



USAID | AZERBAIJAN

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USAID Azerbaijan

2006-2011 Strategy Statement

U.S. INTERESTS IN AZERBAIJAN

Azerbaijan's geo-political position in the Caucasus between Russia and Iran, its corridor to Central Asia, and its expanding importance as a source of hydrocarbons make it critical to U.S. interests in the region. A democratically oriented, stable Azerbaijan is especially important for reducing regional terrorism and transnational threats, given its geographic gateway to the instabilities of the Middle East and Central Asia. The price of instability in Azerbaijan would be high, because it could tempt regional neighbors to fill a potential vacuum. USG foreign policy goals seek an independent, secure, democratic, and prosperous Azerbaijan as a vital passage for commerce and ideas between East and West.

DEVELOPMENT PROBLEMS IN AZERBAIJAN

Despite Azerbaijan's forthcoming oil wealth, the country is far behind many Eurasian countries in its social, economic and political development. It is beset with half of its people living below the poverty line and the risk that a majority of the population may not benefit from the new wealth. The tasks ahead include improving governance and reducing corruption, diversifying the economy from its reliance on oil and gas, creating jobs, and settling the long-standing conflict with Armenia over Nagorno-Karabakh.

Economic sector: Azerbaijan basically has three economies. One is a large and growing petroleum sector that is the driving force for economic expansion. A second is a small, mainly agricultural, non-oil economy where employment growth has been modest. The third is a large, growing informal economy.

From 1994 to 2004, Azerbaijan was able to develop its oil and gas resources and to achieve macroeconomic stability. During that decade, despite hydrocarbon-related foreign exchange inflows, inflation was kept in check. However, in 2005, signs of Dutch Disease appeared. Aggregate economic growth has averaged more than 10 percent annually since 2000. The pace of economic growth jumped to 20 percent in 2005 and is expected to rise even more in 2006 and beyond as oil and gas production, and, consequently, revenues increase. The greatest economic challenge to the Government of Azerbaijan (GOAZ) is to manage the increase in inflation and the appreciation of the manat as oil and

gas revenues flood into the economy. Failure to do so will jeopardize the GOAZ's objective of developing the non-oil sectors of the economy. The largest gaps in economic performance identified by the Bureau for Europe and Eurasia (E&E) Monitoring Country Progress Report (MCP) relate to the proportion of private sector participation in the economy. After initially divesting itself of smaller unprofitable enterprises, the government's pace in implementing privatization of large parastatals has stagnated. Corruption is a significant deterrent to investment, especially outside the energy sector.

Poor executive control over Ministries, weak legal institutions and lack of enforcement of the existing laws and regulations to combat corruption have allowed its pervasive and devastating influence on development and society in general.

Oil and gas exploration and production drive the economy. Oil will account for 90 percent of Azerbaijan's exports through the rest of the decade. Total oil production is expected to peak at around 1,000,000 bpd by 2011 and then steadily decline over the next decade. The new Baku-Tbilisi-Ceyhan pipeline, which was officially opened in May, 2005, will change the region's energy flow to an East-West axis towards Europe, from the existing North-South axis toward Russia, thereby reducing dependence on Russia for movement of Caspian oil. The giant Shah Deniz gas field, discovered in 2001, is scheduled to come into production in 2007, at which time Azerbaijan will become a major gas producer able to supply its domestic market and European markets.

Following national independence, the domestic energy sector has greatly deteriorated, both from physical infrastructure and institutional points of view, and now requires a major overhaul to effectively operate in a market-based economy. Problem areas include poor utility physical infrastructure, an ineffective regulatory system, lack of a rational tariff structure to recover costs, non-payment coupled with non-enforcement for energy usage, theft through illegal connections, absence of accountability for consumption, and subsidized services.

The State Oil Fund of the Republic of Azerbaijan (SOFAZ) was established in 1999 and is a mechanism whereby energy-related revenue windfalls will be accumulated and efficiently managed to underwrite capital investments that will help ensure the economic well being for future generations. In establishing SOFAZ, the GOAZ is demonstrating its determination to manage the inherent shocks to the economy by a large influx of foreign exchange from the oil and gas boom. The Oil Fund is comprised of a portion of the GOAZ's share of oil revenues from Production Sharing Agreements. SOFAZ revenues are invested by professional portfolio managers off shore. The earnings from the off shore investments are treated as revenues in the Consolidated State Budget. In principle, capital spending will be consistent with the GOAZ's poverty reduction program and, furthermore, identified, appraised and included in the Public Investment Program. Given that Azerbaijan's inflow of oil wealth is anticipated to peak around 2011 and decrease by 2025 to approximately 20 percent of that peak, SOFAZ must operate transparently according to the letter of its charter, and the GOAZ must make capital investments according to the Budget System Law in order for the wealth from the sale of non-renewable oil and gas to transform Azerbaijan's future in the non-oil sector.

The agricultural sector employs 45 percent of the labor force, giving it political importance. The collective and state farm system has been dismantled through a land reform program that distributed

1.3 million hectares to rural residents, with the result that most private holdings average less than four hectares. Growth in agriculture remains dependent on government subsidies applied through the tax system and cheap fuel. Key constraints to growth in the sector include lack of maintenance of irrigation infrastructure, an absence of modern machinery, low fertilizer use, substandard farm-to-market roads and a shortage of credit for small-scale farmers. Poor road maintenance leads to high vehicle operating costs and interrupted access to markets, thereby decreasing agricultural competitiveness.

Azerbaijan's banking system has only \$1.6 billion in total assets, which provides a very small base for economic development. At least 40 percent of the money supply remains outside the banking system in the informal economy. Key risks affecting the banking and the financial sector include corruption in the business environment; weak public management, particularly in judicial institutions; low purchasing power; and an uncompetitive economy outside the oil and gas sector. Although significant advances have been made in establishing a legal environment supportive of a market-oriented financial sector, investment and lending are still adversely affected by inadequate frameworks for secure transactions, insolvencies (bankruptcy and liquidation) and anti-monopoly enforcement. These deficiencies stifle non-oil foreign direct investment and lending outside of Baku.

Democracy sector: Since the Presidential elections in 2003 and municipal elections in 2004 (when electoral administration was moderately improved), political stability has been preserved, but the GOAZ has continued to place restrictions on political activity and the overall political environment remains highly polarized. Substantial progress in conducting free, fair, and transparent elections is essential for fostering a pluralistic political system. Political power is centered in the President's Office, while the ruling party dominates party politics and parliamentary actions, as well as business. Constraints on accountability, public trust, and representation must be overcome to establish a competitive political system and representative democracy. Corruption in campaign financing, lack of party platforms, voting irregularities, inadequate oversight and deficiencies in mechanisms for representation must be addressed.

Citizen participation is essentially absent in the development of democratic governance. Reasons for this include an historical culture of nonparticipation, failure of political parties and non-governmental organizations (NGOs) to develop effective representation, and disillusionment with the political process. Advocacy NGOs have a record of weak initiative and ideas, inadequate support and unproductive results. By not registering selected NGOs, the government wields the power to disband them in the event they represent a threat to the ruling authorities. Business organizations and community-based social and development organizations have done better than rights-based civil society organizations or advocacy NGOs. Citizen participation is more dynamic at the local level where daily life is affected most by such organizations.

Major challenges impeding rule of law in Azerbaijan are the subordination of the judiciary to the executive and pandemic corruption throughout the judicial system, as well as the public sector in general. Judges and lawyers do not have access to a complete set of laws, decrees and regulations,

so they are at a serious disadvantage in being able to apply the law equitably. Lack of transparency, corrupt influences and political dependencies add up to an ineffective judiciary.

Social Sector: In spite of Azerbaijan's overall economic growth during the last eight years, forty percent of the population is reported to live in poverty, including 17 percent in extreme poverty. Eighty percent of rural internally displaced person or refugee households are poor. Non-income indicators of poverty, including education, health care, and access to utilities and basic services appear to have deteriorated particularly in the rural areas.

The mortality rate of children under five is among the highest in the region, and is associated with poverty, poor neonatal and infant care, malnutrition, lack of education and financial insecurity. The high maternal mortality ratio is attributed largely to poor access to maternal health services. HIV/AIDS incidence is very low relative to the region, with most transmission from injecting drug users and heterosexual contact. Reported rates for tuberculosis rates are moderate, but tuberculosis is neither diagnosed reliably nor treated effectively in Azerbaijan. In addition, the large gap of eight years in life expectancies between men and women indicates that there are serious issues related to male lifestyles and/or health care. The dominant approach to health development is curative rather than preventative health care. While the health system has a surplus of doctors, nurses and other personnel, their training and knowledge is outdated; they are inadequately trained for preventive medicine and the system is financially starved; many facilities are poorly maintained, equipped and supplied; and quality of care falls while costs to consumers rise, so utilization declines.

The challenges facing the education sector in Azerbaijan are similar to those of other post-Soviet newly independent states. In the broadest sense, these challenges include: (1) maintaining the earlier educational achievements while reversing the deterioration that has taken place; (2) reforming the education system so that it reflects the needs of a democratic society and market economy; (3) controlling corrupt practices; and (4) ensuring access to and equity of education for all groups, regardless of gender, ethnicity, and socio-economic standing. These problems are exacerbated in Azerbaijan by a substantial decline from its pre-1991 levels in the share of GDP devoted to education.

Azerbaijan is regarded as having one of the largest burdens in the world of refugees and internally displaced person, primarily resulting from the Nagorno-Karabakh conflict. Currently, IDPs and refugees comprise close to 10 percent of the country's population. Despite the many special problems they face, most of these vulnerable people have been in their current location for more than a decade and they have lost much of their commonality. A major donor conference in March 2004 concluded that the most effective approach to their assistance would be to integrate them into broader development programs rather than to continue humanitarian assistance or to target them on the basis of their place of origin.

Conflict Vulnerability: The primary external risk, including a potential source of regional instability, is the ongoing conflict over Nagorno-Karabakh (N-K). A resumption of hostilities would result in major economic and human costs, while a peaceful resolution would contribute to the achievement of strategic objectives. The international community is attempting to resolve the dispute through the

OSCE-led Minsk Group. Lack of progress in resolving the status of N-K runs the risk of fueling more radical elements in society and, ultimately, having a destabilizing effect. Discontent over the unsettled situation in N-K is provoked in school textbooks, by government, and the media. Whether or not popular protests will result in the future remains uncertain.

Recent statements have indicated that a possible resolution to the Nagorno-Karabakh issue may be close at hand. Despite similar suggestions in the past which were not realized, USAID is following developments closely and if a turn of events requires assistance, e.g., conflict mitigation, confidence building, or reconstruction, the USAID Mission will be prepared to work with DCHA/CMM, OTI and OFDA/DART, among others, to develop a quick response, and to collaborate with other donors in determining the type of assistance necessary to help the country move forward.

Islam: Azerbaijan is one of few countries with a majority of citizens who are Shiite Muslim. While the GOAZ has demonstrated religious tolerance, it has actively discouraged Islamic extremism and the spread of fundamentalist ideals, especially from neighboring Iran. Azeri students have been banned from attending Iranian religious schools and strong representations have been made to Iran about meddling in religious aspects of Azerbaijan society. The Government closely controls extremism, but there are indications that activities of radical fundamentalist sects have gradually increased in Azeri society. Their inroads, limited to date, tend to be in the more remote northern, underdeveloped areas close to Dagestan, Chechnya and the Pankisi Gorge of Georgia. Although there is no indication of a major shift in religious tendencies, there is the potential of greater Islamic conservatism, possibly along the Iran border area.

BASIS FOR THE USAID APPROACH

The USAID program in Azerbaijan was initiated in 1992 to address the humanitarian assistance needs generated by the conflict in N-K. Section 907 of the FSA in 1992 prohibited U.S. assistance benefiting the GOAZ. Consequently, assistance was limited to humanitarian aid. Later limited approval was given to work in the area of democracy and other specific areas. The President has used the authority given by Congress in 2002 to waive the restrictions of Section 907 each year.

The current USAID/Azerbaijan mission statement calls for assistance to extend the benefits of economic growth and political pluralism to an ever-increasing proportion of the Azerbaijani population. This overarching goal adapts the E&E Bureau principle purpose to the specific conditions of Azerbaijan. Azerbaijan is classified within the USAID White Paper categories as a fair performing, low-income, transformational development country. Therefore, the USAID/Azerbaijan strategy statement addresses the three strategic goals that the E&E Bureau has adopted from the State USAID Strategic Plan. Priorities for the strategy in Azerbaijan respond to the gaps identified in the MCP between current country performance and the exit thresholds for USAID assistance in the E&E region. Within each strategic objective (SO), the areas for emphasis reflect these gaps. However, the level of effort devoted to these priorities is adjusted according to the comparative advantage of USAID.

Critical assumptions underpinning this Strategy Statement for USAID/Azerbaijan include:

- Section 907 of the FREEDOM Support Act will either be rescinded or waived throughout the period of the strategy;
- Economic policy reforms will create an increasingly open environment for broad-based growth; and
- The GOAZ will permit a gradual opening of political space for emerging civil society and democratic institutions.

Strategic Objective 1.3: Growth and Development of Competitive Private Enterprises

Accelerated

The critical problem for Azerbaijan's economy is not in meeting the performance measures reported in the MCP, but in taking advantage of the expected temporary export windfall to ensure sustainable and equitable economic performance. Sustainable growth and transition to an open market orientation are constrained primarily by the pervasive shortcomings in Azerbaijan's public policies and legal framework. Effective governance will require improvement in fiscal policy and its implementation while private sector growth will require an improved legal and regulatory framework. Compounding these shortcomings is the lack of institutional capacity to enforce existing laws and policies. Better privatization and regulation of state-owned enterprises, particularly in the domestic energy sector is particularly critical to private sector growth. In the long run, the economy must be diversified to reduce dependence on the short-lived petroleum boom. This will require improved access to financial intermediation to support investment outside the extractive industries, especially in SMEs. Such investment will also require improvement in key areas of infrastructure, such as public utilities. Further, the aggregate agricultural growth that was induced by land reform can be extended and made more sustainable by improvements in agricultural **market linkages and access to finance**.

SO 1.3 explicitly reflects the E&E Bureau strategic framework by focusing on completing the transition to an open market orientation. The largest gaps between economic performance in Azerbaijan and the exit thresholds are in the share of employment in SMEs, infrastructure that will contribute to long term economic productivity, and large scale privatization. The large state role in the petroleum industry, including extraction, processing and transportation, is beyond the manageable interest of USAID. In the near future the share of SMEs in the economy may decline further as the oil sector dominates economic growth, but USAID will help establish a foundation for private sector job growth through policy and regulatory reform, infrastructure support, and SME development.

The specific results of succeeding in this SO would be heightened investor confidence in the policies, regulations, and practices of the GOAZ. Further, this SO will help provide investors with better access to financial services, and the infrastructure required for growth. Together these results should induce expansion by SMEs that can be sustained beyond the oil boom.

USAID assistance relevant to this SO has only been underway since 2002 with the first waiver of Section 907 allowing work with the GOAZ in the economic sphere. Upon adoption of the new strategy, existing and new programs will be assigned to this SO. With the need to develop and institutionalize

policy reform and practices that form the foundation for a market economy, assistance in meeting this SO is expected to be needed until at least 2012.

The program components served by assistance for SO 1.3 include *Improve economic policy and the business environment (17)*, *Improve private sector competitiveness (18)*, *Strengthen the financial services sector and increase access to capital (19)*, *Expand and improve access to economic and social infrastructure (20)*, *Increase agricultural sector productivity (21)*, and *Promote and support anti-corruption reforms (13)*.

Strategic Objective 2.1: More Representative, Participatory and Better Functioning Democracy

Democracy indicators in the MCP show political process has the largest gap relative to the exit thresholds, with independent media, public administration and civil society also at very low levels, resulting in a planned exit date for USAID from the democracy sector no earlier than 2014. Although this performance is very poor relative to the economic sector, recent developments have lifted expectations about the potential for improvement. Two targets for progress are envisioned to meet this objective: citizens that are more effective and better informed, and government institutions that are more effective and democratic. An important early stage in building democracy will be to better inform citizens of their rights and responsibilities through independent media and civic education. Civil society can be made more effective by strengthening the financial sustainability of non-governmental organizations and by improving the capacity of citizens and groups to engage in political advocacy that is respectful of democratic practice. Government can be made more democratic through improving the conduct, fairness, transparency, and oversight of electoral processes; expanding the mechanisms for citizen and government interaction; and improving the legislative framework relevant to civil society.

SO 2.1 addresses the transition of Azerbaijan to a better functioning democracy in each of the priorities identified by the MCP report. Political process will be assisted through political party development, election monitoring, and training of elections officials. Independent media and civic education will be assisted to provide information on rights and responsibilities to a broad audience. Azerbaijan has little history of democratic practice, so an extensive effort to provide mechanisms for such information is justified. In addition, civil society will be supported both directly to improve its capacity and financial sustainability, and indirectly by supporting legislative reforms that enhance the legal environment for NGOs.

The results targeted by this SO include a larger, more sustainable, and politically active NGO sector, as well as a citizenry that is more cognizant of its rights and responsibilities. These results should be accompanied by government institutions that are more transparent, and more responsive to citizen input, particularly in administering elections. The key measure of success will be to have international recognition of free and fair elections.

USAID assistance relevant to this SO has been underway for several years pursuant to the former strategies, including working with the GOAZ since 1998. Upon adoption of the new strategy, existing programs will be assigned to this SO and success of USAID efforts in this sector will require new

activities to be developed. With the need to develop democratic concepts and practices among the majority of the population, assistance in meeting this SO is expected to be needed until at least 2014.

The program components that represent this SO include *Promote and support credible elections processes (9)*, *Strengthen democratic political parties (10)*, *Strengthen civil society (11)*, and *Promote and Support anti-corruption reforms (13)*.

Strategic Objective 3.2: Increased Use of quality health care services and practices

The indicators contained in the human capital index, as reported in the MCP, show extremely poor performance relative to exit threshold levels or relative to performance in the economy and democracy sectors. Adhering to the E&E Bureau approach for selecting priorities, the health sector is targeted for USAID focus. The aggregate performance in health is represented by very poor levels of life expectancy, abetted by even poorer performance in mortality of children. Although education is also lagging substantially, USAID will focus on public health where poor performance is the most extreme and where public expenditure is far lower than on education.

The poor health status of the Azeri population is due largely to deficiencies in the primary health care system and to widespread misunderstanding of health issues. Substantial improvements in government are necessary to establish a supportive policy and legal environment. The public and private components of primary health care should be implemented with appropriate allocation to needs and with greater efficiency. The quality of care should be addressed, particularly for underserved health issues such as reproductive health. Beyond the health care providers, considerable improvement is needed in public understanding of what primary health care can offer, what rights patients have, and how individual lifestyle can affect health.

Because the health conditions of Azerbaijani citizens have declined dramatically since independence from the Soviet Union and the major sources of decline are well documented, USAID regards progress from current levels to be feasible within its manageable interest. Reversing the decline will be approached generally by assisting in the building of primary health care systems that reach throughout the countryside, resulting in better functioning community-based services in the near term, and improved child survival and life expectancy. Since women in Azerbaijan often use abortion as a method of family planning, USAID will target improvements in reproductive health services to provide more effective and safer means of choice for family planning. An additional legacy has already been formed in improving primary and tertiary health care services for IDP and refugee populations through three partnerships with American medical institutions.

Existing health care programs will be shifted to this strategic objective as soon as it is adopted. Expansion of USAID efforts in this sector will require new activities to be developed. Assistance on this ambitious and critical SO will continue at least until 2014.

The program components that represent this SO include *Reduce transmission and impact of HIV/AIDS (29)*, *Prevent and control infectious diseases of major importance (30)*, *Address other health*

vulnerabilities (31), Improve child survival, health and nutrition (32), Improve maternal health and nutrition, (33), Support family planning (34), and Promote and support anti-corruption reforms (13).

CROSS-CUTTING THEMES

Anti-Corruption will be given preeminent attention by the Mission in the implementation of all SOs. This is being accomplished in coordination with other donors, who are equally dedicated to work on this issue. An anti-corruption strategy is under preparation that will identify opportunities to maximize anti-corruption mechanisms in ongoing and planned activities.

The economic growth activities will address issues of corruption and related mismanagement through institutional and systems improvement by working for a better legal and regulatory framework that focuses on minimizing constraints to business. Community-based activities will assure that civil society participation fights corruption by creating public awareness about effects of corruption and monitoring government actions and decisions in an effort to reduce corruption. Health activities will incorporate anti-corruption mechanisms in delivery of health care services.

Gender will not be addressed in stand-alone activities but will continue to be integrated across all SOs. USAID will emphasize improving knowledge of and project implementation techniques on gender issues.

Global Development Alliances (GDAs) have already been incorporated in the program supported by USAID/Azerbaijan, as evidenced by a GDA within its health portfolio, using Mission funds. In all SOs, the Mission seeks to leverage private sector funds, building on a business forum that USAID recently co-hosted with the American Chamber of Commerce of Baku to introduce the GDA process to foreign and local private sector companies doing business in Azerbaijan, along with interested embassies.

Islam. USAID will seek an approach for the GOAZ to utilize in maintaining Azerbaijan's stable and secular Islamic state while developing into a market-oriented democracy. In each SO, USAID will attempt to engage religious leaders in proximity to our project sites in order to give them an awareness of and, as appropriate, participation in USAID activities in their communities.

Values and social capital will constitute a recurrent theme in ensuring USAID's legacy in Azerbaijan. Each SO in the USAID strategy for Azerbaijan seeks legal and policy reforms, but these are in no case sufficient to accomplish the SO or to instill sustainable change. Thus, USAID assistance will also endeavor to instill confidence by the public that democracy and open markets can be effective and valuable mechanisms to overcome the institutional failures that led to the collapse of the Soviet Union and the stagnation of the Azeri economy. Only by instilling values such as transparency in governance and in commercial relations, respect for human rights, and adherence to the rule of law will the social capital of Azerbaijan become adequate to sustain its transition.

Youth in Azerbaijan are regarded as a key element of USAID's development approach. Each SO will emphasize opportunities to invest development gains in youth to take advantage of their relative flexibility in accepting change and their role as the future of the country.

BUDGET

The annual budget expected for all USAID programs in Azerbaijan is expected to remain approximately constant from current levels through the foreseeable future at about \$30 - \$32 million. The largest part of this funding will be placed in SO 1.3 and the smallest part in SO 3.2.

WORKFORCE

USAID/Azerbaijan began to adjust its staffing to implement the new strategy with the August 2004 hiring of its first health specialist. Additional health expertise is also being provided through the co-funding of a Regional Health Advisor based in Tbilisi. Further staff realignment is underway with the hiring of a USPSC economist and several new FSN program and support staff. When these staffing additions and changes are completed each Strategic Objective team, as well as the Program Office, will have sufficient program and support staff to execute its responsibilities. The total staffing currently authorized includes three USDHs, four USPSCs, one TCN, one fellow, and 21 FSNs. Further, improved interaction with the rest of the USAID/Caucasus Mission in Tbilisi allows the Baku Office to routinely draw upon additional technical and operations support.

EARMARKS AND DIRECTIVES

Section 907 of the FSA prohibits USAID and other agencies from assisting the GOA with development programs. Beginning in FY2002, the restrictions of Section 907 have been waived by the President annually, a practice that is expected to continue in the foreseeable future unless the GOAZ acceptance of democratic principles unacceptably deteriorates.

BIODIVERSITY

A Biodiversity Assessment Update for Azerbaijan was completed in May 2004 and was considered during the preparation of a new Mission Strategy Statement. No activity undertaken or proposed by USAID was found to contribute to the loss of biodiversity. USAID NGO support was specifically cited for its positive effect on encouraging and building confidence of environmental NGOs as well as building their capacity and promoting partnerships. This mechanism for impact on preserving biodiversity will continue to be pursued by USAID in Azerbaijan. As recommended by the biodiversity assessment, SOs 2.1 and 3.2 will help educate Azeris regarding the health hazards posed by pollutants and pathogens. Consistent with another recommendation of the biodiversity assessment, the support planned in SO1.3 for improvement of the domestic energy sector could contribute significantly to reductions in illegal use of fuel wood, thereby protecting forestlands. In addition, the biodiversity assessment identified generally how the regional cooperation with Georgia had been

effective in water management of the Alazani River Basin. A follow-on activity has been awarded to continue this collaborative effort.