azerbaijan and its special characteristics. In its description of the constraints facing civil society (page 2) there is a long list of problem areas, but no mention of corruption. Corruption comes up under "Program Elements that should be taken into consideration during implementation":

Corruption at all levels of strangles Azerbaijan and its development. Often termed a 'tax on the poor to the rich,' in the past it has been addressed through largely ineffective means. The principle obstacle, as one would image (sic), is that political will is lacking to implement key reforms that will stem the growth of corrupt clans and public officials (sic). The present system of governance involves lack of public accountability to the people, decisions of public officials that benefit their interests rather than the broader public interest.

"The new civil society program will work hand in hand with USAID's media program to create public awareness about corruption and its effects; forging of NGO-government and NGO-business partnerships that will conduct specific anti-corruption projects; and creatively work with the media to publicize instances of graft and posit ideas for solution. (pp.13-14)

The statement on corruption does not track with USAID Azerbaijan's draft country strategy, which identifies anti-corruption as a crosscutting issue rather than something that will be treated by specific anti-corruption projects. It is also surprising that the program description does not task the applicant with addressing anti-corruption in its technical proposal; the uninformed reader might think USAID is taking care of this problem otherwise.

¹⁸⁴ USAID/Caucasus, Program Description: Strengthening Azerbaijan Civil Society, March 30, 2005, and USAID/Caucasus, Cooperative Agreement 112-A-00-05-00050-00, Strengthening Azerbaijan Civil Society, undated.

Counterpart’s response in the CA (page 13) has a paragraph titled “fighting corruption and promoting transparency,” which is empty of content but refers the reader to the anti-corruption activities built into objectives 1-5 in the SACS proposal. Reviewing the SACS objectives, a few activities can be identified, as follows in Table 5:

TABLE 5: SACS OBJECTIVES AND ACTIVITIES

	SACS objective 2 – to increase and improve local and national government engagement, leading to increased accountability and transparency	SACS objective 3 – to strengthen the legal enabling environment for NGOs	SACS objective 5 – To improve and expand citizen engagement through partnerships with NGOs and local government
SACS Activities	Citizen Report Cards	Assistance to NGOs to improve accountability, transparency and self regulation/ AZ laws and regulations	Public hearings
	Public Notice Boards	Monitoring registration practices	

Curiously, the program description defines civil society as “voluntary, non profit, organized activity that is autonomous from the state.” One wonders why USAID would exclude from the definition business associations, print and broadcast media, and other interest groups that could be natural allies of the NGO community? Apparently, this design defect was ignored by Counterpart International as it takes a broader view of civil society.¹⁸⁵

Addressing the financial viability of NGOs in Azerbaijan, (page 10), the program description misled all potential grant applicants with the following erroneous statements, and worse yet, seems to invite a response by applicants:

Hopefully, in the near future, the Oil Fund will be available and means to access those funds must be developed by the civil society communities. [And] ...but there is the Oil Fund that is building up capital and that is a source that should be studied and a procedure developed to access it when available.

It is embarrassing for USAID to be spreading misinformation among the community of practitioners. As importantly, USAID could endeavor to educate and mobilize civil society to lobby and influence its own institutions—for example, municipalities, ExComms, and members of Parliament—to advance their interests, including small-scale infrastructure.

Admittedly, the system of public finance is obscure in Azerbaijan and the subject of misinformation. In the interests of clarity, we summarize below some earlier analytical work produced for USAID Azerbaijan in text boxes describing the Oil Fund, the Budget System Law, and the Budget Calendar, essential elements of public finance in Azerbaijan for the early 21st century.¹⁸⁶

¹⁸⁵ Mimica, Livia, “SO 2.1 Comments” on the Draft Recommendations for a USAID Anti-Corruption Strategy”, undated.

¹⁸⁶ Johnson, Charles W. (2004).

The Oil Fund

The IMF and World Bank assert that the creation of the State Oil Fund of the Azerbaijan Republic (SOFAR), decreed in December 1999, was the most significant development in public finance in the recent past. SOFAR's operations are supervised by a board consisting of key government ministers, two members of Parliament, and appointees from the academic world. The board reviews the fund's investment strategy prepared by the Executive Director, which is then approved by the President. To protect Azerbaijan from "Dutch Disease"—wherein great inflows of capital inflate the economy and appreciate the national currency—a large share of fund assets are invested overseas by a competent portfolio manager(s). A fraction of the earnings accruing from these investments is transferred to the State budget, via a Budget Coordination Committee co-chaired by the Executive Director of the Oil Fund and the Minister of Finance. Within the Consolidated State Budget, according to the Budget System Law, all funds are used according to the Medium-Term Expenditure Framework (MTEF) administered by the MOF, and the Public Investment Program (PIP) for capital projects, and prepared by the MED. In principle, all PIP expenditures are consistent with the Government of Azerbaijan's poverty reduction strategy. All transactions must be executed through the Treasury (currently through USAID's TIMS project). Funds must be used in accordance with the State Procurement Law governing all budget expenditures. Finally, the President selects an international auditor to conduct annual audits of the Fund, the results of which are published in the Azeri press. The Chamber of Accounts, the supreme audit authority reporting to Parliament, has the authority to independently audit the Fund. Thus, it may be seen that if SOFAR operates properly, the great part of new oil wealth will be "sterilized" in offshore investments, insulating Azerbaijan from the "resource curse", or Dutch Disease.

And what is the relationship between the Oil fund and the Budget System Law?

The Budget System Law

The comprehensive Budget System Law was enacted in 2002 and important technical amendments were made in June 2003. It defines the country's budgetary system and sets out the procedure for preparing, approving, and administering public monies on an annual basis. The Budget System Law is comprehensive, encompassing all previously separate budgets—that is, "off-budget" or "extra-budgetary," "implicit subsidies," and the budget of Nakhchivan Autonomous Region—as well as any future special-purpose budgets. The law requires the publication of the consolidated budget in the press 10 days after submission to Parliament. Parliament requires itself to review the budget in detail, including approving expenditure and deficit ceilings. Part of the budget package is four economic and budget forecasts. Finally, the law requires the quarterly publication in the press of progress in executing the budget. More specifically, the Budget System Law requires that all capital expenditures must be included in the Public Investment Program (PIP) and that all expenditures must be executed by the MOF's Treasury. Unity in the Consolidated State Budget will be achieved by using the same budget nomenclature, documents, and forms, as well as reports for all elements of the system. According to the Budget System Law, municipalities are fully self-governing entities responsible for preparing, approving and executing their own budgets, provided that they can do so from their own revenue resources. To the extent that municipalities must seek subsidies from the state, they become subject to the government's procedures and priorities for financing. These idealized and legal principles are very far from the current reality wherein municipalities receive ad hoc transfers from the state budget.

According to the letter of the law, the Budget System Law puts an end to spending whims, including the President's. It has the potential to be a powerful tool for making government operations transparent and accessible to public scrutiny, provided that institutional and human capacity can be developed and made operational quickly via the USAID PIPE and TIMS projects.

Finally, what is the Budget Calendar?

Budget Calendar

A simplified calendar for the State budget, as set out in the Budget System Law. Work begins approximately 11 months before the beginning of the budget year, approximately the end of January, for the following budget year.

- **Consolidated budget preparation (led by the MOF).**
 - The Executive (MOF and MED) specifies the medium-term economic and social development program objectives by the end of February.
 - A framework of drafts of the state budget and investment program is prepared by MOF and submitted to the Cabinet of Ministers by April 15.
 - MOF prepares and distributes budget instructions for ministries and other organizations.
 - Municipalities that require financial support from the state budget submit their requests by May 1.
 - Based upon the submissions of the ministries, the MOF prepares a draft, consolidated budget for the Cabinet of Ministers before July 1.
 - MOF prepares a medium-term budget forecast (revenues, expenditures, deficit) and the investment program (budget year plus three years).
 - The draft consolidated state budget is submitted to the Milli Mejlis not later than October 15 and includes: the draft law on the state budget, economic and social indicators, explanation of fiscal policy, information on debt, and a comparison of revenue and expenditures.
- **Parliamentary consideration.**
 - The Executive defends the budget according to the rules of Milli Mejlis.
 - The Milli Mejlis approves the budget by December 20.
 - The Milli Mejlis's approval includes many indicators—total revenues, tax rates, expenditures by functional paragraph, amount of the reserve fund, borrowing limits, limit on budget deficit, etc.
- **Budget execution through the Treasury system, according to a quarterly revenue and expenditure plan.¹⁸⁷**

Returning to SACS: the applicant's proposal (page 19) presents "core methodologies" for financial sustainability. Counterpart International presents several approaches in a general way: 1) financial strategic action planning, 2) social enterprise/fee for service, 3) public-private partnership, 4) grant writing/strategic donor fundraising, and 5) membership service department. The combination of methodologies does not lead the reader to the conclusion that any of the 12 NGOs of focus will be financially sustainable by the end of the project, notwithstanding planned expenditure of \$15 million.

The program description apparently recognizes the importance of local governments with the following language (page 9):

¹⁸⁷ Azerbaijan, Republic of, Law of Azerbaijan Republic on the Budget System, Baku, July 2, 2002; and amendments dated June 5, 2003.

“The Applicant shall not loose (sic) sight of the fact that the local government needs needs (sic) to be an active partner that works with civil society for the good of all. Consequently, there is a need for the Applicant to propose and build into the proposal how local governments will strengthen, educate and given (sic) the tools to improve their performance in respond (sic) to civil society groups.”

Yet USAID did not take the step of engaging the Government of Azerbaijan on this project in a formal agreement. On this point, Counterpart responds in the proposal (page 13):

“SACS will provide government officials with the tools to effectively and constructively respond to the needs of their citizens through mechanisms such as Service Improvement Actions Plans, public budget hearings, open and transparent social contracting policies and procedures. Study tours will expose officials to different techniques and methodologies of capturing public opinion, receiving citizen concerns, engaging in public dialogue, working in coordination with NGOs, and being receptive to and acting upon citizens’ advocacy efforts. *SACS will teach the government the skills to engage citizens in policy dialogue at the national level and strategic planning at the community level – project appraisal, planning and design; on-site progress monitoring for quality assurance/control; and participatory impact evaluation and audit (italics added).*”

Several observations come to mind. If USAID was forcing the PVO to do what it should be doing itself—that is, engaging the Government of Azerbaijan on this project—Counterpart responded even more boldly with an approach about teaching the government how to relate to its citizens. Even if needed, one cannot implement a project with that attitude. Second, Counterpart is proposing to delve into public finance, specifically budget formulation and project preparation, a sphere where it has no credentials and which is, anyway, the purpose of USAID’s PIPE project. Third, there very well could be a great opportunity for SACS and PIPE to cooperate and mutually reinforce each other but it will take coordination between SO teams first and foremost to make that happen.

In terms of coordination with USAID projects and other donors’ projects, the program description names the World Bank, EU Technical Assistance to the Commonwealth of Independent States (TACIS), United Nations Development Programme (UNDP), OSCE, Eurasia Foundation, Open Society Institute, IREX, ABA-CEELI and SME-FSD, CDP, and the Primary Health Care Strengthening projects—without explaining the rationale for the list. Notably absent are USAID’s RECP, ABAD, and PIPE projects, which would seem to be as relevant, if not more so, than the program description list. In the CA, Counterpart drops UNDP and adds Peace Corps, NDI, IRI, and GTZ. There is some educational work to do within the USAID SO teams on the relevance of other projects in other SOs, and with the partners, before USAID can expect genuine rather than paper collaboration between projects.

C. Reviewing the Strategic Objective 3.1 Portfolio – Health Status Improved

- IR 3.1.1 – Policies and a Legal Framework Supportive of Health Care Reforms Established.
- IR 3.1.2 – Mobilization, Allocation, and Use of Health Care Resources Improved.

- IR 3.1.3 – Quality of Health Care Services Improved.
- IR 3.1.4 – People are Better Informed about and Advocate for Health Care Services, Healthy Lifestyles, and Patient Rights and Responsibilities.

Azerbaijan Access, Quality and Use in Reproductive Health (ACQUIRE) project.¹⁸⁸

Judging by the workplan, the project looks to be well designed, technically sound, and well written. While the project was awarded as a CA, ACQUIRE is building Ministry of Health (MOH) capacity and will have significant, continuing relations with the National Reproductive Health Office (NRHO), proving that a PVO funded by USAID can work with a Government of Azerbaijan ministry. The project even obtained approval of the Cabinet of Ministers for its survey questionnaire.¹⁸⁹ Also, “Sustainability” (page 29) is defined and has some meaning.

Project sequencing is not clear (for example, 15 new non-AHAP districts in year 1, then—in year 2— work in 10 old AHAP districts, and then—in year 3—work in 10 new districts). Doing renovations to health facilities and helping to implement district plans means that ACQUIRE will work with ExComms and/or municipalities. There could be budgetary impacts that should be reflected in the recurrent and capital budgets, raising the possibility or necessity of working with PIPE. There is no mention of anti-corruption, though this is a 2005 new project start.

Primary Health Care Strengthening project¹⁹⁰

Judging by the technical proposal, the project looks to be well designed, technically sound, and well written. The grantee, the International Medical Corps (IMC) consortium is strong with Abt Inc. and Johns Hopkins. Using the RFA mechanism may not have excluded superior technical assistance providers, but USAID cannot be certain of that without using an RFP.

A CA undertakes policy and financial reform to create a supportive policy environment that will increase the responsiveness and effectiveness of the primary health care system in Azerbaijan. IMC will work at the central Ministry level and district government (ExComm) levels and will have formal relationships with the MED, MOF, and MOH, which are included in a national steering committee for health finance, policy, and legislation. There is strong overlap with PIPE; in fact, PIPE should be a stakeholder (page 14). The CA reveals some understanding of the budget process, per the Budget System Law. The project could use help from PIPE on the relationship of national poverty reduction goals (such as the new SPPRED 10-year plan) and sectoral investment strategy (which need to be added to the workplan), which is budget constrained by the forthcoming medium term expenditure framework (pp.6-7)

IMC paid considerable, thoughtful attention to corruption (pages 3, 4, 6, 12, 17, 19). proving that whatever the shortcomings in USAID’s guidance on what anti-corruption

¹⁸⁸ Engender Health, The Acquire Azerbaijan RH/FP Project Work plan, October 1, 2004 to September 30, 2005, revised April 25, 2005.

¹⁸⁹ Engender Health, Quarterly Report to USAID Caucasus – Azerbaijan, April 1 to June 30, 2005. July 29, 2005.

¹⁹⁰ International Medical Corps Consortium, USAID Request for Application: 112-05-00, Primary Health Care Strengthening Project, undated.

means as a crosscutting theme, this consortium brought to bear its country experience to address it.

There are potential links to ABA-CEELI on patient rights in coordination with NGOs such as the Young Lawyers Association (page 19), and the CA even mentions civil society and PIPE (page 23).

Establishing Facility Advisory Boards (FAB, page 17), is a parallel idea to the community liaison idea in ACQUIRE, both of which are supported by our separate report on the health sector.¹⁹¹

Global Fund¹⁹²

USAID Washington was one of the principal organizers of the Global Fund in 2001 to support public-private partnerships in the fight against HIV-AIDS, tuberculosis, and malaria. Azerbaijan is one of more than 128 countries that received a Global Fund award (\$11.7 million) for HIV-AIDS and will soon receive an award for TB control as well. While USAID Azerbaijan does not provide bilateral funding to the Global Fund work in-country, the USAID Country Coordinator serves as the Deputy Chairman of the Country Coordinating Committee (CCM) for the Global Fund. There is the potential for conflict of interest on the Government of Azerbaijan side because the Minister of Health is the CCM Chairman and also the named recipient for Global Fund awards. This situation is not unique to Azerbaijan but Azerbaijan's standing as a corrupt country makes the fact or appearance of a conflict of interest much more important. These facts put the USAID Country Coordinator in a delicate position. Another conflict of interest arises because one subgrantee, the NRHO, is a unit of the MOH, rather than a legal entity independent of the Ministry. Specifically, the NRHO maintains a separate bank account that is perhaps being used to transfer Global Fund funds from the principal recipient to the subgrantee, which would be illegal. The Budget System Law requires that all government expenditures be disbursed through the TIMS in the MOF. The CCM has prepared a policy paper to address these issues in an adequate fashion but full implementation needs to be closely monitored.

D. Reviewing Strategic Objective 4.2 – CrossCutting Issues

Strategic Technical Assistance for Results with Training (START)

World Learning prepared an excellent, well written workplan. START is surprisingly wide ranging and also does internal USAID staff training (the environmental training course) and public education. With this kind of latitude, START could be an invaluable resource for USAID staff and projects across SOs.

¹⁹¹ Vian, Taryn with Dilara Valikhanova, *Analytical Paper on Corruption in the Health Sector in Azerbaijan*, prepared by Development Alternatives, Inc. for USAID/Caucasus- Azerbaijan, December 2005.

¹⁹² Ibid, pp. 15-18

III. Recommendations to USAID for an Anti-Corruption Strategy

In this concluding section, all elements of a USAID anti-corruption strategy are presented and discussed.

In III A, “Rebalancing the Portfolio to Maximize Anti-Corruption Impact,” the two main components of revisiting strategy and looking at individual projects are addressed, with a view to maximizing the use of scarce resources for corruption-fighting purposes. Under the rubric of specific projects, an attempt is made to identify linkages with other projects and/or to make individual projects more effective and resistant to corruption.

In III B, “Improving Portfolio Quality and Anti-Corruption Impact,” we discuss measures for improving the overall quality of the project portfolio, including the anti-corruption activities. These measures include a discussion on choosing between grants and contracts, improving project design, articulating anti-corruption as a crosscutting theme, turning the current portfolio toward fighting corruption, and some dangers in the current portfolio.

In Section III C, “Anti-Corruption Policy Dialogue Agenda,” a suggested action agenda is presented for the purpose of magnifying or extending USAID’s program reach.

Finally, in Section III D, “Anti-Corruption Donor Working Group,” some suggestions are made about how to build upon USAID’s initiative when it launched the donors’ working group on September 29, 2005. Sections C and D. are drawn verbatim from the companion paper, *Recommendations for a USAID Azerbaijan Anti-Corruption Strategy*.

A. Rebalancing the Portfolio to Maximize Anti-Corruption Impact

Country Programs are built over many years and continuously evolve as new projects start and old ones close. While their operations are relatively stable in the long term, given four- to five-year program planning horizons, missions are frequently asked to address new special interests without necessarily shedding any of the older ones. Such is the case with “crosscutting” issues, which can be a convenient rubric for problems that a USAID mission has not figured out how to address. Each new year brings changing emphasis to one degree or another, occasioned by changing country conditions, new opportunities, changing budget allocations, new Congressional earmarks, and so on. It should be no surprise that a given country portfolio may look misshapen, with too much (or too little) activity or funding in one SO or another. While anti-corruption is a crosscutting issue, it is clearly a pre-eminent one because it permeates every facet of Azerbaijan’s political, social, and economic life.

1. Revisiting Strategy to Maximize Anti-Corruption Impact

Surveying the entire portfolio at one moment, several problems of proportionality and significance emerge: project life spans and funds allocated to them are immediately apparent. Most importantly, the CDP and SACS projects are very large in SO 2.1, compared to other recent projects in other SOs. This would not be surprising except that these projects are so empty of content and seemingly operating far from best practices. There are no clues as to why, for example, USAID decided to dedicate

\$15.5 million for SACS over five years, with \$6 million dedicated to subgrants. On this point alone, USAID may be exposing itself to unanticipated risks of appearing to support corruption, if each subgrant is not handled in a perfectly fair and transparent manner. This possibility comes up in public opinion survey work, cited above, suggesting that a significant fraction of the Azeri population believes that services cannot be obtained from PVOs or NGOs without paying bribes.

Another curiosity is that both the RECP and ABAD projects are amply financed, long-lived, and poorly designed, while PIPE is well designed, important in fighting corruption in public finance, but short-lived and underfunded vis-à-vis its scope. The newly launched SME-FSD project is confused, has insignificant objectives, yet warrants \$6 million for life-of-project funding, while the soon-to-terminate Banking Supervision project is less than \$3 million, very important, constrained by its budget, and terminating without being replaced. USAID should immediately reverse its decision to withdraw from the financial sector—particularly banking supervision—given USAID’s strategic placement in the NBA and the demonstrated, well documented need to radically strengthen bank supervision as the country struggles to recycle its oil wealth into productive investment in the non-oil sector. Improving the operating transparency of the 43 commercial banks—that is, full implementation of International Financial Reporting Standards—is a major corruption-fighting measure.

These balance and proportionality issues may be kept in mind as we discuss specific project suggestions because the resources required to implement them are probably within USAID/Caucasus-Azerbaijan’s control if the attendant redesign work can be accomplished in cooperation with USAID’s implementing partners.

2. Specific Project Suggestions

Azerbaijan Business Assistance and Development Program (ABAD)¹⁹³

The design and work plan of ABAD merit attention by the USAID SO 1.3 team with a view to reducing its scope to recognized best practices, with any resulting liberated funding shifting to more worthy activities in SO 1.3 or elsewhere in the portfolio. The grant making is troublesome because it is far from best practice and if not handled extremely well, could create the appearance of corruption or favoritism between the project and the selected beneficiaries. This matter becomes more serious as USAID’s intention to brand its name brings “USAID” more prominently into display, rather than the technical assistance provider’s identity.

Azerbaijan Energy Assistance Project¹⁹⁴

USAID could advise the contractor of the importance of the anti-corruption issue across the program and request that PA Consulting specifically devise measures within its current workplan that would make it more difficult and/or make the

¹⁹³ International Rescue Committee, Azerbaijan Business Assistance and Development (ABAD) Work Plan: Year 2, August 5, 2005 through August 4, 2006.

⁴³ PA Government Services, Inc., Azerbaijan Energy Assistance Project Work Plans (Year Two), 22 February 2005 and PA Government Services, Inc., Azerbaijan Energy Assistance Project Quarterly Report, 2nd Quarter 2005, 10 July 2005.

operations of SOE energy companies more transparent and visible to Executive, parliamentary, and public monitoring.

Treasury Information Management Systems (TIMS)¹⁹⁵

TIMS is a very important project. With some additional work, coordination with PIPE and the U.S. Treasury Advisor in the MOF Budget Department—coupled with some forthcoming World Bank work—and a relatively modest financial increment, TIMS would be at the intersection for transforming improved planning and budgeting (via PIPE) into transparent budget expenditures to budget organizations. TIMS has the near-term potential to make the Government of Azerbaijan budget execution much more transparent. These dramatic improvements within the public finance system are within reach over the next two years.

Such improvements would require additional time (perhaps 18 to 24 months) and additional funds to add new modules to TIMS to radically increase the transparency of Government of Azerbaijan budget operations. The full package might range in cost between \$2.5 and \$3.3 million, consisting of a) the budget preparation module, b) the fixed asset module, c) the audit module, and (d) the human resource module:

- The Budget Preparation module would enable tracing project expenditures to the project level and would have enormous impact upon project planning and budgeting, particularly in the PIP (cost: \$1.0-1.2 million);
- The Fixed Asset Module would require a full inventory of the Government of Azerbaijan’s capital stock and prove to be invaluable for recording and measuring depreciation and improving recurrent cost calculations in the Consolidated Budget (cost \$1.0-1.2 million);
- The Audit module would allow internal and external audit authorities to drill down through the budget to the transaction level, thereby illuminating procurement practices and facilitating both official audit and public monitoring (cost: \$ 240,000 to \$300,000). This module is essential for empowering the Chamber of Accounts, Parliament’s external audit arm; and
- The Human Resources module for tracing salary deposits to actual employees and their bank accounts—critical for purging the Government of Azerbaijan’s payroll of phantom employees (cost: \$500,000 to \$600,000.)

Carana Corporation could be of service to USAID by preparing a paper or brochure in layperson’s language to describe TIMS, its function, and its importance to all anti-corruption efforts in the public finance sphere. Such a presentation, in English and Azeri, would be of great interest to other USAID projects, other donors, the Government of Azerbaijan, the media, and civil society. USAID Azerbaijan is unintentionally hiding a project that could have near revolutionary impact upon public finance in Azerbaijan. These same matters should be addressed in detail in a fully developed narrative workplan and reported quarterly, as the project is a key to USAID’s anti-corruption efforts.

¹⁹⁵ Carana Corporation, Treasury Information Management System (TIMS) power point presentation; Carana Corporation, *TIMS 1 June- 30 September 2005 Quarterly Report*.

Banking Supervision¹⁹⁶

The most important recommendation for this project is to extend or re-compete it and in the process expand the project's activities to cover the full implementation of international financial reporting standards in the commercial banks while helping the same banks to create functioning internal controls and internal audit capacity. Given USAID's past and current investments in MFIs and NBFIs, it would also be appropriate to expand the scope of the Banking Supervision project to bring their supervision under the NBA's control (which the NBA is required by law to do but does not have the skills and capacity to execute).

USAID could also advise the contractor of the importance of the anti-corruption issue across the program and request that Bankworld specifically devise measures within its current workplan that would make corruption more difficult in NBA operations and/or make NBA supervision operations more transparent and visible to Parliamentary and public monitoring. These measures should be reported quarterly.

PIPE Project¹⁹⁷

Now that the diagnostic phase is over, it is imperative that the PIPE offices be physically relocated to the MED and MOF as soon as possible because the project's objectives cannot be achieved without a strong PIPE presence in each ministry to develop the required professional relationships. Making this adjustment will likely require the sustained attention of the USAID Country Coordinator, the Ambassador, or the EUR/ACE Coordinator. Time is of the essence on this point.

As important as PIPE is, the workplan is too ambitious, and the project life is too short and underfunded, as discussed above. As implementation proceeds, the contractor and USAID should be asking whether the number and breadth of components is the optimum mix. As an example, choosing to put more emphasis on the fit of the PIP within the Consolidated Budget—including attendant questions about the balance of recurrent and capital spending—would require intensive engagement with the MOF, which has not embraced PIPE to date. On the other hand, PIPE could reduce the scope of one component by leaving the long-range planning to the World Bank, per a previous agreement. There is also a huge uncovered area for creating capital budgeting capacity in regional and local governments. This is an area that USAID could look at from the perspective of its CDP and SACS projects or, possibly, shop to other donors.

As discussed below for SO 2.1, USAID could profitably make the effort to negotiate a SO Agreement encompassing all projects that relate to public finance, an agreement that would help the Government of Azerbaijan recognize and better support related projects as well.

¹⁹⁶ Bankworld, Inc., *Technical Assistance to the National Bank of Azerbaijan in Banking Supervision, Work Plan for year 2005*, January 2005.

¹⁹⁷ Development Alternatives, Inc., *Public Investment Policy and Efficiency Project: Work Plan July 2005-End 2007*, June 2005.

ABA-CEELI—Azerbaijan Rule-of-Law Program

From an anti-corruption perspective, USAID earns high returns on its \$2.5 million investment in the ABA-CEELI program. Though its work program is broad and aggressive, perhaps even too dispersed, USAID might consider requesting that ABA-CEELI mentor USAID staff and implementing partners on anti-corruption. ABA-CEELI is a key player in the “International Legal Reform Group,” a network of donors that support legal reform, and is therefore well placed to provide best practice information and guidance, if it could take on this task.

Working to Heighten Awareness Through the Media (WHAM)¹⁹⁸

USAID might consider how to engage IREX as a mentor and resource for USAID staff and implementing partners who need guidance and information on how to use the media in their sectoral programs and projects that require or have anti-corruption elements.

Community Development Project¹⁹⁹

Because of the size and cost of the CDP, USAID Azerbaijan sent either its CDP concept paper or AAD to USAID’s central Democracy, Conflict and Humanitarian Assistance (DCHA) bureau three times for comments and USAID revised the program description with each round of comments. USAID Azerbaijan was designing the CDP simultaneously with the SACS project discussed below in a time period when the SO 2.1 team was very short staffed.²⁰⁰ Given USAID Azerbaijan’s small size even fully staffed, it would appear to have been DCHA’s responsibility to consult with the other pillar bureau, Economic Growth, Agriculture, and Trade (EGAT), on those elements of the project design outside of the “democracy and governance” realm. USAID Azerbaijan would have greatly benefited from a literature search by DCHA or EGAT for best practices in community development. There is a rich history of USAID involvement in integrated rural development that USAID Washington should have made available to USAID Azerbaijan. Had the literature been consulted, basic design defects relating to local government, the confusion of public and private goods, and the curious mix of program components might have been avoided. Subsequent to a review of the first draft of this report, USAID Azerbaijan appears to have decided to limit the project to 1) increased citizen participation, 2) increased inter-community cooperation, and 3) improved social and economic infrastructure,

¹⁹⁸ International Research & Exchanges Board (IREX), Working to Heighten Awareness through the Media in Azerbaijan, Work Plan: September 1, 2004 – August 31, 2005, October 11, 2004 and IREX, Quarterly Report, April-June 2005, undated

¹⁹⁹ USAID/Caucasus, Program Description: Community Development Project, July 5, 2005 and USAID/Caucasus, Cooperative Agreement I 12-A-00058-00, Community Development Activity in Azerbaijan, undated.

²⁰⁰ Trebes, Catherine, “Program Office Comments on the Draft Recommendations for a USAID Anti-Corruption Strategy”, December 20, 2005.

²⁰¹ thereby eliminating components that did not conform to best practices. These are positive steps.

On major procurements such as CDP, it is imperative that USAID articulate in its program descriptions why anti-corruption is the pre-eminent crosscutting issue. There should be citations to topical literature to help offerors understand the importance of the issue and to inform their technical proposals.²⁰² Once proposals or applications are received, the technical evaluation committee should review every proposal for responsiveness to the RFP/RFA and reject those not fully responsive to USAID's requirement for anti-corruption strategies and programs. As painful as this may be, it is the most effective way to be serious about anti-corruption, and it must be done project by project.

Since the CDP is just starting, it would make sense for USAID to backtrack to engage the Government of Azerbaijan in a formal agreement outlining the roles, responsibilities, and contributions of each government and carving out a legitimate niche for CHF. Such a step could significantly ease CHF's burdens implementing the project and eliminate any unintended impression that USAID was attempting to circumvent that Government of Azerbaijan. Reportedly, USAID Azerbaijan intends to take this step for both the CDP and SACS projects, as follows: "USAID will inform the President's Office....about starting negotiations with each of the regions (ExComm and the municipalities...) in order to sign a Memorandum of Understanding...which will provide an outline of Government of Azerbaijan ExComm and USAID's responsibilities and obligations including a short list of possible projects."²⁰³

Strengthening Azerbaijan Civil Society (SACS)²⁰⁴

As discussed above with CDP, and given the duration and cost of SACS, USAID Azerbaijan would have greatly benefited from better support from the DHCA bureau, particularly a literature search on best practices, during the writing of the program description. Optionally, opening competition to both the for-profit and not-for-profit communities via an RFP (rather than an RFA) would have very likely drawn in best practices in proposals from a larger group of offerors. This is a kind of insurance measure any mission can take (that is, ensuring maximum competition, when it is unsure of best practices itself).

With the large number and high value of subgrants expected under this CA, USAID would do well to protect itself by close monitoring of subgranting operations under the CA, perhaps by third parties such as an audit firm, or requiring the grantee to

²⁰¹ Mimica, Livia, "SO 2.1 Comments" on the Draft Recommendations for a USAID Anti-Corruption Strategy", December 2, 2005.

²⁰² For example, see OSCE, *Best Practices in Combating Corruption, 2005*, a handbook in paperback form, easily available from the OSCE office in Baku or on its website.

²⁰³ Mimica, Livia, "SO 2.1 Comments" on the Draft Recommendations for a USAID Anti-Corruption Strategy", December 2, 2005.

²⁰⁴ USAID/Caucasus, Program Description: Strengthening Azerbaijan Civil Society, March 30, 2005 and USAID/Caucasus, Cooperative Agreement 112-A-00-05-00050-00, Strengthening Azerbaijan Civil Society, undated.

use audit firms. Apparently, USAID has taken this matter to heart and will require the grantee, Counterpart International, to provide comprehensive audit coverage of subgrants in the workplan.²⁰⁵

On major procurements such as SACS, USAID must articulate why anti-corruption is the pre-eminent crosscutting issue for the country program and important in the Embassy's Mission Performance Plan. There should be citations to topical literature to help offerors understand the importance of the issue and to inform their technical proposals. Once proposals or applications are received, the technical evaluation committee should vet every proposal for responsiveness to the RFP/RFA and reject those not fully responsive to USAID's requirement for anti-corruption strategies and programs. As painful as this may be, it is the only way to be truly serious about anti-corruption, and it must be done project by project.

The poorly articulated program description for this project, including misleading information on the Oil Fund, increases the returns on a Mission review that brings expertise from other SOs into the review process. Presumably, an experienced officer from SO 1.3, or the Program Officer, would have caught the Oil Fund error. To be successful at the fastest possible pace, this project would be well served by a formal relationship with the Government of Azerbaijan, via a project agreement or an SO Agreement that encompasses more than one project. Since SACS is just starting, it would make sense for USAID to backtrack to engage the Government of Azerbaijan in a formal agreement outlining the roles, responsibilities, and contributions of each government and carving out a legitimate niche for Counterpart that should significantly ease its burdens implementing the project. Per the above comment on CDP, USAID now intends to engage the Government of Azerbaijan along these lines, a positive step.²⁰⁶

Since creating a core group of strong NGOs is the purpose of this project, it would seem that financial sustainability should be USAID's major preoccupation. Following up on Counterpart's proposal, USAID should challenge the grantee to lay out a detailed plan, with benchmarks, on how each of the 12 NGOs will become self sustaining at the end of five years. This matter should be addressed in a modified workplan and monitored closely in periodic reports. Apparently, USAID finds merit in this suggestion and intends to ask the grantee to address the issue in its workplan.²⁰⁷ If the plans are not plausible, USAID could consider reprogramming funds for higher priority activities or ones which have a higher probability of success.

Azerbaijan Access, Quality and Use in Reproductive Health (ACQUIRE) Project²⁰⁸

The ACQUIRE Chief of Party or SO Team Leader could provide guidance to other SOs on how to approach the Cabinet of Ministers and gain needed approvals on issues that rise above the line ministry level. PIPE could be a beneficiary as it is

²⁰⁵ Mimica, Livia, "SO 2.1 Comments" on the Draft Recommendations for a USAID Anti-Corruption Strategy", December 2, 2005.

²⁰⁶ Ibid.

²⁰⁷ Ibid.

²⁰⁸ Engender Health, The Acquire Azerbaijan RH/FP Project Work plan, October 1, 2004 to September 30, 2005, revised April 25, 2005.

trying to introduce new planning and budgeting processes to the approval of Cabinet of Ministers.

Primary Health Care Strengthening Project²⁰⁹

USAID should design a model citizens' advisory board for every locale where there are USAID activities with interactions with municipalities, ExComms, schools, health centers, or any other government service delivery point.

Global Fund

In her report, Taryn Vian makes six recommendations to improve the transparency and accountability of the Global Fund's operations in Azerbaijan. While all are important, USAID should insist that CCM create terms of reference and bylaws for its operations, such as rotating officers, using secret ballots, and creating specific requirements for reporting by grantees and subgrantees. Since the CCM has upward of 40 members, it would be important to create a steering body to meet monthly, closely supervise CCM operations, and review the reporting from grantees. USAID should also lead an effort to investigate the legal standing of the NRHO and endeavor to bring its financial operations into conformance with Azerbaijan's Budget System Law.²¹⁰

B. Improving Portfolio Quality and Anti-Corruption Impact

This section presents specific measures to improve the quality of the USAID portfolio for the purpose of conserving scarce funding and putting it to the highest effective use, particularly for fighting corruption. The hypothesis is that a higher quality portfolio will free up funding for other USAID priorities, including the pre-eminent crosscutting issue of fighting corruption in Azerbaijan.

1. Competition is the Hallmark of the U.S. Government's Procurement System USAID staff is responsible for obtaining the best value in technical assistance with the appropriated funds in their custody. The most important way to achieve this objective is to ensure the widest possible competition in the procurement of goods and services (projects) needed to implement the USAID program. Federal Acquisition Regulations require that each major procurement unit (USAID Caucasus in Tbilisi is such a unit) appoint a "competition advocate" who works as a kind of ombudsman to ensure competition.²¹¹ We suggest that USAID Azerbaijan work with the Regional Mission in Tbilisi to make sure that the competition advocate reviews significant papers that will lead to a future procurement (for example, concept papers and AAD). If the advocate cannot attend USAID Azerbaijan review meetings, perhaps authority could be delegated to a responsible officer in Baku.

²⁰⁹ International Medical Corps Consortium, USAID Request for Application: 112-05-00, Primary Health Care Strengthening Project, undated

²¹⁰ Vian, Taryn with Dilara Valikhanova, *Analytical Paper on Corruption in the Health Sector in Azerbaijan*, prepared by Development Alternatives, Inc. for USAID/Caucasus- Azerbaijan, December 2005, pp. 22-23.

²¹¹ Federal Acquisition Regulations, subpart 6.502

2. Choosing between Acquisition (Contracts) and Assistance (Grants) Instruments

Choosing between procurement instruments is the critical first step in obtaining best value. In general, the RFP is the instrument that ensures the broadest participation in USAID procurement because both for-profit firms and not-for-profit entities can compete without suffering financial hardship. An RFA, on the other hand, discourages for-profits from competing because they cannot collect fees and their cost structures require making a profit. But there are many other factors to consider when choosing a procurement instrument, and all of them impinge upon USAID's understanding of what constitutes best value. Using the example of microenterprise and microfinance development projects, the following checklist was developed for determining the best instrument and hence best value, in another USAID-financed study (but elaborated in more detail for USAID Azerbaijan).²¹²

Choosing Between a Contract and Cooperative Agreement

- If the USAID mission is persuaded that there are several experienced, "best practices" technical assistance providers offering technical approaches with which the Mission would be fully comfortable, a competitive RFA solicitation leading to a CA is appropriate. Note that for-profits can also compete under RFAs, but they cannot take fee.²¹³
- If the USAID Mission designs its own project and wants to be closely involved with—and direct—implementation, for example in sensitive policy work, then a competitive RFP leading to a contract is the best choice. Note that not-for-profits can also compete under RFPs.
- If the USAID Mission anticipates it will need detailed, frequent program and financial reporting, contracts are superior to CAs. If the USAID Mission anticipates there will be a requirement for ad hoc reporting, especially for politically or policy sensitive project work, contracts are superior to CAs. Under CAs, the CTO receives lump-sum, bottom-line financial reporting with, typically, a lag of six months in reporting disbursement information against letters of credit. USAID missions can obtain accrued expenditures faster under contracts than CAs—an important difference for both CTOs and Controllers.
- Of note: Any U.S. not-for-profit that receives awards greater than \$ 500,000 per year must be audited annually, whereas for-profits are typically audited once every four or more years.
- Under both contracts and CAs, but not grants, the USAID Mission has a say in personnel selection and retention, but it is significantly stronger under contracts. Under contracts, USAID may approve salary levels whereas under CAs, it cannot.
- If the USAID Mission is concerned about the quality of personnel, it should use the "key personnel" clause during procurement and recognize that large for-profit consulting firms are more likely to have robust recruitment databases and more aggressive search capabilities than not-for-profits.
- If the USAID Mission is concerned about branding, a for-profit is more likely to be responsive to USAID requirements than a not-for-profit.

²¹² Johnson, Charles W. and Jeremy M. Black, *Study of Microenterprise Umbrella Programs- Final Report*, prepared by the Emerging Markets Group for the Office of Microenterprise Development, Bureau for Economic Growth, Agriculture and Trade, USAID, Washington DC, July 2005, Annex E: Decision Check Lists.

²¹³ Note that fee is not synonymous with profit. Firms charge fee and from fee they pay interest expense as well as taxes, all of which are detailed in their NICRA, "Negotiated Indirect Cost Rate Agreements," which are reviewed and approved by federal auditors and cannot be changed without U.S. Government approval. This is to say that interest expense and taxes are not allowable expenses, reimbursable by USAID. Thus, fee minus interest expense (to cover operating expenses) and taxes equals profit. This explains why for-profit firms are reluctant to respond to RFAs. Not-for-profit entities do not collect fee, but all of their expenses, including interest expense, are legitimate costs within their NICRAs and, in effect, reimbursed by USAID.

- From the point of view of efficiency to the U.S. Government, there is an important difference between “for profit” and “not for profit” firms and organizations, respectively. Under CAs, USAID advances funds to not-for-profits for all operations, including grants, and in time the not-for-profit “clears” the advance. Under contracts, the firm must finance its own operating costs as well as grant awards, and seek reimbursement from USAID with the presentation of appropriate documentation. This rule in federal contracting favors large for-profits over small for-profits and for-profits over not-for-profits, from a government economy point of view.

3. Program Descriptions: Articulating Anti-Corruption as the Pre-eminent CrossCutting Goal

As noted above, the program descriptions reviewed by this study suggested a number of problem areas that need to be addressed and corrected both to improve the overall quality of the portfolio and to advance anti-corruption as a pre-eminent crosscutting theme.

The most striking problem was that several program descriptions were not based upon generally recognized best practices (for example, ABAD, SME-FSD, CDP, and SACS). Inferior design compounds itself because the offerors’ or applicants’ response may be not rise above it. Best practices can usually be found quickly with internet searches or, if not, by consulting central bureaus’ technical backstops, or by networking with other officers in other missions. In general, the Global Health bureau has the strongest technical backstopping, followed by EGAT. DCHA is the weakest. It is the CTO’s responsibility to find best practices and build them into the program description. It is mission management’s responsibility to make sure the CTO has done his or her job by putting the question “does this design reflect agency or industry best practices” first on the document review list.

Some program descriptions were so poorly written that false information was provided to applicants, such as on the Oil Fund (SACS and CDP). A possible cure would be to require all SO teams to clear every program description and also to be represented in technical evaluation committees.

Most program descriptions were not clear on what USAID means by “financial sustainability” and therefore it is no surprise that offerors do not make serious proposals. Thereafter, USAID cannot hold them accountable (as in ABAD, CDP, and SACS). Terms like these must be defined and then offerors and applicants should be required to explain exactly how financial sustainability will be achieved.

Unfortunately, sustainability is such an overused word in development circles that staff treat it as a fully developed concept that is relatively easy to achieve. In reality, sustainability in any organizational entity is difficult to define and very hard to achieve, and achieved much less frequently than claimed.

Most program descriptions were not clear on why or how corruption is a serious problem in Azerbaijan and why USAID has made it the pre-eminent crosscutting issue. There should be citations to topical literature to help all offerors and applicants understand the importance of the issue and to inform their technical proposals. Perhaps drawing on the collection of reports generated under this anti-corruption study, USAID could draft language for program descriptions that accurately describe the Mission’s view on the importance of the problem.

Not surprisingly, most proposals did a poor job of addressing anti-corruption. Once proposals or applications are received, the Mission’s technical evaluation committee should vet every proposal for responsiveness to the RFP/RFA and reject those not

fully responsive to USAID's requirement for anti-corruption strategies and programs. As painful as this may be, it is the only way to be truly serious about anti-corruption, and it must be done project by project.

4. Turning the Current Portfolio toward Fighting Corruption

Many of the projects in the Mission's current portfolio were designed and contracts or grants awarded before the Mission declared that anti-corruption is a crosscutting issue. Therefore, it is time to help these projects catch up by giving them the guidance mentioned above for program descriptions and by requiring them to respond with specific plans and activities in the next workplan.

In this regard, the workplans reviewed were extremely uneven, ranging from very good (PIPE, ACQUIRE, and START) to unavailable (TIMS), to useless (IRI). USAID could advance many interests simultaneously by preparing a workplan template, making it mandatory in every program description, and requiring all implementing partners to use it for the annual workplan update. The corollary is that workplans that do not satisfy USAID's standards should be rejected until the implementing partner is fully responsive to the requirement. USAID Azerbaijan has recently initiated the practice of requiring contractors and grantees to make formal workplan presentations to USAID staff, in connection with the periodic portfolio review. This initiative will likely greatly improve the relevance of workplans and make performance monitoring much more accurate, timely, and useful.²¹⁴

5. Dangers in the Current Portfolio

With USAID's increasing attention to branding its own name, great care should be taken in grant making to narrow it to proven, best practice purposes, and to be certain competition and selection are transparent. Grants to individuals for any purpose should not be done, as they may create the appearance of favoritism or corruption, blemishing USAID's name. In the light of the fact that almost 18 percent of the Azeri public believes international PVOs and local NGOs are corrupt, grant and subgrant making must be undertaken very seriously.²¹⁵ Given the number of and potential monetary volume of grant making in ABAD, RECP, CDP, and SACS, their intended purposes and procedures—and the issue of whether they conform to best practices—merit urgent scrutiny.

6. Tool for Focusing on Project Intersections

USAID might consider investing in a geographic information system (GIS) mapping capability covering all projects in all SOs nationwide to ascertain parallel or overlapping activities. Such an investment could facilitate cross-SO cooperation and extend USAID's reach in terms of attracting other donors' involvement. As discussed above, there are possible intersections among PIPE, ABAD, RECP, CDP, SACS, ACQUIRE, and the Primary Health Care Strengthening project.

²¹⁴ Workplan presentations have been launched, per Catherine Trebes, Program Officer, in late November 2005.

²¹⁵ Transparency International, Country Corruption Assessment: Public Opinion Survey in Azerbaijan, Baku 2004

C. Anti-Corruption Policy Dialogue Agenda²¹⁶

AS USAID MOVES MORE TOWARD DIRECT, BILATERAL RELATIONS WITH THE GOVERNMENT OF AZERBAIJAN, IT MAY BE USEFUL TO DEVELOP A USAID MISSION-WIDE POLICY DIALOGUE AGENDA THAT IS UPDATED REGULARLY (FOR EXAMPLE, WITH THE MONTHLY SO PROGRAM AND BUDGET REVIEW MEETINGS CONVENED BY THE PROGRAM OFFICE) AND IS SYSTEMATICALLY WORKED ON BY THE USAID, THE AMBASSADOR, THE JOINT ECONOMIC TASK FORCE (JETF), THE REVENUE MANAGEMENT GROUP (RMG), AND AD HOC VISITING DIGNITARIES, ESPECIALLY DURING HIGH-LEVEL CALLS. IT WOULD BE A WAY TO GET THE EMBASSY ON TO THE USAID AGENDA.

1. USAID Policy Agenda

For a policy dialogue agenda to be effective the topics must be the subject of excellent staff papers, complete with white papers and “non-papers” than can be shared with the Government of Azerbaijan at various levels. Such papers need to be updated periodically. Once the first sets are done it should not be too onerous to keep them updated. This idea is illustrated in Table 6, which indicates the topic, a possible responsible office, and the venues in which each topic might be pursued.

²¹⁶ Verbatim from Johnson, Charles W., *Recommendations for an USAID Anti-Corruption Strategy*, January 2006.

TABLE 6: REFORM TOPICS, RESPONSIBLE PARTIES, AND VENUES

Topic	Policy Dialogue Papers: SO Team & Impl. Partner	USAID Bilateral Policy Dialogue	U.S. Embassy and Other Donors	Joint Economic Task Force
Redeploy PIPE to MOF & MED	1.3 and PIPE	MOF & MED	MOF & MED	Minister of Finance
Deepen MTEF	1.3 and PIPE	MOF & MED	RMG	Ministers of Finance and Economic Development
The Banking Sector	1.3 and Bank World	NBA	RMG	Chairman of the NBA
Privatization – SOE energy companies	1.3 and PA Consulting	MED and MOF	RMG	Ministers of Finance and Industry & Energy
Privatization – IBA	1.3 and Bank World	MOF and NBA	RMG and Pres. Apparat.	Minster of Finance and NBA Chairman
SOFAR	1.3	MOF & MED	RMG and Pres. Apparat	Pres. Apparat and Minister of Finance
Government of Azerbaijan A-C Commission	2.1 and ABA-CEELI	A-C Commission	President	Pres. Apparat
Government of Azerbaijan-wide code of ethics & asset declaration	2.1 and ABA-CEELI	A-C Commission	ILRG and Pres. Apparat	Pres. Apparat
Independence of Judiciary	2.1 and ABA-CEELI	MOJ	ILRG and Pres. Apparat	Pres. Apparat
Downsizing key ministries, e.g. MOH	3.1	MOF and MOH	Pres. Apparat	Ministers of Finance and Health
Alternative Dispute Resolution	2.1	MOJ	ILRG and MOJ	Minister of Justice
Pharmacy policy & Industry reform	3.1	MOH		Ministers of Finance and Health

RMG – Revenue Management Group; ILRG – International Legal Reform Group

2. The U.S. Mission’s Policy Agenda

All of the foregoing material could become the substance of what USAID wants the Embassy to engage in, particularly in its Mission Performance Plan and policy dialogue agendas. At every opportunity, USAID could help the Embassy to stay on message, especially if the staff papers are well done. From the Government of Azerbaijan’s perspective, such concerted efforts would create the impression of a coordinated, determined U.S. mission. The same logic could hold for the RMG and the semi-annual JETF. As the table above shows, several topics have been more or less abandoned by the donor community, even though they are worthy of continuing pressure. This is obvious with respect to the privatization of SOEs in energy, transportation, and the banking sector as well as pursuing the Government of Azerbaijan to obtain full implementation of the Anti-Corruption Law and numerous Presidential decrees.

D. Anti-Corruption Donor Working Group

Upon preparing the Annual Report in the fall of 2004, USAID determined that mitigating corruption was the main challenge for Azerbaijan to maintain stability, provide broad-based economic growth for the population, and maximize the energy revenues that would be pouring in. In that regard, USAID Azerbaijan hosted the first informal meeting in December 2004 for donors. The donors expressed concern about pervasive public corruption and the looming prospect of it becoming much worse with the oil boom. One idea was for donors to identify a few key areas, develop a common policy stance about them, and relentlessly pursue the Government of Azerbaijan to make necessary changes. USAID offered to contract an anti-corruption study to provide a foundation for donors to act together to combat corruption. The study consisted of several sectors that donors determined were of paramount importance. During the study, USAID hosted meetings of the donor working group in September and November 2005. The meetings were well attended and the discussion lively. Presentations about various anti-corruption activities were well received. Now, at this writing, it is not clear what the future holds for the working group. Some questions that come to mind:

- Is it enough for the donors to meet informally and frequently to exchange information about the current scene and about individual donors' intentions in specific spheres?
- Are there areas of agreement on what constitutes the key areas of intervention to blunt, arrest, and reduce corruption?
- Is there, or could there be, a consensus among the donors to work together on joint position or policy papers and to present such positions as a group to the Government of Azerbaijan?
- Are the donors' home offices supportive of country-level coordination of this kind?
- On a more technical level, is there interest among subsets of donors to form subworking groups to more closely facilitate the exchange of information and to coordinate technical expertise and training within specific sectors?

Emerging Areas of Agreement

This study, in its several parts, should be understood to say that in the big picture, it is the grand corruption or state capture that presents the true threat to Azerbaijan's political future as a succeeding state rather than a failed one and to securing the economic wellbeing of its citizens. In the big picture, the urgent need is to identify and fix all of the gaps and leaks in the public finance system as rapidly as possible, and secondarily to beef up the financial sector, particularly the banking system, immediately. It will be necessary, even if unpopular and difficult, to support these efforts in public finance and the banking system by supporting the government's effort to completing its privatization program as rapidly as possible, for the reasons explained in Sections I.B., "Why Fighting Corruption is the Overarching Goal," and I.D, "Priorities for Donors."

The foregoing is not meant to overlook the petty corruption pandemic that is so widely accepted among citizens. It would be useful for every donor project to adopt norms and practices that make petty corruption more difficult and more obvious for all citizens to see. Better yet would be project-level coordination among USAID projects and between donors. For example, finding common ways to enable citizens

to monitor government service delivery can both empower citizens and cause governments to require changed behavior among public servants.²¹⁷

MANY TECHNICAL INTERVENTIONS WILL BE REQUIRED BUT THEY ARE CRITICAL, IF COMPLEX, ESPECIALLY IN THE PRESENT AZERI ENVIRONMENT IN WHICH PUBLIC AUTHORITIES RESIST ALL CHANGES THAT UNDERMINE OR THREATEN THEIR PRIVATE INTERESTS. IN THIS REGARD, IT IS IMPERATIVE THAT THE DONORS MAINTAIN PRESSURE ON THE GOVERNMENT AT THE VERY HIGHEST LEVEL TO FULFILL ITS COMMITMENTS TO FIGHTING CORRUPTION. BELOW ARE A COUPLE OF SUGGESTIONS WHERE THE DONORS MIGHT QUICKLY AGREE ON BOTH THE IMPORTANCE OF THE TOPIC AND A COMMON APPROACH FOR PURSUING IT WITH THE GOVERNMENT OF AZERBAIJAN. IF THE DONORS' WORKING GROUP COULD REACH AGREEMENTS ON THESE TOPICS, THE ODDS OF THE GROUP BECOMING MORE COHESIVE AND EFFECTIVE WOULD INCREASE.

The Government of Azerbaijan Anti-Corruption Commission Unfortunately, fatigue has set in among donors about the utility of the Commission, despite the fact that it was created by the President as the result of considerable donor pressure, especially by the Council of Europe and the OSCE. The Government of Azerbaijan has passed a comprehensive anti-corruption law, a commission has been appointed, an extensive website set up, detailed programs of work laid out, and so on. Yet, the donor community is generally dismissive of these efforts and seems to have a preference for looking to other solutions. USAID's global strategy notes that the creation of anti-corruption commissions has become a popular strategy for appeasing civil society and donors. This is very likely the case in Azerbaijan but no harm would come if the donor community frequently asks for a review of progress and identification of obstacles from the Government of Azerbaijan. Sustained pressure would seem to offer possibilities for positive responses, if only because it may eventually prove so embarrassing as to provoke action.

Macroeconomic Forecasting

Several donors are preoccupied with the question of improving planning in the light of the flood of oil wealth that will begin soon. One very appealing area is macroeconomic forecasting. USAID's PIPE project will work on this with the Macro Economic Forecasting Department in the MED as it relates to the formulation of the PIP. The Asian Development Bank is interested in assisting the Center for Economic Reform, a semi-autonomous entity of the MED but one that is outside the budget system, for a similar purpose. UNDP plans to provide limited assistance to the SPPRED, another planning and coordinating body in the MED also outside the budget system. BP is assisting SOFAR to improve its modeling capabilities. The NBA has its own separate forecasting department, as it should. It could be very instructive to address the specific purposes of these donor-supported activities with a view to eliminating overlap or competition among them, especially in the context of helping the Government of Azerbaijan to create the capacity to prepare an effective MTEF, as the link between long-range development goals and annual budgets. These two topics for initial efforts by the donors working group are meant to underscore the point that donors should not be distracted from the big picture where

²¹⁷ Shah, Anwar and Mark Schacter (2004).

fixing the public finance system, bolstering the banking system, and completing privatization are the urgent priorities. By their persistence and dedication, the community of donors has shown that they will continue with their development programs for the sake of the future wellbeing of the citizens of Azerbaijan, and for regional political stability, no matter how recalcitrant the government. The formation of the donors working group is a first step in the direction of taking concerted action to improve anti-corruption efforts. It is for the donors to find the will and energy to make it happen.

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