

# The World Bank Group's Strategy

## A. Implementation of the Last CPS

1. **The FY07-10 CPS was prepared at the start of the oil boom.** Growth in the years immediately preceding the CPS was robust, and even higher growth rates were anticipated with the coming on stream of several new oil and gas fields and the BTC pipeline in 2006. The Government saw this as an opportunity to accelerate development and achieve the Millennium Development Goals as soon as possible, particularly given the temporary nature of this income. These ambitious goals were laid out in its PRSP. It viewed the Bank as a reliable partner that could help prioritize increased investments as well as ensure that they were carried out with adequate fiduciary oversight.

2. **The level of Bank support was ramped up dramatically in tandem with the Government's desire to accelerate development and its increased creditworthiness.** Up to FY05, Azerbaijan was an IDA-only country, receiving about \$50-75 million per year. In FY05, Azerbaijan was declared creditworthy for IBRD lending, but IBRD lending was limited to two loans in FY05-06. The total amount of lending envisaged in the FY07-10 CPS was increased significantly to about \$1.2 billion over four years (IDA plus IBRD). Further, the Government indicated its intention to provide 20-50 percent in cofinancing on Bank lending. Just a year into the FY07-10 CPS, many loans were larger than anticipated and the Bank had lent the full amount authorized. As a result, the Government requested a further increase in the lending envelope to support its ambitious development plans, and the amount was ramped up to \$2.4 billion under the CPS Progress Report. However, this proved too ambitious and in the end, the Bank extended only \$1.6 billion during the CPS period.

3. **The instruments envisaged were investment and technical assistance operations, as well as IFC investment and advisory services.** While there were relatively good results from the Bank's Development Policy Operations, given the lack of budgetary need, no further policy operation was envisaged during the CPS period. Rather, regular policy dialogue on key reforms was envisaged based on analytic work as well as monitoring under the CPIA. The danger of overheating the economy was recognized but it was felt that our public expenditure dialogue plus the well functioning Oil Fund (established with the help of the Bank) would help to prioritize expenditures and channel excess funds for future generations. Portfolio risk was also recognized but at the time, there were not significant portfolio issues and the disbursement ratio was reasonably strong at 20 percent.

4. **The focus of the CPS was quite broad, covering four pillars:** (i) *improving public sector governance* (including public expenditures, accounting, the business environment and the judiciary), (ii) *supporting growth of the non-oil economy* (including access to financial services, SME support, rural infrastructure, transport, energy and water infrastructure), (iii) *increasing the quality of and access to social services* (including health care, education, social assistance, and improving the living conditions of IDPs) and (iv) *improving environmental management* (including cleaning up legacy pollution, supporting biodiversity and natural resource management, and disaster management). Governance was a cross-cutting theme.

## Results

5. **Overall country-level results during the CPS period were mixed.** As noted, growth rates were in the 20-30 percent range and poverty levels fell dramatically, from close to 50 percent to about 16 percent in 2008. Non-oil growth was also very high, though much of this is indirectly linked to oil

production. Progress has also continued to be made towards most of the Millennium Development Goals (MDGs – See Annex 5). However, progress on overall policy reform and institutional deepening was more mixed. The CPS set out to monitor this through the CPIA ratings, but only about half of the targets on these were met. The greatest progress was against the overall macro-economic framework, meeting social needs, and improving rural and community infrastructure services. Health care and basic education services have improved and the social assistance program is increasingly well targeted. Reform progress was weakest in the areas of public expenditures, transparency and governance, and the environment. Overall, the perception of corruption in Azerbaijan continues to remain high. Though it should be noted that Azerbaijan has made the important achievement of becoming the first EITI compliant country.

6. **The design of the CPS as regards the specific activities and goals it supported proved to be overly ambitious.** The CPS as originally designed was consistent with the Government’s strategy and built on the substantial results achieved in the previous CAS period, including a reasonably well performing portfolio and steady progress by the Government on structural reforms. However, it proved overly ambitious in two key ways: First, the Bank knew from experience elsewhere that reform progress often slows in situations of rapid income growth. Without a development policy operation or a clear replacement to anchor policy reforms, the policy dialogue was unable to make significant progress during the CPS period in several key areas such as public expenditures and certain elements of the business environment. Second, the ramp up of lending overwhelmed implementation capacity. Some projects were brought to the Board without meeting readiness conditions and implementation was protracted. The Bank took corrective action on both accounts during the second half of the CPS, including by (i) holding a High Level Policy Forum to help galvanize decision makers on key reforms needed, (ii) conducting a Joint Portfolio Review which brought high level attention to problem projects and established a Working Group representing key Ministries to maintain and elevate such attention, and (iii) slowing new lending and placing greater attention to readiness at entry.

7. **As a result, achievements as measured against CPS results targets were measured as moderately unsatisfactory according to the CPS Completion Report.** The best results came from smaller operations in community development, where lending to rural and IDP communities have continued to help improve people’s lives. Good results were also achieved in the social protection areas, and to a lesser extent in health and education where reforms and improved infrastructure have been slow but steady. Progress has also been achieved in rural development, including irrigation, avian influenza control and agriculture credit. More mixed results were seen in the larger infrastructure projects – Highways, Water, and Rail – where implementation has been delayed but are on track to deliver results largely during the coming CPS period. The poorest results were seen in the public expenditure, governance and environmental areas where little progress has been made. The area of environment is particularly disappointing given the importance of making progress in cleaning up legacy issues in the Absheron Peninsula. In light of the difficulty in getting agreement with the Government on the way forward, two of the three loans in this regard were withdrawn in FY10 before becoming effective.

8. **IFC was relatively more successful than the Bank, committing \$133 million in 20 projects from FY07 to date.** IFC saw steady growth in its investment portfolio reflecting strong economic growth, and increased human resources dedicated to Azerbaijan through its special initiative for Central Asia and Azerbaijan. Notably, all of this investment was outside of the oil and gas sectors supporting the non-oil economy, mainly through financial intermediaries, primarily banks. This represented a significant shift for IFC. In the prior five years (FY02-06) approved investments outside the oil and gas sector were \$5 million or less per year. IFC’s outstanding portfolio currently totals \$102 million with 59% of this in financial institutions, 22% in the oil and gas sector, and 19% in the real sectors (primarily retail). This growing portfolio is generally performing well even through the crisis, although the level of risk in some of its bank exposures has increased, and one of its investments has started experiencing problems in 2010. IFC also increased advisory activities in investment climate, access to finance, and corporate governance,

with some successful legislative and regulatory interventions, improvements made to individual FIs and real sector clients, and public awareness initiatives.

### ***Key Lessons and Recommendations***

9. Based on the CPSCR, the following key lessons can be learned from the implementation of the FY07-10 CPS:

- **Increase the focus on implementation.** The Bank should increase its attention to implementation of existing operations, and focus primarily on achieving results under existing operations. Where implementation is substantially stalled, the Bank and the Government should consider cancelling operations in order to better focus on those operations where success can be achieved more quickly.
- **Be more selective in new operations.** The Bank should try to narrow the focus of its activities, based on Government commitment and Bank experience. This will mean deepening project engagement in those areas where success has been achieved, and focusing on those areas of development priority, strong Government demand, and clear Bank comparative advantage. At the same time, the Bank should not shy away from playing an advocacy role in other areas where there is a high development need and Bank comparative advantage, but limited Government ownership.
- **Apply a stronger readiness filter for new operations.** In the previous CPS, a number of projects were brought to the Board where procurement and institutional arrangements were not fully developed. As a consequence, these operations were unable to disburse for 18 months and two had to be withdrawn. This wastes precious time, budget and focus. For the new CPS, project implementation arrangements should be more fully advanced before taking loans to the Board.
- **Rebalance Bank activities towards more concrete mechanisms for knowledge sharing and policy dialogue.** It may be useful to consider more concrete mechanisms for carrying the policy dialogue forward, including increased use of analytic work to underpin new lending and potentially some policy-based lending. The high level policy forum in 2009 yielded promising results and may also provide a mechanism to enhance dialogue.

10. **In addition, a FY10 Bank internal review echoed some of these lessons on implementation for the Bank's program in Azerbaijan:** (i) *Do not underestimate risks*--The sharp increase in lending did not adequately recognize the risks in low absorptive capacity and non-transparent decision-making, (ii) *Ensure readiness for disbursement*--While cutting preparation times, many projects did not have fully developed procurement and policy agreements. Inadequate preparation and lack of ownership have led to slow disbursements, (iii) *Strengthen portfolio monitoring*-- The Bank should provide increased support to country efforts at portfolio monitoring and coordination, and (iv) *Focus management attention early on project issues* --Bank management should be persistent in including implementation issues in its dialogue: in the absence of results on specific projects, restructuring and cancellation should be pursued.

### **B. The New Country Partnership Strategy for FY11-14**

11. **The design of the CPS reflects the key challenges facing Azerbaijan in the medium term.** It is tightly focused on achieving results in two key pillars: (i) building a competitive non-oil sector and (ii) strengthening human and social services. These two pillars constitute independent developmental objectives but, at the same time, they are mutually re-enforcing. Further, a key lesson from the last CPS

is that public investments grew faster than institutional capacity could improve thus resulting in opportunities for rent seeking and slowing implementation. Therefore, a cross-cutting filter for all activities will be improving governance and institution-building, without which it will be difficult to achieve sustainable results.

12. **How the strategy will be implemented is just as important as the focus areas.** The previous CPS also focused on priority areas for Azerbaijan, but did not achieve adequate traction. In light of this experience, the new CPS will focus in the first instance on implementation of the large existing Bank portfolio, including faster disbursements but also restructuring and closing projects when needed. New operations will be calibrated against existing operational progress. Because of this, most of the Bank's results objectives will be based on existing operations. Second, more attention will be paid to building analytic knowledge and strategies in particular sectors in order to ensure that there is an agreed approach before launching operations. Third, a more structured approach towards policy dialogue will be sought through several vehicles – a regular high level forum focusing key policy makers on developing a shared reform agenda, a potential joint economic research program between the Government and the World Bank, continued close cooperation between the Bank and IFC on policy advice to the Government related to the private and financial sectors, and exploring a possible development policy operation to help support reform implementation.

13. **IFC and the Bank will play complementary roles** whereby IFC's advisory and financial services for private sector's benefit will reinforce the Bank's lending and AAA in the public sector. IFC will support the private sector to address CPS objectives, namely (1) building a competitive economy through greater access to finance and an improved business climate, (2) strengthening human and social capital through possible support to private sector participation in addressing issues such as provision of health care services, infrastructure, and possibly energy efficiency, and (3) improved governance and institution-building through the promotion of transparent business practices and capacity building for financial institutions and agencies key to private sector development.

### **Strategic Objective 1: Building a Competitive Non-Oil Economy**

#### **Results area 1: Enhancing macro-economic stability and growth policies**

- Outcome 1: Prudent macroeconomic and fiscal management
- Outcome 2: Improved trade policy and institutions
- Outcome 3: Sustained improvements in business environment
- Outcome 4: More transparency and efficiency in public institutions

14. **Prudent macroeconomic and fiscal management.** In light of the leveling off of oil and gas revenues, the key element of macroeconomic management will be to help Azerbaijan keep its expenditure levels in line with sustainable income expectations. This will also provide an incentive to prioritize public investments, contain inflation, and avoid crowding out the private sector. The key indicator will therefore be the reduction in non-oil deficit as a percent of non-oil GDP. The goal by the end of the CPS period will be to reduce that.<sup>1</sup> The primary instrument will be the *programmatic public expenditure review*, which will focus on improving the use of medium term planning (MTEF) and sustainable

<sup>1</sup> Fiscal sustainability analysis presented in the Country Economic Memorandum for Azerbaijan (2009) indicates that if Azerbaijan wants to maintain fiscal sustainability, the non-oil deficit should be reduced to about 30 percent of non-oil GDP by the end of the CPS period (2014). At present, the absence of a fiscal rule and of an effective Medium Term Expenditure Framework makes the achievement of this result uncertain.

recurrent cost financing. This would be combined with other instruments to make our overall policy dialogue more concrete (regular high level *policy forums*, exploring the potential for a *DPO* series as well as a *Joint Economic Research Program – JERP* – and possibly *IFC advisory services* to increase the ease of paying taxes. These efforts would help, inter alia, by building more effective inter-agency coordination on macro-policy. The Bank’s Treasury Department will continue to provide support to the Oil Fund on *asset management*. Close coordination with the IMF will be essential.

15. **Improved trade policy and institutions.** All studies and practice point to currently restrictive and non-transparent trade policies and institutions as a primary road block to achieving private sector led non-oil growth. Key indicators of success will be growth in the volume of non-oil exports and reduction in time and cost to export and import. An overall measure of progress would be an improvement in the ease of Border Crossing in Doing Business (2009 Doing Business ranked Azerbaijan 177 out of 183 countries on ease of trading across borders). At the heart of making this happen is a non-oil export strategy by the Government now under preparation. The Bank will provide *analytic support on the export strategy* to ensure it focuses on central policy and institutional issues, and is endorsed with a time bound action plan and success markers. The Bank will also provide longer term *analytic assistance on WTO* to help the Government move forward on WTO accession which will spur increased and open trade. Several of the possible new instruments for policy dialogue (*Policy Forum*, *JERP*, and possibly a *DPO*) may also be utilized to support this outcome. If requested by the Government, IFC could provide complementary *advisory services to improve the ease of trading across borders*. Close coordination with the EU on reforms to enhance trade integration will be pursued.

16. **Sustained improvements in the business environment.** While Azerbaijan has made progress, there are quite a few areas where further significant improvement is possible to increase the ease of doing business and access to finance. The overall benefit of these improvements will be measured through various surveys (BEEPS, Doing Business, IFC SME survey etc). More specifically, in addition to improvements in tax and customs (see above), the following targets will be supported and monitored: (i) a significant reduction in land registration processing time, (ii) increase in the use of mortgages to finance investments, (iii) development of the domestic capital markets, and (iv) the number of micro and SME loans made through IFC-supported banks, and (iv) further progress in streamlining permits and inspections. The Bank will support these efforts through the ongoing *Real Estate Registration Project*, and the proposed new *Capital Markets Modernization Project*. The latter will be particularly important in promoting corporate transparency and providing new avenues for financing enterprises and supporting non-oil growth, given the weaknesses in the banking sector. The Bank will also maintain a *regular technical assessment and policy dialogue* with the CBA and other financial sector institutions, funded in part through the FIRST initiative. Several of the possible new instruments for policy dialogue (*Policy Forum*, *JERP*, and possibly a *DPO*) may also be utilized to support this outcome. The *CAPSAP project* will address weak financial reporting practices and underdeveloped audit profession to strengthen the business environment for SMEs. IFC will continue to provide *financing to SMEs*, in particular through financial institutions. It will also continue to provide *investment climate advisory work* to reduce regulatory burden on businesses, *corporate governance advisory services*, and *financial infrastructure advisory services* (credit information sharing and secured lending). SECO will remain a key IFC and Bank partner in this area.

17. **More transparency and efficiency in public institutions.** Greater transparency and efficiency in public institutions will reduce the opportunities for rent seeking, enable the Government to operate effectively within a tighter fiscal budget, and strengthen market based approaches. Key goals during the CPS period will be (i) greater utilization of the MTEF in budget formulation and the provision of a budget summary to the public, (ii) an increase in the number of public investment projects prepared on the basis of rate of return criteria, (iii) an increase in the number of SOEs and agencies using international financial standards, (iv) and an increase in user satisfaction of the courts, (v) more effective use of public

procurement, and (vi) strengthen the capacity of the Chamber of Accounts to conduct ISA based audits. The Bank will support these goals directly through the ongoing *Public Investment Capacity Building Project*, *Judicial Project*, and *Corporate and Public Sector Accountability Project* and indirectly through other projects working through SOEs. Analytic work on budget transparency will be supported through the annual *Public Expenditure Review*, follow-up to the *Country Procurement Assessment Report*, and analytic work on helping the Government develop a market based *SOE strategy*. IFC, through its *Investment Climate Advisory* activities will help to improve the private sector awareness of regulatory processes and increase transparency through an *updated SME survey* and capacity building with the Government on surveys related to government services, for example a tax client survey currently being launched. A new *ROSC* may be considered in the outer years to measure progress in the area of Accounting and Audit development.

## Results area 2: Upgrading Key Growth Supporting Infrastructure

- Outcome 1: Transport time and vehicle operating costs reduced
- Outcome 2: Improved agriculture and irrigation services

18. **Transport time and vehicle operating costs reduced.** Improved transportation is a central part of Azerbaijan's effort for non-oil growth since it will help to (i) strengthen inter-country linkages, (ii) provide greater export market access to local producers and (iii) build Azerbaijan's role as a regional East-West and North-South transit corridor. The overall goal is to upgrade highway and so reduce road user cost on the sections supported by Bank operations. For Railways, the goal is to purchase new locomotives and rehabilitate rail track so as to reduce the East-West transit time. With Bank support, the Government would seek to increase the volume of rail transit traffic (from 11 million tons to 23 million tons) and improve locomotive reliability. Bank supported activities include the ongoing *Highways 2 and 3* and *Railway Projects*, combined with a regional *Transport Sustainability Review*, a *Transport Sector Review*, and an *IDF grant for transport quality enhancement*. Dependent on implementation progress under Highways 2 and 3, an additional new *Highways 4 project* and a *regional life-line roads project* could be considered. IFC is looking into possible *investments in private logistics companies* and/or investment support to *private participation in transport infrastructure*. A key partner will be the ADB which is also providing significant transport investment to Azerbaijan.

19. **Improved agriculture and irrigation services.** Agriculture in Azerbaijan, with its myriad of micro-climates and close access to both Europe and Asia, holds great economic potential. Rural areas are also where most of the poor live and providing greater incomes in rural areas would help stem migration towards already crowded urban areas. The goal would be to continue to increase productivity and income levels of participating farmers under Bank projects. Irrigation services would also be strengthened (the volume of irrigation water would be increased from two irrigations to four irrigations per season). Water User Associations would continue to be expanded and strengthened. The Bank would support these efforts through its ongoing *Agriculture Development and Credit Project (ADCP) 2*, a follow up *ADCP3*, and a new *Irrigation Project (Irrigation II)*. The Bank would support these projects with increase analytic work – an *Agriculture and Irrigation Sector Update*, and continuing analytic work on related trade issues – quality standards and WTO access. IFC would consider direct financing of agribusiness or related sectors (e.g. retail, packaging, logistics), as well as indirect support through financial institutions, and may also consider launching advisory services that contribute to improved competitiveness of the sector, for example in areas such as food safety standards and/or agrifinance.

## Strategic Objective 2: Strengthening Social and Municipal Services

### Results Area 3: Improving Social Services

- Outcome 1: Strengthened social protection and employment services
- Outcome 2: Wider access to health services
- Outcome 3: Improved quality of basic and higher education
- Outcome 4: Improved living conditions for IDPs
- Outcome 5: Improved road safety

20. **Strengthened social protection and employment services.** The Government has already made major progress in establishing a user-friendly targeted social protection system. At the same time, further improvements are needed in the social protection system, particularly to ensure that the coverage of social assistance for the very poor. In addition, the matching process between those seeking employment and businesses in need of staff is not functioning well. It would be helpful to ensure that the employment services be able to reach and serve a larger number of job seekers. If more job seekers can be helped, this will both help to focus social assistance on those that need it most, and facilitate business growth. The main mechanism the Bank has for pursuing this is the ongoing *Social Protection Project*. This will also be complemented by analytic support through the *Programmatic Poverty Assessment*.

21. **Wider access to health services.** Key health indicators have improved but more progress is needed if the MDG targets are to be met, particularly to address the growth of drug resistant TB. In order to do so, the Government is currently expanding and upgrading health facilities and improving health care organization and delivery of services with Bank support. The Bank is also supporting the Government in building an effective health strategy which would among other things help to make the sector more efficient and effective. However, the Government needs to continue to increase public health spending to reduce out of pocket expenses for the population, particularly to ensure a sustainable supply of essential medicines. Key goals would be the further improvement in health indicators in supported regions and the adaptation of an effective health strategy that would start to reduce out of pocket expenses. The main mechanism the Bank has to support these activities is the ongoing *Health Sector Reform Project*. Depending on market developments, IFC will also consider *possible investments in private health care services*.

22. **Improved quality of basic and higher education.** Popular access to basic education is not the issue. Rather there is a need to improve the quality and cost effectiveness of basic education. The Government has launched with Bank support reform in the basic education system, including curricula reform and streamlining the number of schools. In turn the success of these efforts would be measured against improvements in basic educational outcomes. As regards higher education, there is significant room for improvement both in the percent of population who go on to tertiary education and the quality of tertiary education. Ultimately, Azerbaijan needs a highly skilled workforce if it is to be competitive internationally. These reforms are therefore important not just for social reasons but to improve Azerbaijan's overall competitiveness. The Bank will support efforts in basic education through its ongoing *Education APL2*. The Bank will complement this with an *Education Strategy*, covering both basic and higher education. If agreement can be reached on an effective higher education strategy, the Bank will provide financing for a *Higher Education Project* in support of this.

23. **Improved living conditions for IDPs.** Up to 900,000 or so IDPs (10 percent of the population) remain relatively poorly integrated into society and rely heavily on Government assistance. This is a large source of human capital that is not being effectively utilized. The need is to both improve the living conditions of the IDPs while strengthening their ability to generate their own livelihoods. Success in this

area would be measured through the number of micro-projects that meet IDP community needs and if the number of IDPs generating self-reliant income can be increased. The main mechanisms for this are the *ongoing IDP project* and a proposed follow-on *IDP II Project*. The Bank would also support *analytic work on IDPs* during the CPS period to further determine how best to provide services and integrate them into society. Issues would also be tracked and analyzed in the *programmatic poverty assessment*.

24. **Improved road safety.** Azerbaijan has a high level of road traffic injuries and fatalities even by ECA standards. As Azerbaijan improves its road network, added efforts are needed to strengthen road safety systems, enforce existing laws and regulations and educate the population to prevent risky road behavior and protect pedestrians. The goal is to help Azerbaijan effectively implement a Traffic Safety Strategy and reduce road injuries. To this end, the Bank is providing support under the *Highway 2 project* to implement this strategy on the entire road network and to decrease the fatalities rate on the portion of the network being rehabilitated.

#### Results area 4: Improved municipal and rural services

- Outcome 1: More reliable water supply and sanitation
- Outcome 2: Improved reliability of solid waste management services
- Outcome 3: Improved access to rural infrastructure

25. **More reliable water supply and sanitation.** The Government has established the provision of reliable water and sanitation as a priority for the country. The World Bank, the ADB, KfW, JBIC and the Government itself are all supporting this priority. For the World Bank supported operations, the goal is to increase the number of people with improved water supply and sanitation. A second target would be improving reliability in water supply in the serviced population. The primary vehicle for achieving these results will be the ongoing *National Water Supply Projects 1 and 2*. Depending on implementation performance of these projects, the Bank could consider a follow up project. If there is potential and government support for private sector participation, IFC would consider extending advisory services or investment support, though at the moment no agreement on this exists.

26. **Improved reliability of waste management services.** Azerbaijan faces the need for a major upgrading of its disposal management for both waste water and solid waste. For solid waste, the goal would be to extend waste collection services for the currently un-served population of Greater Baku. This would include the rehabilitation of the largest informal waste dump in Baku. For waste water, the Government is upgrading several water treatment plants and has requested Bank assistance to put into place a mechanism to dispose of this water (after treatment) in an environmentally sound manner. On solid waste management, the primary vehicle for Bank support would be the ongoing *Solid Waste Management Project*. On waste water, a new project is under preparation - *the Hovsan Wastewater Outfall Project*. Follow-on projects could be considered for both activities, dependent on implementation performance. The Bank will invest in analytic work to ensure policy coherence in *solid waste and waste water management*.

27. **Improved access to rural infrastructure.** Comprehensive efforts to support rural communities by identifying and supporting the highest priorities are proven cost-effective methods of supporting local infrastructure. While there are many improvements to be made, one key area is rural roads and it is anticipated that the number of people with improved access to rural roads would increase significantly

Rehabilitation of small scale irrigation works is estimated to increase production. Schools' rehabilitation to increase school enrollment in affected remote mountainous communities. Rural infrastructure projects also have a high impact in employment generation. The primary vehicle for achieving these outcomes will be the ongoing *Azerbaijan Rural Investment Project (AzRIP)* and follow-on *additional financing* for this.

28. **Improved environmental and energy planning.** Environmental needs loom large in Azerbaijan. While the importance of addressing these issues is widely recognized, there is not yet an agreed approach and methodological base for decision making. This CPS addresses this gap through investment in analytic work on *prioritizing environmental investments*. Analytic work on climate change would also be carried out built on the initial environmental cooperation with SOCAR currently underway, and would help inform Bank projects such as irrigation. The Bank would also support the environmental agenda through its water and waste management projects as well as environmental impact assessments under several infrastructure projects. Closely linked to the environmental agenda is the energy agenda. The Bank has just completed support for a power transmission project which is improving efficiency in energy use, and we are also working with SOCAR on gas flaring and utilization options. The Government also took steps towards improving the financial viability and governance in the sector, through increased tariffs and in the case of Azerenerji moving to IFRS for its financial statements. Energy trade and energy efficiency continue to be important areas and the Bank will remain open to exploring ways to advance this agenda during the CPS period. IFC could consider possible advisory and/or investment in financing for energy efficiency improvements building on its experience in other ECA markets and the energy efficiency survey it completed in Azerbaijan in 2009.

Cross-Cutting Filter: Strengthening Governance and Institutions
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29. **Within each of the proposed interventions the Bank will aim to help the Government strengthen key policies and institutions.** Azerbaijan cannot achieve sustainable growth or cost-effective service delivery without investing more in improving governance and institutions. Success would be measured against progress in four dimensions, where there are related activities and results targets in each of the main areas of focus.

- **Project Implementation Capacity:** The simplest dimension is the use of internationally accepted practices for accounting, procurement, and environmental assessments. The Government looks to the Bank to ensure that public funds are used in an efficient and effective manner. The Bank will continue to strengthen procurement practices throughout the Government through follow up on the recently prepared Country Procurement Assessment Review (CPAR). Beyond this, the Bank has a wealth of experience in helping the Government to ensure projects have strong Monitoring and Evaluation systems and are adequately staffed to design and review quality standards. Project implementation will also be supported by closer supervision, greater attention to capacity building, increased analytic work, and feedback channels from stakeholders. Decentralized procurement staff will help with risky projects and capacity building in the PIUs from the Country Office, and on-site technical supervision of the projects implementation will be further strengthened. The Bank will provide more procurement and financial management training for the PIUs and the government.
- **Institutional Capacity Building:** Building capacity beyond project activities within individual agencies will be an essential element in achieving results. Helping to strengthen the newly established Waste Management Company, the newly commercialized Azerbaijan Rail Company, the Roads Department, and various Ministries (health, education, labor, justice) rests at the heart

of Bank supported projects. This can be accomplished through building the legal and regulatory framework, budgeting and accounting systems, information systems, adequate staffing, training, and study tours. The *Public Sector Capacity Building Project* and the *CAPSAP project* provide cross-cutting support for institutional capacity. Capacity building will also be embedded in the Bank's sector *analytic work that will underpin new investments*. IFC would provide capacity support for financial institutions and key Government ministries through its advisory work in the areas of access to finance and investment climate.

- **Policy reforms to reduce corruption:** Within each of the Bank's activities, we will be looking to identify and support policies or processes that reduce opportunities for corruption. This includes technical solutions such as providing ATM cards for recipients to withdraw social assistance directly without going through a middle man (see Box 3) or introducing methodology of the community based decision making and supervision of small public investments under the AZRIP project.. The Judicial Modernization Project and the Social Protection Project provide solutions for merit based hiring of judges and appropriate remuneration for public employees. Analytical work within individual sectors to provide a framework for new operations would be particularly important. Bank and IFC analytical work will help the Government identify ways to reduce corruption in cross-border activity and the high level policy forum provides a mechanism to focus on critical policy reforms needed. Much of IFC's work in investment climate is designed to increase the transparency of administrative procedures and requirements, which decreases opportunities for rent-seeking; with Doing Business Report having an important role in securing high level political support for change.
- **Promoting transparency and public debate:** The Bank's efforts to build transparency through the Real Estate Registration Project, the Judicial Modernization Project, the CAPSAP project, and the proposed Capital Markets Project, along with the PER in strengthening the use of the MTEF and the policy forum would all promote this objective. However, the progress on improving governance will require strengthened demand for governance and not just the supply, and will require more systematic cooperation with other donors, the civil society, and business

#### **Box 1: Improving Governance in Social Assistance**

Targeted Social Assistance was introduced in Azerbaijan in 2006. Since then, Bank projects have assisted the Government in fully automating pension and social assistance systems. The new MIS gathers all information in one place to facilitate accurate planning and transparency. In the past, Pension Fund employees went door to door, collecting money which may or may not have been transferred. Now there is a formula based system that automatically collects funds. Second, the distribution of pensions and social assistance is also automatic through bank transfers. Now, 97% of pensioners have a visa card which they use to withdraw their pensions from ATMs – providing flexibility in terms of time and location, and reducing the opportunity for corruption. Third, the penetration of the economy has also increased. More and more people are opening accounts to receive social assistance as well.

A next step towards increased transparency and reduction in fraud is to consolidate the process. Once people are registered as employees, self-employed or business owners, they are to be registered both for social contribution and tax purposes. Trust in the system has been built by both internal controls and a successful PR campaign which included Public Service Announcements on TV, leaflets and posters in every region.

By the end of 2010, online services will be introduced to further improve transparency. A calculator will be available on an official website where people can work out their pension allowance without the aid of consultants. As time progresses, accounts will be accessible online so that pensioners can monitor their account activity themselves. As a result of these efforts, the State Social Protection Fund (SSPF) was awarded the winner of the European Competition of the International Social Security Association (ISSA) for Efficient Governance in 2010.

organizations. Within most Bank projects, the Bank will seek to promote public awareness, strengthen transparency, and build in mechanisms for consultations with stakeholders. Government publications on activities, policies and achievements would be supported. Success would be measured through improvement of user satisfaction through periodic surveys. Some examples of this would be an annual survey of railway users, a survey of irrigation water users in supported areas, a survey of the satisfaction of farmers with locally available seeds, and surveys of IDPs and rural communities on their satisfaction with supported micro-projects. IFC would complement these efforts through surveys of the private sector, including an update to the SME survey and survey work together with the Government related to tax services and other topics to be selected in the future. Public dissemination and discussion of these surveys would be built into the Bank Group's efforts.

30. **Progress on these fronts will take time and is a medium term challenge.** Nevertheless, over time the proposed governance filter is expected to lead to improvements at all three levels- - project, sectoral, and national.