

**INTERNATIONAL MONETARY FUND AND
INTERNATIONAL DEVELOPMENT ASSOCIATION**

AZERBAIJAN REPUBLIC

**Interim Poverty Reduction Strategy Paper
Joint Staff Assessment**

Prepared by the Staffs of the International Monetary Fund and
The International Development Association

Approved by O. Havrylyshyn and M. Fetherston (IMF) and S. Katsu and C. Gray (IDA)

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1. The Interim Poverty Reduction Strategy Paper (I-PRSP) reflects the ongoing efforts of the Government of Azerbaijan Republic to develop a comprehensive and participatory plan for reducing poverty. It provides an analysis of poverty, proposes policies to reduce it, and outlines the existing and future consultation process. The I-PRSP was prepared by a team including representatives of 34 government and non government agencies, led by the Ministry of Economic Development. A draft version of the IPRSP was fully discussed in a Steering Committee which included a wide range of ministerial agencies and national NGOs. The final draft was approved by the Committee, chaired by the Prime Minister.
2. The staffs of the Fund and the Bank assisted the authorities by commenting on the drafts of the I-PRSP. In addition, government institutions, NGOs and donors met on several occasions to contribute to the development of the I-PRSP, through their participation in poverty alleviation seminars in Moscow, Manila, and Washington, and a seminar in Baku dedicated to the formulation of a poverty reduction program and policies for Azerbaijan Republic. The EU, UNDP, EBRD, ADB, DFID and other international donors have been in regular contact with the Government, the Bank and the Fund during the preparation of the I-PRSP and continue to express high interest in supporting the PRSP process.

Poverty Diagnostics and Monitoring

3. **Poverty trends:** The I-PRSP contains a candid discussion of poverty in the Azerbaijan Republic. It identifies weaknesses in the existing poverty data and describes which additional data are needed for the full PRSP. The paper points to the dichotomy between oil and non oil sectors. Strong growth in the oil sector has contributed to strong growth in GDP since 1997, but has not led to a reduction in income inequality. Moreover, more than half of the one million internally displaced persons (IDPs) do not have jobs and live on small government allowances. The I-PRSP barely mentions the gender aspect of poverty reduction, although a high proportion of the poor in the Azerbaijan Republic are women. The gender issue needs to be reexamined in the full PRSP.

4. **Data gaps:** The Bank has been providing technical assistance to the State Statistical Agency to reform the household survey system. While the the results are positive, more attention should be paid to ensuring that the investment so far made is sustained and that the work being done is improved further. We look forward to a full PRSP that uses improved household surveys to provide a clearer diagnosis of changes in poverty levels and income distribution over time. Given the importance of the shadow economy noted in the I-PRSP, it will be useful to have a Gini coefficient defined in terms of household expenditure surveys, as a complement to information based upon formal incomes.

5. **Future targets and indicators:** The authorities' poverty monitoring and evaluation plans are preliminary and future work is needed to develop input, intermediate, and outcome indicators, and to establish clearer priorities among their poverty reduction policies. The absence of a clear choice among various measures of current poverty makes it difficult to establish targets for poverty reduction. The I-PRSP contains ambitious indirect quantitative targets for reducing overall poverty through high growth of the non oil sector. The full PRSP would be expected to establish targets related to poverty reduction, and -- in deciding the best way to reach these targets -- would need to use the most recent (2001) household survey. This would lead to a more detailed picture of who the vulnerable are. This is especially important in view of the fact that 61 percent of the household population had incomes below the poverty line according to the 1996 living standard survey. In a broader sense, the full PRSP could usefully examine International Development Goals (IDG) as a frame of reference for monitoring progress in social development and poverty reduction. The full PRSP should develop a tighter link between priority policy measures and the targets selected for measuring performance.

Policy Agenda

6. The I-PRSP views strong **economic growth** as a necessary condition for reducing poverty in the Azerbaijan Republic. Maintaining macro-economic stability is viewed as essential both for growth and for poverty reduction. The strategy to combat poverty focuses on achieving high growth in the non-oil sector (especially in agriculture) and in the regions. Economic growth is to be driven by a dynamic private sector and supported by a more streamlined, efficient and transparent public sector. In addition, social protection to the lowest income group is to be enhanced and better targeted. We fully agree that these must be the central elements of a successful poverty reduction strategy. Indeed, the World Bank has based its FY 00-02 Country Assistance Strategy on the same principles, and these principles also underlie the program to be supported under the IMF's Poverty Reduction and Growth Facility (PRGF). The I-PRSP's medium term expenditure program corresponds to the fiscal targets agreed under the PRGF program.

7. **Private sector development:** The Bank and Fund staffs support the I-PRSP's commitment to reducing barriers to both foreign and domestic investment and to establishing a level playing field for the private sector. The Government has issued decrees for the privatization of large enterprises in the utility and manufacturing sectors, and is now privatizing electricity distribution. The Government also recently took measures to create more equal opportunities in the banking sector, and intends to sell the

remaining government shares in commercial banks. However, the I-PRSP also reveals a hesitancy to take strong steps to develop the market economy and tends to rely excessively on targeted interventions to ensure further development in industry and agriculture. We believe that market reforms should be strengthened in the policy agenda and that directed policies should be limited to alleviating poverty for specific groups, IDPs and refugees in particular. Rather than granting differentiated tax concessions to some investors, the government should seek to lower taxes on enterprises in a uniform way. The government should refrain from providing certain sectors or enterprises with cheap or free energy. It is important that adequate incentives to economize on the use of energy are put in place.

8. **Rural sector development:** The I-PRSP sees the **rural sector** as a major provider of employment opportunities in the future and lines up a series of policy measures to further develop the sector: creation of infrastructure, improvement of the institutional environment for the provision of credit (land market, insurance), improvement of utility services, and rehabilitation and modernization of irrigation. The Bank and Fund, as well as Technical Assistance for Commonwealth of Independent States (TACIS) and Islamic Development Bank, fully support this Government priority through their ongoing and planned programs. The links between improvements in the environment and poverty alleviation in the Azerbaijan Republic are well identified in the I-PRSP. The Bank and Fund support the policy recommendation to further protect the poor from degradation of land and to increase the provision of potable water.

9. **Energy sector:** The I-PRSP is candid in acknowledging that the sector is currently delivering low quality, unreliable services, with a high and poorly targeted subsidy content. However, the I-PRSP could be more concrete and more ambitious in addressing non-payment and arrears in the energy sector. A huge share of the country's energy resources is currently wasted because consumers do not receive incentives to economize on the use of energy. In the view of the Bank and the Fund, it is important to replace untargeted social assistance on the basis of subsidized energy prices and tolerance of non-payment by targeted social assistance via the budget. Reducing the difference between internal and external oil and gas prices can also play an important role in reducing incentives for corruption. Attention also needs to be paid to improving the efficiency of SOCAR's own upstream and downstream operations, which are at present often loss making. The I-PRSP's call for increased private sector participation in the energy sector is encouraging, and should be applied expeditiously across all parts of the electricity, gas and oil industries to reduce inefficiencies and improve collection rates.

10. **Oil Fund:** The I-PRSP notes that Azerbaijan Republic's newly created Oil Fund can play an important role in addressing social and economic problems, and in improving Azerbaijan Republic's infrastructure. In the process toward the completion of a full PRSP, it will be important to develop a plan for the eventual utilization of funds accumulated in the Oil Fund, in a comprehensive participation process. The Oil Fund can play an important role in the financing of policies proposed in the I-PRSP. However, given concerns about the potential for Dutch Disease, as well as continuing problems of governance, the authorities will have to move cautiously with regard to the expenditure of these funds.

11. **Governance:** Corruption, particularly administrative corruption, has been a major constraint to Azerbaijan Republic's economic growth and poverty alleviation. Recent high-level initiatives offer an important opportunity to improve governance in Azerbaijan Republic. These include ongoing implementation of the Anti-Corruption Decree, the new Civil Service Law, and judicial reforms. Also of significance is the I-PRSP's commitment to pursue the restructuring of the Cabinet of Ministers, the elimination of duplication of functions among government agencies through mergers, the full establishment of the Chamber of Accounts, as well as the strengthening of Treasury operations and budget process. These important policies are fully supported by current Bank and Fund programs under preparation or implementation. The I-PRSP could have, however, put more stress on the need for simple tax laws with uniform rates as an important element in a strategy to combat corruption. A clearer separation of regulatory and commercial functions of state enterprises could also contribute to improved governance in Azerbaijan Republic.

12. **Increased Government revenues and improved expenditure management:** The I-PRSP envisages an increase in government spending to 22–23 percent of GDP over 2001-04 as a tool for poverty alleviation. Tax collection in relation to GDP is also projected to increase slightly over this period, and will come largely from improved tax and customs administration. Although such projected improvements are realistic, it would be prudent to wait until they are actually realized before including corresponding expenditure in the 2002 budget. In the area of budgetary planning, the government also intends to enhance its medium-term focus of budgetary planning. An important ambition of the I-PRSP is to strengthen links between policy objectives and budget allocations.

13. **Health and education:** The I-PRSP rightly stresses the crucial importance of better human capital development for Azerbaijan Republic's future. It recognizes the need for improvement of services in health and education and the corresponding necessity to increase budget allocations. The predicament of the health sector is especially acute, as the weakening of attention to anti-epidemic measures has facilitated the resurgence of malaria, tuberculosis and other infectious diseases. While overall the document makes a strong case for focusing health and education expenditures on the most important areas (primary health, general schools), the I-PRSP is not fully consistent in this respect. Both in education and in health, it is not yet clear what the government intends to deliver for free and what should be paid for. There is need for a review of the rationalization possibilities, the identification of clear priorities for expenditures, and a review of the financing options.

14. **Social Protection:** We share the document's emphasis on the role of social assistance programs -- and the family poverty benefit in particular -- in alleviating extreme poverty. In the short term further efforts will focus on measures to improve social programs administration. A deep reform of the pension system is also urgently needed.

15. **Decentralization:** While the I-PRSP foresees the need for public decisions to be increasingly made at the local level, it does not provide the requisite institutional mechanisms. Local governments in Azerbaijan Republic face major shortages of managerial capabilities. It may take some time and considerable technical assistance to

ensure a real shift of responsibilities to them. In addition, serious administrative reform may be required to back up the Government decentralization strategy.

16. **Costing of proposed policies:** The I-PRSP does not provide a cost estimate associated with proposed policies. Adequate costing estimates will have to be developed in the full PRSP. Two policy measures proposed in the I-PRSP that seem particularly unaffordable are the increase in pensions to up to 50 percent of the average wage level, and the full indexing of frozen Sberbank deposits. The Government must also find resources for the planned increases in spending on priority items such as primary health, general education, and critical infrastructure maintenance.

17. The Bank and Fund staffs believe that only part of this increase could derive from improved revenue collection, and some further cuts in low priority sectors would be necessary. Clear setting of priorities will not be easy, but it will nonetheless be essential if the strategy is to be implementable. The full PRSP should estimate the **cost of the newly proposed reforms in the social sector**, and the possible trade-offs in social expenditures due to overall budget constraints. Allocation decisions will be greatly facilitated when the 2002-2004 Medium Term Expenditure Framework is ready. The full PRSP will need to be developed with the MTEF timetable in mind.

18. **Macro-economic framework:** The three-year macro-economic framework set out in the Appendix was developed in close consultation with the IMF and the World Bank. It aims to combine maintained macro-economic stability with sufficient budgetary resources for expenditures targeted at poverty reduction. The framework will have to be refined in the work towards a full PRSP.

Preparatory Process of the full PRSP

19. The I-PRSP was written entirely by the government of the Azerbaijan Republic. The I-PRSP has been through various drafts, each of which has been discussed intensively, mainly among government agencies. Successful follow up for the preparation of the full PRSP will depend on Government commitment, and civil society involvement. For the purpose of the preparation of the main PRSP, the Government will establish specialized groups in each main sector of the economy, in order to provide broader participation and ownership. The Working Groups and the Steering Committee which oversees them will have a central role in ensuring that the Government has a genuine and cohesive commitment to these reforms. The I-PRSP also sets out an agenda for civil society involvement in the full PRSP. The agenda includes information dissemination and consultation. It will be important to ensure that the views of civil society are genuinely welcomed and taken into account by the Government.

20. Although the experience in building broad consensus during the preparation of the I-PRSP is encouraging, the participatory process will need to be further strengthened in the work toward the full PRSP. Key elements to strengthen the process include the formation of a consultation team that includes more than 30 government and non-government organizations, and a public commitment from the authorities to a strong participatory process. The participatory process in Azerbaijan Republic is only just starting but encouragingly the timetable provided in the I-PRSP for the preparation of full

PRSP implies more initiatives from the Government and civil society in the coming months to make the full PRSP participatory. The proposed timing of the full PRSP remains ambitious in that respect.

21. The preparation of the full PRSP will include holding regional and national workshops to discuss issues and policy responses in the main economic and social areas identified, with the purpose of promoting greater support from the people of the Azerbaijan Republic for the poverty reduction program. A monitoring and evaluation program to follow future progress in poverty eradication will also be established at the time of the preparation of the PRSP in consultation with civil society.

Risks

22. While the development of the PRSP as a whole is on the right track, there are a number of risks :

- The **administrative capacity** of the government is limited. Carrying out a comprehensive poverty reduction strategy with deep reforms in various sectors of the economy may prove to be difficult. While privatization of many large scale enterprises remains to be done, the government has a relatively weak capacity to privatize enterprises and banks via international procedures. More generally, there should be far more recognition in the full PRSP that training people and investing in human development is key to reducing poverty.
- **Oil and gas sector dependence:** Azerbaijan Republic's government revenues are highly sensitive to international oil and gas price developments. Moreover, the projected high growth rates in the oil and gas sector from 2005 onwards depend crucially on the successful implementation of a small number of large projects: full field development of the Azeri-Chirag-Guneshli field, the development of the Shah Deniz gas field, and the construction of the Baku-Tbilisi-Ceyhan pipeline. Adverse developments in oil and gas prices or in the completion of one or more of these projects could significantly limit the government's capacity to successfully address poverty. A related concern is that a failure to make SOCAR more efficient could lead to much of the profits from increased oil production being used to subsidize loss making activities and unnecessary expenditure within SOCAR.
- **Regional Instability:** Azerbaijan Republic's economic development in the first decade of independence and transition has been negatively effected by the military and political conflict with Armenia. Any renewed regional political instability could divert attention and resources from pressing social and economic reforms.
- **Exogenous Shocks:** Azerbaijan Republic has suffered from a number of other unanticipated setbacks in recent years - earthquakes, landslides and droughts - and there is unfortunately no certainty that similar shocks will not occur in future. This, and uncertainty over the level of external aid flows, means that there is considerable downside risk, and the PRSP will need to identify a core of priority

public expenditures to be able to preserve essential expenditures in case where unforeseen events imply budget cuts.

23. **Overall Assessment:** The staffs of the World Bank and IMF consider that this I-PRSP provides a sound basis for the development of a fully participatory PRSP, and for Bank and Fund concessional assistance. The staffs recommend that the respective Executive Directors of the World Bank and the IMF reach the same conclusion.

Annex: Key Bank/Fund Events Related to PRSP

Institution	Event	Expected Date
IMF/World Bank	JSA of I-PRSP	July 2001
IMF	PRGF Board Presentation	July 2001
World Bank	Update of Poverty Profile	October 2001
World Bank	SAC II	November 2001
IMF	PRGF midterm Review and Article 4 consultation	December 2001
World Bank	Public Expenditure Review	February 2002
IMF/World Bank	Board Discussion of Second Annual PRGF	April-May 2002
IMF/World Bank	JSA of PRSP	During FY02
World Bank	CAS	During FY02