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RECOMMENDATIONS FOR A USAID AZERBAIJAN ANTI- CORRUPTION STRATEGY

JANUARY 2006

This publication was produced for review by the United States Agency for International Development. It was prepared by Charles W. Johnson, Team Leader for Development Alternatives, Inc.

RECOMMENDATIONS FOR A USAID AZERBAIJAN ANTI- CORRUPTION STRATEGY

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for
USAID/Caucasus-Azerbaijan
Anti-Corruption Strategy Study

Under
USAID/FMI Prime Contract No. FFP-I-00-04-00095-00
Task Order FFP-I-02-04-00095-00
DAI/FMI Subcontract No. 01-DAI-CLIR, Task Order No. 1
DAI Project # 5155-100-05S-001

The authors' views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

Acknowledgments

The DAI study team would like to thank the entire staff of USAID/Caucasus-Azerbaijan for facilitating the complex set of tasks that made up this study. We would like to thank in particular Catherine Trebes, the Program and Project Development Officer and Cognizant Technical Officer for the study, for the many substantive suggestions she made, insights about the USAID program, as well as interviews and contacts she personally facilitated.

The study team also acknowledges the help of several donors and USAID implementing partners, especially the American Bar Association/Central European and Eurasian Law Initiative (ABA-CEELI), which provided guidance, suggestions, and contacts for the study team.

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. (DAI).

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ACRONYMS

ABA-CEELI Initiative	American Bar Association/Central European and Eurasian Law Initiative
ACQUIRE	Access, Quality and Use in Reproductive Health Activity
ADB	Asian Development Bank
ADR	alternative dispute resolution
BSL	Budget System Law
BTC	Baku-Tbilisi-Ceyhan
CBC	Caspian Business Consultants
CCM	Country Coordinating Mechanism (Global Fund)
CDP	Community Development Program
CHF	Community Habitat Foundation
CIS	Commonwealth of Independent States
CM	Cabinet of Ministers
CPI	Corruption Perceptions Index
DAI	Development Alternatives, Inc.
DCA	Development Credit Authority
EBRD	European Bank for Reconstruction and Development
EU	European Union
FDI	foreign direct investment
GDP	gross domestic product
GTZ	German Technical Assistance
HAI	Health Action International
IBA	International Bank of Azerbaijan
IFC	International Finance Corporation
ILRG	International Legal Reform Group
IMF	International Monetary Fund
JETF	Joint Economic Task Force
JTC	Judicial Training Center
MED	Ministry of Economic Development
MFI	microfinance institution
MIE	Ministry of Industry and Energy
MOF	Ministry of Finance
MOH	Ministry of Health
MOJ	Ministry of Justice
MTEF	Medium Term Expenditure Framework
MTFF	Medium Term Fiscal Framework
NBA	National Bank of Azerbaijan
NGO	nongovernmental organization
OSCE	Organization for Security and Co-operation in Europe
PD	Program Description
PIP	Public Investment Program
PIPE	Public Investment Policy and Efficiency project
PVO	private voluntary organization
RMG	Revenue Management Group
SACS	Strengthening Azerbaijan Civil Society

SCC	State Customs Committee
SCP	Baku-Erzurum South Caucasus gas pipeline
SME	Small and Medium Enterprise
SO	Strategic Objective
SOCAR	State Oil Company of Azerbaijan
SOE	state-owned enterprise
SOFAR	State Oil Fund of Azerbaijan
SPPRED	State Program for Poverty Reduction and Economic Development
SSC	State Statistics Committee
START	Strategic Technical Assistance for Results with Training
TI	Transparency International
TIMS	Treasury Management Information Systems
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
WHO	World Health Organization

FOREWORD

USAID/Caucasus-Azerbaijan's Fiscal Year 2005 Annual Report lays out some of the specifics 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.²¹⁸

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; and 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. Subsequently, USAID decided that the present study, *Recommendations for a USAID Azerbaijan Anti-Corruption Strategy* should address strategy exclusively.

In a fourth category, DAI undertook more detailed studies of sectors that were identified by USAID. International experts were engaged to carry out studies in the health, judicial, and public finance sectors. Supplementing the public finance study were separate analyses on the State Procurement Agency, the Parliament's Chamber of Accounts, and the State Customs Committee. These supplementary studies were undertaken by Azeri consultants engaged by Caspian Business Consultants (CBC), which worked under DAI's guidance.

In these sectoral studies, the consultants attempted to accomplish the following:

1. Identify supporters and opponents of anti-corruption reform and their respective interests, and assess the presence of political will to make reform happen.
2. Examine the extent of corruption from sporadic to pervasive.
3. Determine the forms of corruption—administrative, grand, or state capture—and how it is organized—vertically, linking superiors and subordinates, horizontally, linking ministries, or along family or clan lines across public and private institutions. Evaluate whether some public institutions are notably corrupt while others are notably clean and whether there are significant differences among national and local governments units.
4. Analyze the administrative and regulatory framework to identify gaps in oversight, and vulnerabilities where administrative corruption exists.

²¹⁸ USAID/Caucasus-Azerbaijan, Annual Report FY 2005 (including "Azerbaijan: the Development Challenge"), April 2004.

5. Assess attitudes in civil society toward corruption.
6. Identify corrective actions within manageable interests, likely to produce the greatest results.

Coincidentally, the fieldwork for the study was undertaken in the two months preceding the Parliamentary elections on November 6, 2005, with the consequence that many officials would not make themselves available for interview.

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I. Perspectives on Corruption in Azerbaijan

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 remaining far below the threshold of 3.0—the lower limit for a severe corruption problem—is important. Azerbaijan now shares the same CPI with Cameroon, Ethiopia, Indonesia, Iraq, Liberia, and Uzbekistan. Tajikistan and Turkmenistan are the only members of the Commonwealth of Independent States (CIS) with scores worse on the composite index.²¹⁹ 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.

²¹⁹ Transparency International, *Corruption Perceptions Index 2004*, October 20, 2004, and *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%
WORSENERD 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).²²⁰ 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.²²¹ The high percentage of people who admit to paying a bribe is a strong indicator of how pervasive, indeed commonplace, corruption is.

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, 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.

²²⁰ Transparency International, Country Corruption Assessment: Public Opinion Survey in Azerbaijan, Baku 2004.
²²¹ Ibid.

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 follows 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.²²²

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 2006.²²³ 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 changed its planning assumption to \$40 per barrel. Oil production is expected to peak around 2011, plateau for a few years, and then decline to about one quarter of the peak level by 2024—assuming no new reserves are discovered.

With oil revenues alone, 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.²²⁴ Azerbaijan's oil wealth can be recycled in four ways: 1) by repatriating capital and profits by the oil consortia per the terms of the Production Sharing Agreements; 2) through public spending (capital investments in infrastructure, recurrent expenditures for government salaries, and expendable supplies and social benefits); 3) through the banking system for private consumption and investment; and 4) by being sterilized by the State Oil Fund of Azerbaijan (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 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 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

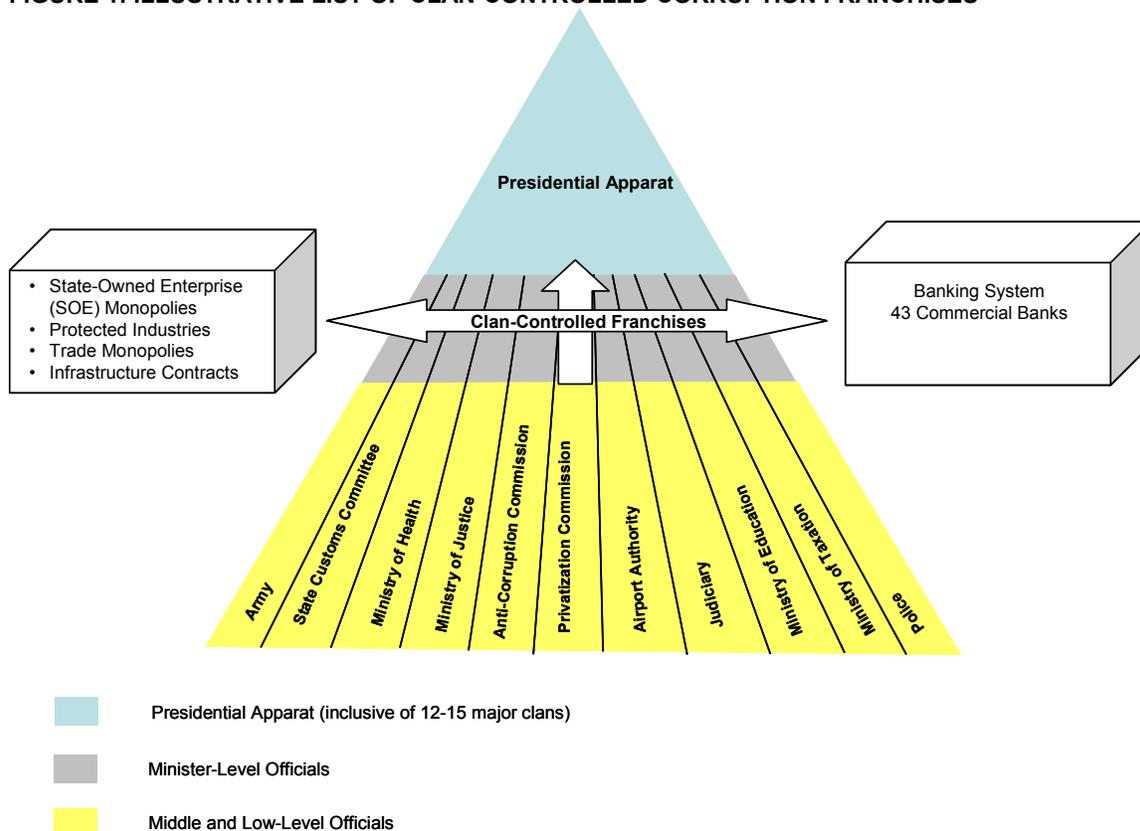
²²² World Bank, Azerbaijan Public Expenditure Review, report no. 25233-AZ, April 3, 2003, pp. 33, 34.

²²³ U.S. Mission to Azerbaijan, *Mission Performance Plan FY 2006*, 2005, p. 3.

²²⁴ One million barrels per day, at \$45 per barrel, yields \$16 billion in gross revenues per annum.

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 clan member is the Minister or head of agency for the corruption franchise. Variations on this vertically integrated model are described separately in the reports on the health, judicial, and public finance sectors.²²⁵ Some other 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 personal fortune of

²²⁵ 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.

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 yet the head of such a franchise can be expected to resist

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.

all efforts to downsize the Ministry because each job generates a continuing stream of revenue toward the top of the pyramid.

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.²²⁶

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.

²²⁶ 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.

D. Priorities for Donors

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

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; INSTITUTE COMPETITIVE PROCUREMENT; ASSERT PARLIAMENTARY AND JUDICIARY INDEPENDENCE FROM THE EXECUTIVE.
OPAQUE GOVERNANCE AND LIMITED ACCOUNTABILITY	TRANSPARENCY: FREEDOM OF INFORMATION LAW, FINANCIAL DISCLOSURE, CODE OF ETHICS, OPEN BUDGET PREPARATION PROCESS, EMPOWERED OMBUDSMAN, TRANSPARENT FINANCIAL SYSTEMS. 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. SANCTIONS: ELECTORAL, ADMINISTRATIVE, AND CRIMINAL SANCTIONS ADMINISTERED BY INDEPENDENT JUDICIARY.
PERVERSE INCENTIVES	REALIGN INCENTIVES: PROGRAM OR PERFORMANCE BASED BUDGETING, ADEQUATE SALARIES, CODES OF CONDUCT, ELIMINATING EMPLOYMENT FEATHERBEDDING.
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, AND BUILDING THE WATCHDOG AND ADVOCACY FUNCTIONS IN CIVIL SOCIETY.

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

Addressing public finance first, Table 4 illustrates potential types of corruption and where they might reside within a public finance framework. As is evident, corruption is endemic in Azerbaijan and is a symptom of failed governance at virtually very level (and, branch) of the public sector.

TABLE 4: AREAS OF CORRUPTION IN THE PUBLIC FINANCE SECTOR

	ADMINISTRATIVE CORRUPTION	GRAND CORRUPTION	STATE CAPTURE
--	---------------------------	------------------	---------------

CAPITAL EXPENDITURES	•	•	•
TAX EVASION	•		•
UTILITY SUBSIDIES		•	
NONTRANSPARENT 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: Schaeffer, Michael, *Analytical Paper on Corruption in the Public Finance Sector: Azerbaijan Anti-Corruption Strategy Study*, Development Alternatives Inc., January 2006.

Corruption in Azerbaijan assumes three broad forms:

- Administrative/bureaucratic corruption, involving low-level officials and 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, and 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.²²⁷

The whole system of planning, budgeting, and budget execution must be radically transformed very quickly to stem the flow of public funds leaks into poorly planned investments, ruinous welfare plans, corrupt schemes, and theft. USAID/Caucasus-Azerbaijan anticipated this finding; for this reason, public finance is addressed in a separate report. Already, USAID and the U.S. Embassy are strategically placed in this area with the Public Investment Policy and Efficiency project (PIPE) in the Ministry of Economic Development, the Treasury Management Information Systems (TIMS) project in the Ministry of Finance, and the U.S. Treasury Advisor in the Budget Department of the Ministry of Finance (MOF). The World Bank and the Asian Development Bank have projects in this area 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 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

²²⁷

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

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. USAID Anti-Corruption Strategy

USAID headquarters in Washington D.C., recently published an anti-corruption strategy paper that is on the mark for Azerbaijan:

Anticorruption efforts have tended to focus on what is sometimes the most immediately visible dimension of the problem: administrative corruption—mostly smaller transaction involving mid-and low-level government officials. Anticorruption efforts need to be expanded to better encompass grand corruption—exchanges of resources, access to rents, or other competitive advantages for privileged firms and high-level officials in the executive, judiciary, or legislature, or in political parties.

There is an emerging global consensus that fighting corruption and building good governance are essential for the development of people, markets and nations. Corruption undermines social cohesion and broad participation in economic and political life by distorting the allocation of resources and the delivery of public services, usually in ways that particularly damage the poor. It also damages prospects for economic growth by reducing foreign direct investment, skewing public investment, encouraging firms to operate in the informal sector, distorting the terms of trade, and weakening the rule of law and protection of property rights. In doing all of this, corruption fundamentally weakens the legitimacy and effectiveness of new democracies.²²⁸

The USAID worldwide strategy calls for a four-pronged approach:

- Confront the dual challenges of grand and administrative corruption;
- Deploy USAID resources strategically to fight corruption;
- Integrate anti-corruption goals and activities across all programs; and
- Build the agency's anti-corruption knowledge base²²⁹.

USAID/Caucasus-Azerbaijan addresses corruption in each of the three SOs in its draft country strategy statement²³⁰ and states that among cross-cutting themes “Anti-Corruption will be given pre-eminent attention by the Mission in the implementation of all SOs. This will be accomplished in coordination with other donors, who are equally dedicated to work on this issue....” Furthermore, “USAID strategy...will identify opportunities to maximize anti-corruption mechanisms in ongoing and planned activities.” These intentions define the purpose of this subject study.

²²⁸ USAID, *USAID Anticorruption Strategy*, PD-ACA-557, Washington D.C., January 2005, p. 1

²²⁹ USAID, *ibid.*, p.2

²³⁰ USAID/Caucasus-Azerbaijan, *Draft Strategy Statement*, August 10, 2005, pp. 7–8.

III. Recommendations to USAID for an Anti-Corruption Strategy

In this section, some elements of a USAID anti-corruption strategy are presented and discussed. Other elements are addressed in a separate report, “Improving Program Design and Management to Enhance Anti-Corruption Impact in the USAID Azerbaijan Portfolio.” First, suggestions are made for current USAID projects to enhance anti-corruption impact. Then, new challenges and tasks are identified and described for the attention of USAID and the donor community. Following that discussion, a suggested action agenda that aims to magnify or extend USAID’s program reach is presented. Finally, some suggestions are made about how to build upon the donors working group on anti-corruption that USAID launched on September 29, 2005.

A. Specific Project Suggestions for USAID

1. Treasury Information management Systems²³¹

TIMS is a very important project. With some additional work; some coordination with PIPE, the U.S. Treasury Advisor in the MOF Budget Department, and 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 for budget organizations. TIMS has the near-term potential to make the Government of Azerbaijan budget execution greatly more transparent than it is at this writing. These dramatic improvements within the public finance system are within reach over the next two years.

Such improvements would require additional time and additional funds to add additional modules to TIMS to increase radically the transparency of Government of Azerbaijan budget operations. The full package would consist of four modules: budget preparation, fixed asset, audit, and human resources. To illustrate their importance:

- 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.
- 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.
- 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. This module is absolutely essential for empowering the Chamber of Accounts, Parliament’s external audit arm.
- The human resources module would allow for tracing salary deposits to actual employees and their bank accounts—critical for purging the Government of Azerbaijan’s payroll of phantom employees.

²³¹ Carana Corporation, 2005, *TIMS Quarterly Report, June 1 to September 30, 2005*, Treasury Information Management System (TIMS) power point presentation.

2. Banking Supervision²³²

The most important recommendation for this project is to extend its duration, and in the process, expand the project's activities to cover the full implementation of international financial reporting standards in commercial banks while helping the same banks to create functioning internal controls and internal audit capacity. Given USAID's past and current investments in microfinance institutions (MFIs) and nonbank financial institutions (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 currently have the skills and capacity to effect).

3. Public Investment Policy and Efficiency Project²³³

Now that the diagnostic phase is over, it is imperative that the PIPE offices be physically relocated to the Ministry of Economic Development (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. Time is of the essence on this point.

As implementation proceeds, USAID ask 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 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 Community Development Program (CDP) and Strengthening Azerbaijan Civil Society (SACS) project or possibly seek the engagement of other donors.

4. American Bar Association/Central European and Eurasian Law Initiative (ABA-CEELI) Azerbaijan Rule-of-Law Program

From an anti-corruption perspective, it would appear that USAID earns high returns on financial support for the ABA-CEELI program. Even though its work program is broad and aggressive, USAID might wish to request that ABA-CEELI become the active mentor to other USAID staff and implementing partners on matters relating to anti-corruption. ABA-CEELI is in the network of donors that support legal reform and can provide best practice information and guidance, if it could take on this task.

5. Working to Heighten Awareness through the Media (WHAM)²³⁴

Like ABA-CEELI, USAID should consider how to engage the International Research and Exchanges Board (IREX) as a mentor and resource for USAID staff and implementing partners who need guidance and information on how to use the media

²³² Terry L. Stroud, Charles P. Sheridan, and Frank E. Blimling, *Work Plan for Year 2005, Presented to the National Bank of Azerbaijan* (Technical Assistance to the National Bank of Azerbaijan in Banking Supervision by BankWorld), January 2005.

²³³ Development Alternatives, Inc., Public Investment Policy and Efficiency Project, *The Workplan for July 2005-End 2007*, June 2005.

²³⁴ 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.

in their sectoral programs and projects that require or have anti-corruption elements. Other donors may be interested in IREX's capabilities as well.

B. Cross Project Coordination

With a USAID Energy Assistance project in the Ministry of Industry and Energy (MIE) addressing the energy SOEs, the MIE should or could become PIPE's top priority for improving sectoral planning and formulating capital projects in the PIP. However, USAID has taken the stance that the Government of Azerbaijan must adopt legislation to establish an independent regulatory commission in the power sector as a kind of indicator of the Government of Azerbaijan's seriousness of purpose and thereby justify the continuation of USAID assistance. This report provides an additional rationale for continuing assistance to MIE. In the previous section on priorities for donors, we discussed SOCAR and its subsidiaries investing in capital projects on a scale much larger than the Government of Azerbaijan's entire capital budget, but with no discipline or scrutiny and apparently outside the purview of the Public Procurement Law. In this respect, 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. Therefore, it would be prudent for USAID to stay engaged in this key sector and continue to press for the privatization of these SOEs.

There are overlapping interests across the three USAID/Caucasus-Azerbaijan SO teams, defined by the intersection of activities in rural communities and municipalities. These projects include Access, Quality and Use in Reproductive Health Activity (ACQUIRE) and Primary Health Care Strengthening in the health sector (SO 3.1), the PIPE project for improving the quality of capital projects (within SO 1.3 for economic growth), and two large, new projects, CDP and SACS, under SO 2.1 for democracy and governance, which will work with rural communities and towns. As an interdisciplinary effort, the three USAID teams could map the intersections of these projects to specifically identify the interfaces between community organizations, municipalities, district governments, the MOF, and MED on recurrent and capital spending.

The next step would be for USAID to devise a strategy for creating a voice for communities to articulate their needs, influence budget allocations, and monitor the implementation of the state budget. Achieving some integration across the USAID SO teams, and with their implementing partners, could make the challenge of improving the technical capacity of regional and local governments more interesting and less daunting for other donors.

Another example would be in the realm of creating a citizens' voice. The Primary Health Care Strengthening and ACQUIRE projects are or will be working in communities creating health boards to manage community-based financing schemes, or problem solving for better healthcare. The previously mentioned CDP and SACS projects plan to launch similar public education or advocacy activities. These initiatives are meant to promote government accountability through community oversight. Working with receptive local government officials, these projects should consider ways to expand health boards to include other development activities on local governance issues. Educating citizens through these projects, and via the media, on health-related law and patient rights (that is, what is supposed to be covered by official fees and what is supposed to be available for free), can have a powerful impact both empowering citizens and reducing opportunities for the ease of corrupt practices.

USAID could task World Learning's Strategic Technical Assistance for Results with Training (START) project to design a standard anti-corruption training module on ethics, codes of conduct, disclosure, and freedom of information to educate USAID staff and implementing partners on best practices. The subject matter could be of interest to other donors as well.

Since the START project services all SOs, there are many possibilities for complementing the ongoing work of other projects to improve anti-corruption impact. For example, in the public finance sector, START might be commissioned to develop and implement the following kinds of in-country training:

- Program and Performance Budgeting - Training courses could be provided to central government ministries and agencies and regional and local government units in program and performance budgeting, which would go beyond the PIPE project's ambitious training program in capital project preparation and appraisal.
- Budget Management and Analysis - Training could be provided to MOF financial managers in developing medium-term fiscal forecasting, budgetary frameworks, and evaluating risk in forecasts, in collaboration with the preparation of the PIP in the MED. Training should encompass building alternative financing scenarios and dealing with budgetary pressures. The courses should introduce budget analysis tools and techniques.
- Internal Controls and Audit - This training course could include the basics of government accounting rules and standards. It should also review internal control and internal audit procedures combined with case studies in other countries or, better yet, from Azerbaijan.
- External Controls and Audits - Training could be provided with respect to external performance auditing and controls. The basic purpose of this type of training is to provide financial managers (including local government) with basic tools in performance auditing, conditions necessary for performance audits and case studies to illustrate how performance auditing has worked in other environments.

C. New Anti-Corruption Opportunities and Tasks

In Section I., Perspectives on Corruption in Azerbaijan, we attempted to put the problem of corruption in Azerbaijan in context and explain why fighting corruption must be the overarching development goal (Section 1.B.). We completed this analysis by hypothesizing how corruption is organized in the public sphere (Section I.C.). These pieces underpinned Section I. D., Priorities for Donors. Taking into account the literature review and the more detailed analyses of the judicial, health, and public finance sectors, it seems clear that both politics and the opportunities for corruption (and to fight it, as well) adhere to the axiom "follow the money." With this adage in mind, it was quickly possible to discern where and why corruption is most severe and damaging to the nation's future. We said, "because of Azerbaijan's natural resource wealth, three areas require emergency attention. These are public finance and the banking system and related to both, resuming and completing the privatization of state owned enterprises (SOE)."

The whole system of public finance is a hotbed of corrupt activity and has the potential to become much worse as the exploitation of Azerbaijan's energy resources proceeds and accelerates. In a related fashion, the primitive financial sector, the small size of the banking system, and the inability of the NBA to supervise and regulate the banking sector are also cause for concern. As we explained in Section I., a successful attack on corruption in both spheres is likely to

require a redoubling of effort to complete the privatization of SOEs, particularly in the energy and banking sectors.

Preceding this anti-corruption study, USAID correctly anticipated, in our opinion, the importance of the public finance sector. But, neither USAID nor DAI anticipated the finding on the importance of the banking system or the necessity of completing the long-stalled program of privatization. Realizing the importance of the banking system and privatization came too late in the study's execution to shift resources to "follow the money." However, we do strongly recommend that USAID continue and expand its assistance to the NBA for banking supervision (Section III.A above), but we have no specifics to offer as to how to proceed on the privatization front. Accordingly, this section of the study addresses what was anticipated at the outset by USAID and agreed to by DAI: public finance, the judiciary, and the health sector.

1. The Public Finance Sector

Some of the following material and recommendations were drawn from the sector study on public finance, *Analytical Paper on Corruption in Public Finance Sector: Azerbaijan Anti-Corruption Strategy Study* by Michael Schaeffer.²³⁵ In this following section, some areas that require attention are identified and the rationale provided.

a. Medium Term Expenditure Framework (MTEF) – Linking Development Goals and Budget

The MTEF is supposed to be the link between the Government of Azerbaijan's long-range development goals, now best expressed in the State Program for Poverty Reduction and Economic Development (SPPRED) and the annual budget, particularly capital spending through projects prepared, appraised, and included in the PIP. The MTEF is largely missing in Azerbaijan because of lack of interest, confusion about its proper home (in the MED or MOF or a combined effort), and by the Cabinet of Ministers' practice of approving sectoral goals and spending plans ad hoc, without reference to either the SPPRED or the PIP. The concepts that underpin a MTEF are relatively straightforward but very difficult to develop and implant within public planning and budgeting systems. They consist of increasing the staff capacity to develop and defend a Medium Term Fiscal Framework (MTFF) with targets that accurately describes the government's fiscal policies in detail. Once approved by the executive authority—the President or Cabinet of Ministers—the technical staff use the MTFF to prepare a Medium Term Budget Framework, which allocates resources to achieve the country's development goals as articulated in the SPPRED and broken out by line ministries and other spending agencies. Creating the staff capacity to prepare these major MTEF building blocks and thereby link long-range development goals to current budget planning and execution is an important priority that is not yet addressed by any donor or combination of donors in a coherent fashion.

²³⁵ Schaeffer, Michael, *Analytical Paper on Corruption in Public Finance Sector: Azerbaijan Anti-Corruption Strategy Study*, DAI for USAID/Caucasus-Azerbaijan, January 2006.

b. Improving the Budget System Law (BSL)

The BSL is a good framework law that contains many of the necessary provisions to ensure budget accountability and transparency. It defines the main concepts of budgeting and budget execution. The BSL is an initial step in curtailing corruption. However, the Government of Azerbaijan has not fully implemented it. Concurrent with full implementation of the BSL, at least two places in the budget formulation process could be strengthened to help reduce the discretion of individual ministries and bring more rule-based transparency to the budget formulation process: 1) making budgetary ceilings a binding constraint for budget organizations, and 2) linking the sector development programs of budget organizations to their actual budgets, both of which flow out of an MTEF process.

c. Norms, Funding Formula, and Block Grants

The Government of Azerbaijan allocates funds based on “norms” for inputs in all sectors. For example, jurisdictions with the most school buildings (and teachers) or the most hospitals (and hospital beds) received the most funds. However, finance should follow function, that is, the amount of funds should follow the number of students or patients. Program or performance budgeting is almost universally accepted as the means of developing effective programs and budgeting processes. The funding formula per patient (or per student) can be adjusted for factors that result in differences in costs, such as population density. The formula must be simple and transparent with only a limited number of adjustment factors. In capitation, or demand-side financing schemes, public funds are allocated as ‘block’ grants according to a formula. The formula can also be designed to reward service delivery improvement or the efficiency with which the institution uses inputs. Institutions then would have the flexibility to reallocate resources as they see fit. This is a very significant area for coordination between USAID’s SOs 1.3 and 2.1, especially in the PIPE, SACS, and CDP projects.

d. Public Investment and Local Governments

The role, responsibilities, and authorities of the 2,650 Municipalities are set out in the Law on Status of Municipalities. However, there is substantial overlap with the local executive authorities (the ExComms) that fall under the Office of the President and have a separate Budget Head (Local Executive Powers 1251) and are responsible for significant infrastructure development projects. On the other hand, the PIP focuses solely on Ministries and Agencies, and excludes the municipalities. As evidenced here, planning and budgeting for capital projects is not integrated in reality, despite the BSL, which increases the likelihood of missing important opportunities to alleviate poverty and corruption. This is a significant area for

cooperation and coordination among donors, between USAID SO teams 1.3 (PIPE) and 2.1 (especially with the SACS and CDP projects).

e. The State Oil Fund of Azerbaijan

SOFAR was established by Presidential decree. Current SOFAR²³⁶ regulations require that only interest revenues earned on SOFAR's offshore investments can be used for public expenditures and that its non-operational expenditures are strictly limited to funding projects within the Consolidated Budget, including capital projects, and the PIP, and in conformity with the MTEF. There are already cases in which SOFAR has made direct expenditures in Government of Azerbaijan programs, despite its own governing regulations and the BSL. Because of the huge volume of resources that SOFAR should be managing offshore, and not directly investing in the domestic economy, two things should be done. First, SOFAR should be established by law. Second, SOFAR's interest revenues must be channeled through the PIP and Consolidated State Budget, per the BSL. This is an important matter for the U.S. Government's and donor community's policy agenda.

f. Taxation, Corruption, and Investment

There are 92,000 active taxpayers or legal entities in Azerbaijan, of which only 640 are considered to be "large" taxpayers. Fiscal evasion remains a huge and pervasive problem with perhaps 50 percent of GDP in the informal economy. This large number is a function of both the discouraging business environment and the high frequency of extortion and bribes that encourage individuals and firms to stay outside of the formal tax system. Lowering the highest marginal tax rate to 24 percent would create an incentive to bring those now in the informal economy into the formal sector, reduce corruption, and increase revenues in the near term. Coordination should occur with the U.S. Treasury Advisor in the Ministry of Taxation. In another revenue center, the State Customs Committee, corruption is deeply embedded.²³⁷ The United Nations Development Programme (UNDP) has a small, ongoing technical assistance activity that is not making any apparent headway in the anti-corruption sphere. Corruption in the State Customs Committee (SCC) is widely regarded as one of the most important factors discouraging FDI in the non-oil sector and domestic investment in the formal economy. Some measures that would make corruption more difficult include better data collection and control through the adoption and refinement of an automated data capture system; using international standards for import-goods valuations; shifting toward an audit-based system for import/export goods movement control; and a broader use of automated processes for customs documentation for importers, including licensed customs brokers, creating specialized units that perform audits (and, customs valuations), and implementing a system targeting selective transactions and consignments. SCC is of interest to the U.S. Embassy as well as the IMF and UNDP.

g. Budget Execution

²³⁶ See World Bank, *Azerbaijan Public Expenditure Review*, Report No. 25233-AZ, 2003, Executive Summary, p. xiii.

²³⁷ Schaeffer, Michael, *Analytical Paper on Corruption in Public Finance Sector: Azerbaijan Anti-Corruption Strategy Study*, DAI for USAID/Caucasus-Azerbaijan, January 2006.

Public procurement is another area that is open to widespread and very costly corrupt practices, and has been mostly ignored by the donor community with the exception of the World Bank. Addressing all of the problems would require a comprehensive, multi-year effort and implicate every ministry and agency that can legally procure goods and services. For a pilot effort, attention should be directed to the State Procurement Agency's Procurement Review Department for improving recruitment, training on best practices; standardizing tender documents, contracts, and clauses; and building and maintaining a database register of procurement transactions, thereby enabling the dissemination of information to contracting entities, the Parliament's Chamber of Accounts, and the public.

h. Accountability

Public finance is complex and very difficult to understand. Azerbaijan's lack of tradition of record-keeping, standardized procedures and norms, and no tradition of disclosure or public access to government records, make the whole system opaque. It will take time and disciplined efforts to create transparency. Public accountability will only become possible once the foregoing systems are operational and transparent. The ideal would be to educate the citizenry to monitor the government according to law, such as through new Freedom of Information Acts, but such an environment and possibility is decades away. It is possible that shortcuts could be taken via a more strenuous effort to educate the media, broadcast, and print. Even so, citizens and the media need access to expert analysis and facts.

The two most important ways to create this capacity are to build internal and external audit capacity, which are now weak, corrupt, and/or non-existent in Azerbaijan. The internal function is the exclusive responsibility of the Control Inspection Department of the MOF because independent audit authorities have been eliminated in all other ministries and agencies. The external function is the responsibility of the Chamber of Accounts, a body that operates under the authority of the Parliament. It was established by law in 1994 but did not become operational until 2001. It has the legal mandate to inspect or audit any public institution, including SOEs. In reality, the SOEs (such as the state-owned Caspian Shipping Company) simply refuse to allow auditors on their premises. The Chamber is understaffed, the personnel are not required to pass accounting and auditing examinations, and the staff do not have the necessary working tools to carry out their responsibilities.²³⁸ The Chamber is a shell rather than an effective body for ensuring accountability. It has been the subject of some interest by the World Bank but, to date, no program of assistance has been mounted.

This huge area has not been touched in any significant way by any donor even though creating effective audit capacity is essential to many anti-corruption efforts. Internal and external audit capacity could be an important priority for consideration by the Donor Working Group.

2. The Judicial Sector

The sector study authored by Mary Noel Pepys presents a number of institutional reforms that are indispensable in developing an independent, transparent, and accountable judiciary. Like the health sector (discussed below), the root corruption

²³⁸

Ibid.

problem in the judiciary system is the sale of jobs and the related requirement to pay for securing tenure, both of which underpin the whole system of extortion. In the absence of political will, no tactics will be completely effective in stopping corruption. However, there are indirect measures that might help mitigate corruption by making it more obvious and more shameful than today. These reforms are summarized below.²³⁹

a. Structural and Institutional Reforms

The judiciary cannot be independent as long as the Ministry of Justice can examine its operations and is responsible for its administration and budget. Among the measures needed are creating an administrative office of the courts that would manage personnel and budget, enhancing the Judicial-Legal Council by changing both its composition and the selection process to favor the judiciary, and creating budget autonomy for the judiciary with adequate resources to ensure its independence and smooth functioning. These measures would need to be implemented along with efforts to modernize the operations of the courts by improving court administration, particularly the case management system, to reduce opportunities for collusion and move toward random case assignments, verbatim trial transcripts, and publishing higher court decisions.

b. Improving Human Resources

With the quality and honesty of judicial personnel being the core problem in the court system, the Government of Azerbaijan and donor investment should focus on developing the Judicial Training Center (JTC). The JTC should provide new and sitting judges with systematic training, including substantive and practical courses that are relevant and effective and are given in a timely and qualified manner. This would involve preparing a strategic plan that addresses the immediate requirements of new judges and the long-term requirements of sitting judges based upon a comprehensive needs assessment of judges throughout Azerbaijan. The curriculum should be updated frequently to incorporate the increasing number of new and amended laws, particularly those that consist of legal concepts and principles, unfamiliar to many judges. Additionally, the JTC should require qualified instructors with modern adult teaching methodology. As a corollary to both better selection and in-service training, the Judges Association should be strengthened so that it will become a locus of judicial activism, protecting the independence of the judiciary. Further, the Government of Azerbaijan should be strongly encouraged to continue to improve the judicial appointment process by continuing to improve the objective examination and evaluation of candidates for judgeships; making the appointment of candidates to certain courts competitive based upon performance at the Judicial Training Center; and instituting new procedures for personnel actions (promotion, demotion, termination, early retirement, and reevaluating life-term tenure). Related to improved personnel practices, there is an urgent need to introduce and enforce a code of ethical conduct and monitor the annual declaration of assets closely. The declaration of assets should be published in the press.

²³⁹ Pepys, Mary Noel, Analytical Paper on Corruption in the Judicial Sector: Azerbaijan Anti-Corruption Strategy Study, prepared by DAI for USAID/Caucasus-Azerbaijan, November 2005.

c. Competition, Accountability, and Rewards

Mary Noel Pepys views the Azeri judiciary as strongly influenced by market forces rather than the rule of law,²⁴⁰ yielding perverse and destructive impacts upon the very foundations of civil society. In this construct, one approach would be to introduce competition to the judiciary by developing an alternative dispute resolution (ADR) mechanism. Such alternative channels have proven to be very effective and relatively inexpensive in commercial law adjudication. The other impact, if fully implemented, would be to reduce the corrupt judiciary's monopoly on justice. A starting point might be to build upon an informal arbitration procedure known as the Court of Referees.

Strategies need to be devised to engage civil society on monitoring the consistency of judicial decision making based upon published decisions, probably through a better trained public broadcast and print media. The same civil society groups should also monitor the new requirement for public office holders to declare all assets and income and to spotlight those that do not conform to known reality, such as expensive real estate holdings or equity positions in major companies.

If all of the foregoing "tactical changes" were put in place, and if there was a significant demonstration of political will to end the sale of judgeships and to punish corrupt officials, a case could be made for improving remuneration and working conditions, since these two factors are commonly cited as excuses for corruption. However, without the political will to root out the sale of positions, there would be no justification to increase the pay of judges.

3. The Health Sector

The sector study authored by Taryn Vian presents a more detailed picture of corruption in the health sector, including where linkages among continuing projects can be forged or strengthened. As with the judiciary, the root corruption problem in the Ministry of Health is the sale of jobs and the related requirement to pay for securing tenure, both of which underpin the whole system of extortion. In the absence of political will, no tactics will be completely effective. However, there are indirect measures that might help mitigate corruption in the sector, including the following.²⁴¹

a. Structural and Institutional Reforms

Reform of healthcare budgeting is an urgent priority. USAID should continue supporting the move to a needs-based funding formula, revising the financing flows to enhance full management control over inputs and outputs used to produce government services (either a public contracting model or full devolution), and rationalization of the hospital sector by dramatically reducing the number of beds and staff. As discussed above under public finance, there is wide scope for collaborative efforts with USAID's PIPE project which seeks to improve the identification, appraisal, and budgeting of capital investments in the consolidated state budget, working with both the Ministries of Finance and Economic Development. Financial management reforms cannot be accomplished without

²⁴⁰ Ibid.

²⁴¹ Vian, Taryn with Dilara Valikhanova, *Analytical Paper on Corruption in the Health Sector: Azerbaijan Anti-Corruption Strategy Study*, prepared by DAI for USAID/Caucasus-Azerbaijan, December 2005.

developing performance measures. Within their existing scopes of work, USAID projects such as Primary Health Care Strengthening and ACQUIRE should explore ways to evaluate performance using external performance audits to provide a check on falsified data.

Reforming pharmaceutical policy and industry is another urgent priority. One approach would be to start with a drug price monitoring study such as the Medicine Prices manual designed by the World Health Organization (WHO) and Health Action International (HAI).²⁴² The WHO/HAI methodology includes trend analysis of drug prices and availability, using comparative data on prices of common drugs by sector (public facilities, private for-profit facilities, private for-profit pharmacies, and private not-for-profit facilities). Local prices are shown in relation to international reference prices. The pricing methodology detects and analyzes reasons for price variation such as local costs (transportation, duties, taxes, and mark-ups) and helps to highlight irrational drug use and patterns of high sales unexplained by local cost factors. Once the factual situation is better understood, USAID or another donor could develop an anti-corruption action plan for the pharmaceuticals sector. A World Bank study on the pharmaceutical sector that has not yet been released may have already covered this issue. Once released, the World Bank report should be reviewed and USAID should tailor the next study to plan interventions in areas such as improving the process of registering drugs and licensing pharmacies; increasing online, public access to lists of registered drugs and pharmacies; cleansing the market of fake or sub-therapeutic drugs; creating pharmaceutical legislation to reduce conflict of interest in ownership of pharmacies by physicians (The Primary Health Care Strengthening project is supporting a legislative review that could be expanded to include this topic); introducing legislation to regulate procurement practices of wholesalers; and implementing an essential drug list and enforcing its use.

b. Improving Human Resources

Hiring practices within the government are largely opaque and the MOH is not exception. USAID or another donor should support the government's idea of a computerized system for the MOH personnel office to collect information on available job vacancies in all districts and MOH functions and advertise them to the public. USAID should also advocate for further changes that improve transparency and limit discretion in hiring, including, for example, transparent hiring protocols, an electronic system for people to apply for jobs online, hiring reports that justify decisions made based on criteria, and so on. USAID could also support electronic systems for tracking other personnel functions such as payroll via the USAID project in SO 1.3 in the Ministry of Finance, TIMS. Related to improved personnel practices, there is an urgent need to introduce and enforce a code of ethical conduct as well as monitor closely the annual declaration of assets, which should be published in the press. Training for MOH employees on patient rights and the ethics of physician and pharmaceutical industry interactions are especially important and should be the subject of periodic retraining.

²⁴² See web site at <http://www.haiweb.org/medicineprices/>

c. Competition and Accountability

In terms of competition, another tactic for attacking corruption, improving medical care, and reducing its cost is to encourage the formation of small, private medical practices and ensure that they are properly regulated. Given the extensive reliance on out-of-pocket payments and privately purchased medicines in government-run service delivery now, this change would not entail a significant shift in behavior on the part of the public. Downsizing the government’s healthcare delivery role (via the “needs based” funding formula discussed above) will allow more of the current informal revenue to be channeled to actual service delivery, instead of being captured by senior administrators in the form of kickbacks from government providers.

With respect to accountability, it is very important to create a voice for citizens in service delivery. USAID should build upon its earlier successes in empowering communities to problem solve and provide input to governance. The Primary Health Care Strengthening and ACQUIRE projects are or will be in communities creating health boards to manage community-based financing schemes, or problem solving for better healthcare. Other new projects in SO 2.1, Community Development and SACS, are planning to launch similar public education or advocacy activities. These initiatives promote government accountability through community oversight. Working with receptive local government officials, these projects should consider ways to expand health boards to include other development activities or local governance issues. In a related fashion, educating citizens through these projects, and via the media, on health-related law and patient rights—such as what is supposed to be covered by official fees and what is supposed to be available for free—can have a powerful impact empowering citizens and reducing the ease of corrupt practices. USAID should also continue to emphasize public education and information in Azerbaijan civil society via the broadcast and print media. Education on patient rights and the dissemination of objective drug information aimed at providers and consumers can act help to counteract the powerful influence of pharmaceutical companies.

USAID and other donor projects should also experiment with how to best disseminate performance data within Government, to the Parliament, and to civil society to enhance accountability and transparency in government operations. While these recommendations are directed toward the health sector, they could also apply to education or wherever services are delivered. In addition, civil society groups should be trained and supported to monitor the new requirement for public office holders to declare all assets and income and spotlight those that do not conform to known reality, such as expensive real estate holdings or equity positions in major companies.

C. Anti-Corruption Policy Dialogue Agenda

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 the Table 5, which indicates the topic, a possible responsible office, and the venues in which each topic might be pursued.

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 5 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.

TABLE 5: POLICY PAPER TOPICS

TOPIC	POLICY DIALOGUE PAPERS: SO TEAM AND IMPL. PARTNER	USAID BILATERAL POLICY DIALOGUE	U.S. EMBASSY AND OTHER DONORS	JETF
REDEPLOY PIPE TO MOF AND MED	1.3 AND PIPE	MOF AND MED	MOF AND MED	MINISTER OF FINANCE
DEEPEN MTEF	1.3 AND PIPE	MOF AND MED	RMG	MINISTERS OF FINANCE AND ECONOMIC DEVELOPMENT
THE BANKING SECTOR	1.3 AND BANKWORLD	NBA	RMG	CHAIRMAN OF THE NBA
PRIVATIZATION – SOE ENERGY COMPANIES	1.3 AND PA CONSULTING	MED AND MOF	RMG	MINISTERS OF FINANCE AND INDUSTRY AND ENERGY
PRIVATIZATION – IBA	1.3 AND BANKWORLD	MOF AND NBA	RMG AND PRES. APPARAT	MINISTER OF FINANCE AND NBA CHAIRMAN
SO FAR	1.3	MOF AND MED	RMG AND PRES. APPARAT	PRES. APPARAT AND MINISTER OF FINANCE
GOVERNMENT OF AZERBAIJAN ANTI-CORRUPTION COMMISSION	2.1 AND ABA-CEELI	ANTI-CORRUPTION COMMISSION	PRESIDENT	PRES. APPARAT
GOVERNMENT OF AZERBAIJAN-WIDE CODE OF ETHICS AND ASSET DECLARATION	2.1 AND ABA-CEELI	ANTI-CORRUPTION COMMISSION	INTERNATIONAL LEGAL REFORM GROUP (ILRG) AND PRES. APPARAT	PRES. APPARAT
INDEPENDENCE OF JUDICIARY	2.1 AND ABA-CEELI	MINISTRY OF JUSTICE (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
ADR	2.1	MOJ	ILRG AND MOJ	MINISTER OF JUSTICE
PHARMACY POLICY AND INDUSTRY REFORM	3.1	MOH		MINISTERS OF FINANCE AND HEALTH

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 incoming energy revenues. In that regard, USAID/Caucasus-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. This study consisted of reviews of several sectors that donors determined were of paramount importance. During the study, USAID hosted meetings of the donors working group in September and November 2005. The meetings were well attended and the discussion was 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 sub-working groups to more closely facilitate information exchange and to coordinate technical expertise and training within specific sectors?

1. 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 well being of its citizens. The primary urgent need is to identify and fix all of the gaps and leaks in the public finance system as rapidly as possible, and secondarily, 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 and to support the Government in 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.

Nevertheless, one must not overlook the petty corruption pandemic that is so widely accepted among citizens. It would be very useful for every project by every donor 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.²⁴³

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

²⁴³ Shah, Anwar, and Mark Schacter, "Combating Corruption: Look Before You Leap" *Finance and Development*, December 2004, p. 43.

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.

2. 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 Organization for Security and Co-operation in Europe (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.²⁴⁴ 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.

3. 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 (ADB) 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 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

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USAID, *USAID Anticorruption Strategy*, PD-ACA-557, Washington, D.C., 2005, p. 12.

to improve anti-corruption efforts. It is for the donors to find the will and energy to make it happen.

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ANNEX A: PERSONS CONSULTED

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