

Country Strategy Paper 2002-2006

National Indicative Programme 2002-2003

Azerbaijan

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Summary

The Azerbaijan Country Strategy Paper (CSP) was adopted by the Commission on 27 December 2001 and provides the strategic framework within which EC assistance will be provided for the period 2002-2006. The CSP follows the guidelines set out in the Framework for Country Strategy Papers, and takes its basis from the Regulation for the provision of assistance to the partner countries in Eastern Europe and Central Asia (Council Regulation (EC, Euratom) No 99/2000 of 29 December 1999). The CSP constitutes the Indicative Programme as described in article 3.2 and 3.3 of the Regulation and revises and updates (as foreseen in article 3.6 of the Regulation) the Indicative Programme for 2000-2003 adopted in 2000. The CSP sets out EC cooperation objectives, policy response and priority fields of cooperation based on a thorough assessment of policy agenda and political and socio-economic situation of Azerbaijan. The National Indicative Programme (Chapter 6 of the CSP) sets out the response in more detail, highlighting objectives, expected results and conditionality for Tacis in the priority areas of cooperation for the period 2002-2003.

Azerbaijan is a full participant in the Partnership and Cooperation process. It has experienced a period of political stability, demonstrated increasing respect for democracy, rule of law, human rights and continued growth. The main challenges facing Azerbaijan over the medium term notably are reducing poverty, resolution of the Nagorno Karabakh conflict, economic diversification, improving governance including the reduction of widespread corruption, improvement of the country's infrastructure and reform of the banking and financial services sector. Azerbaijan also faces the difficult task of balancing its interests with those of its regional neighbours. It also has the task of completing the adjustment to the challenges of the market economy including changes in attitudes, structures and educational systems.

The political situation in Azerbaijan and its relationship with the European Union cannot be separated from the country's regional context, economic potential and cultural heritage. Following the events of September 2001 there are new threats weighing upon the world and the geopolitical location enhance Azerbaijan's strategic importance.

Within that context and taking into account the objectives of the Partnership and Cooperation process, the EC Tacis programme can most effectively assist the partner country in meeting those challenges by focusing on priority sectors : **(i)** support for institutional, legal and administrative reform. There will be continued support for the implementation of the PCA and the approximation of Azerbaijani legislation to that of the EU, as well as support for the implementation of the PRSP, notably in the context of public sector reform, and for legal and judicial reform; **(ii)** support to the private sector and assistance for economic development, including assistance to the newly created Ministry of Economic Development and measures to assist the improvement of tendering procedures and the business climate.

These priorities are consistent with the objectives of the Azerbaijani National Programme for Poverty Reduction (originally called the Poverty Reduction Strategy Paper PRSP).

The Food Security Programme shall remain an essential instrument to contribute to the poverty reduction policy.

EC grants for cooperation with Azerbaijan from the Community budget will be around € 14 million for period 2002-2003 (excluding food security).

1. EU/EC policy objectives

The EU's cooperation objectives are to build a relationship with Azerbaijan in which the respect of democratic principles and human rights and the transition towards a market economy are fostered and supported. The objectives are based on the Partnership and Co-operation Agreement which forms part of a proximity policy, reflecting the political and strategic importance of Azerbaijan to the EU. The strategic importance of this relationship will further increase as the EU enlarges to the east.

The PCA provides for trade liberalisation and wide-ranging cooperation, based on respect of democratic principles and human rights. Tacis is the main financial instrument supporting the implementation of the PCAs, assisting Azerbaijan in the strengthening of democracy and the rule of law, the consolidation of a market economy and the strengthening of administrative capacity linked to the implementation of the agreement, particularly in the areas of trade and the internal market.

The EC Development Policy Statement, with its objective of poverty reduction, applies to Azerbaijan, one of the poorest, developing countries of the NIS region.

Enlargement will bring the EU frontier closer to the Caucasus and Azerbaijan. It is therefore important that Azerbaijan is helped to prepare for the day that it will be a neighbour of the EU.

The EU, together with its Member States, is the largest provider of assistance to Eastern Europe and Central Asia. Since the beginning of the nineties, when EU technical assistance activities were started, the relationship with the partner countries has become much more institutionalised and political.

Decisions by the Council of Ministers in 2001, with respect to conflict resolution in the southern Caucasus, have intensified the EU's political commitment to the region. The EU stands ready to look for further ways in which it could contribute to resolve the conflicts, as well as in post-conflict rehabilitation. Political dialogue with all the interested parties will be used to support the peace process.

Azerbaijan and the other countries in the southern Caucasus have a pivotal role to play in the opening up of alternative transportation routes for trade and oil and gas resources from the Caspian and Central Asia to Europe. The EU has both direct trade as well as indirect political interests in fostering regional cooperation.

2. Policy agenda of Azerbaijan

Azerbaijan has adopted two main political priorities to guide the development of the country: resolution of the conflict with Armenia over Nagorno Karabakh, and the economic and social transformation of the country to strengthen stability in the country

and the region. Azerbaijan's public development plans have yet to take account of the potential economic impact of a settlement.

Development, while greatly constrained by the conflict, is proceeding. However, it is unlikely to achieve its full potential, while the conflict over Nagorno Karabakh remains unsolved. Azerbaijan has begun the process for the preparation and elaboration of its development strategy in the form of a National Programme for Poverty Reduction (NPPR).

This strategy confirms the existence of widespread poverty and unemployment and indicates that Azerbaijan will have to embark on a long-term and concentrated effort to resolve these problems. The Government is committed to reducing poverty and improving the living standards and well-being of the population.

The main principles of the government strategy are to complete the **transition** from a command economy to a market economy, to continue to strengthen **macroeconomic stability**, to create the environment for economic **growth** and stimulation of commercial **investments** for the development of the country's regions, to make substantial improvements in the delivery of **public services** to the lowest-income segments of the population, and to improve the **social protection** system.

Overall, the NPPR sets a very ambitious programme in terms of its timetable and overall objectives, aiming to complete its activities by the end of 2005. The EU has agreed to assist the Azerbaijani Government to prepare the NPPR. The importance of the NPPR / PRSP still needs to be fully grasped in all levels of the government; ensuring that this understanding is achieved will be a key task during the preparatory phase of the NPPR / PRSP. Regular evaluation of progress will be required to ensure that there is no slippage in timetable or that policy drift occurs.

3. Country analysis

Country snapshot

Area (km ²)	Population (million) (2000)	GDP/capita (USD) (2000)
87,000	8.1	650
Real GDP growth rate (2000)	Real level of 1999 GDP as % of 1989 GDP	Inflation rate 2000
11.1 %	47%	1.8 %

- *Political situation*

The **political situation** in Azerbaijan cannot be separated from its **regional context**. The war with Armenia over Nagorno Karabakh has dominated Azeri politics since 1988, before independence from the Soviet Union. The ceasefire declared in 1994 has held relatively well, if seen from the perspective of major outbreaks of fighting. That 20% of

Azerbaijan's territory is occupied and 10% of its population is displaced cannot be ignored in the context of establishing a development strategy with Azerbaijan.

Settlement of the conflict offers one of the great opportunities to stabilise a very difficult region. Equally, a peace that cannot be sold to the peoples of Azerbaijan and Armenia poses a great threat to the region.

Conflicts in the southern Caucasus impact on all three south Caucasian republics affecting security trade and regional cooperation. Instability in the north Caucasus Republics in the Russian Federation only adds to the problem. In 2001 it is estimated that there are around 7,000 refugees from the fighting in Chechnya living in Azerbaijan. Their presence is problematic from a humanitarian and political viewpoint.

Relations with the Russian Federation remain key to the economic and political stability of Azerbaijan, no matter how much Azerbaijan seeks to become integrated into the global economy. Russian investments in Azerbaijan most notably in the oil sector, remittances from Azeris living in the Russian Federation and trade with the Russian Federation add economic weight to Russia's political influence on Azerbaijan. The degree of understanding between the two countries on certain key issues is exemplified by Azerbaijan's close cooperation on border security measures and the fact that Russia has not sought to introduce a visa regime for Azeris living and working in Russia.

Azerbaijan's relationship with Iran is also problematic. Azerbaijan has concerns over religious interference, economic and political differences over the use and division of the Caspian Sea and about fundamentalist religious movements. There is a further element, in that, of the total ethnic Azeri population living in the regions, some 60% live in the north of Iran; the question of nationality is one which is raised frequently by nationalists on both sides.

Turkey is Azerbaijan's closest ally, providing political, moral, economic, military and technical support. In the early days, it provided a very visible counterbalance during the war with Armenia. Today the strength of the alliance between Azerbaijan and Turkey is still one of the key strategic elements in the region, despite the frequent tensions between the two countries over matters such as trade.

Internal stability is undoubtedly greatly improved compared to the early years of independence when there were a number of attempted coups. This has in part been achieved by focussing on the need for national unity in the face of the Nagorno Karabakh conflict. Any peace settlement will have to be achieved with the full backing of the Azeri people. Without this it is difficult to see how the same degree of political stability can be maintained.

Accession of Azerbaijan to the Council of Europe is a very positive step for Azerbaijan. It recognises the democratic aspirations of the country and the amount of progress made since independence. The Council of Europe has applied certain conditions to membership, notably progress on the constitutional, media and election laws. The attention paid to the issue of electoral law is a reflection of the problems encountered during the 2000 parliamentary elections which coincided with final discussions on accession to the Council of Europe. The Council of Europe is also acting very strongly in

the sphere of human rights and political prisoners. Membership of the Council of Europe gives Azerbaijani citizens redress in the Human Rights Court in Strasbourg which will undoubtedly be an important factor in the development of civil society. Through the PCA the EU has the opportunity to add to the critical dialogue on these issues.

There are a number of **human rights issues** which are now beginning to benefit from the involvement of the Council of Europe, the most notable being that of political prisoners. While state censorship is abolished, there is a very strong sense of self-censorship in Azerbaijan by the written and broadcast media. Despite these reservations, Azerbaijan has a wide range of political opinion expressed in newspapers and journals, unlike many of its neighbours in Central Asia.

Prison conditions have been criticised by human rights organisations. In particular the high incidence of TB in prisons is of concern, especially for long term “political” prisoners. The actions of the police have also been questioned notably over the treatment of detainees.

The parliamentary elections held in November 2000 showed some improvements on previous elections; however, significant problems remained. The Government, in re-running the elections in the constituencies where there were the most flagrant violations of the election law, were considered to have taken a step in the right direction. Multi-party democracy is only 10 years old in Azerbaijan and needs to be nurtured carefully. Many other donors are active in the development of civil society, and it remains to be seen just how successful their efforts are in the short term at least.

Undoubtedly family and “clan” allegiances play a large role in political life in Azerbaijan and these have helped to slow the move towards a full expression of European democratic principles. Equally, the family has provided the social safety net for many in Azerbaijan where the state has simply ceased to function. Reform will need to address the issue of family ties which can be linked to some expressions of corruption, ensuring that the system of “support” is replaced with a fully operational alternative.

Women play a secondary role to men reflecting the strength of traditional family structures and this is most marked in rural society.

- *Economic and social situation*

Economic performance further strengthened in 2000, with real GDP growth estimated to have accelerated to 11.1 percent from 7.4 percent in 1999. The major contributing factor was the 20-plus percent upsurge in the oil and oil-related sectors in the first half of 2000, which benefited from rising world oil prices. But also the agriculture sector grew by an impressive 8 percent. However, growth in other labour-intensive sectors is estimated to have remained weak. Consequently, the level of unemployment is estimated at 18 percent in 2000, similar to the 1999 level.

The current account deficit improved significantly in 2000 to 2.7 percent of GDP (\$150 million) from 13.2 percent (\$600 million) in 1999, primarily because of a stronger trade balance, on which a surplus of \$123 million was posted in 2000, compared with a deficit of \$634 million a year earlier. Among the contributing factors were growing oil exports

and a smaller increase of imports due to the slowdown in oil equipment imports. Gross foreign exchange reserves increased slightly from \$676 million in 1999 to \$680 million in 2000, equivalent to about six months of imports. Total external debt rose to \$1.2 billion, from \$962 million over the same period but remains at a sustainable level of less than 25% of GDP.

The Government adopted a tight fiscal stance in 2000. The total fiscal deficit is estimated to have been reduced to close to zero percent of GDP in 2000 from 5.1 percent in 1999. Improved budget revenues and a lower level of public expenditures were the main reasons for this. On the monetary side, an eased policy stance that began in mid 1999 continued. Inflation (measured by the consumer price index) was at 1.8 percent in 2000, compared with deflation of 8.5 percent in 1999. Without jeopardising currency stability, the Government has continued its flexible exchange rate management approach. The local currency, the manat, which is managed by the National Bank in the context of the Manat / US Dollar exchange rate, depreciated gradually by 7.8 percent to an average level of 4,474 manat per \$ in 2000 from 4,126 manat in 1999.

To better manage the expected increase in oil revenues, the Government established the State Oil Fund in November 1999. The international financing community has expressed concerns over the lack of parliamentary oversight of the oil fund. Some of these concerns have been allayed with the decision in 2001 to include oil fund expenditure in the national budget and the adoption of satisfactory regulation for the management, spending and financial scrutiny of the oil fund with regular reporting and annual financial audits by reputable, international auditing teams.

While the oil and gas sector are likely to fuel the development of the economy of Azerbaijan, with an estimated 25 percent share of added value in GDP in 2001, the impact on domestic non oil industrial production will be limited unless special efforts are made to ensure that investment in a modern efficient and diversified domestic industry takes place. Analysis of foreign direct investment (FSI) between 1992 and 1999 highlights the dangers and the advantages of the oil and gas sector. With 74.3% of FDI in the oil and gas sector Azerbaijan is particularly exposed to the so called "Dutch disease". Unless substantial efforts are made to ensure diversification the full effect of FDI is likely to be relatively limited.

In addition, progress has been made in implementing policy reforms, with respect to both the civil code and the amended tax code. However, structural reforms, particularly in the banking sector, have lagged behind. Crucial reforms are needed in this sector to improve supervision and strengthen enforcement of prudential regulations in line with international best practice.

The economic outlook for 2001 appears to be promising in view of positive prospects in the oil-related industries and indications of improved performance in agriculture. However, real GDP growth in 2001 may be lower than in 2000, due to a softening in world oil prices and a slowdown in foreign investment. In the short term, the Government is expected to maintain its current tight fiscal and somewhat loose monetary policy mix. Improved value-added tax collection and the adoption of the amended tax code will help in maintaining the fiscal deficit close to zero percent of GDP. However, it remains a challenge for the Government to lift much-needed social expenditures, while keeping the fiscal deficit under control. After significant deflation during 1998–1999 and a moderate rate of inflation of 1.8 percent in 2000, inflation in 2001 will likely continue to rise. In

view of slowing foreign capital inflows, the manat will be subject to greater pressure to depreciate further.

Issues in Economic Management

Azerbaijan's impressive economic performance over the since 1997/8 is not without its flaws as Azerbaijan remains one of the poorest countries in the NIS.

To maintain investor confidence, the Government needs to make a serious effort in implementing structural reforms. Important areas include privatisation, financial sector restructuring, the promotion of micro, small and medium sized enterprises, the reconstruction and modernisation of local infrastructure and the improvement of the business climate with the introduction of good governance to establish institutions and the rule of law conducive to a market-based economy being the top priority. The increasing dependence on oil exports is a concern, and the development of non-oil sectors will be crucial to achieving a balanced external account position and sustainable growth. Understanding this, the Government made the issue of non-oil sector development a priority in its recent development strategy.

Improved tax collection rates, increased revenue collection for utilities payments are required if budget targets are to be achieved and sustained. Increased revenue flows should reduce the pressure to privatise at over hasty rates. The issue of vested interests also needs to be addressed as these very often hinder the rational development of the economy.

Environmental concerns in the past did not play a significant role in economic management. This is very visible in the oil fields around Baku and in the agricultural land of the Mugam Steppe. Exploitation of the Caspian Sea has also had serious problems notably exploitation of its fisheries resources which are a national and regional issue. Placing sturgeon on the CITES list of endangered species in 2001 is an indication of severity of the problem and a problem that illustrates the linkage between the environment and economy.

Social issues

The lack of reliable data on poverty prevents a definitive analysis in the NPPR. Existing World Bank data from 1995 shows that 61.5% of the population were categorised as poor, of whom 20.4% were very poor. Of the refugee and IDP population, 74.5% were poor and 37.5% were very poor. Regional variations occur with Naxcivan being the poorest region of Azerbaijan where 84.5% were poor, of whom 31% were very poor. Since these survey data there has been significant economic growth, but it is unclear how far this has benefited the poorest members of society.

Per capita GDP totalled \$664, putting Azerbaijan in 98th place out of 189 countries; as such it is classified by the WB as being among the low income countries. Nominal money income per capita was equal to \$505 per annum or \$1.40 per day. Pensioners receive \$0.57 per day. The existence of a considerable informal economy which results in aggregate consumption being 3-5% higher than GDP is an indication of the difficulty in commenting with certainty on poverty levels with any degree of accuracy. Without confirming data it is difficult to comment on the size of the poverty gap today.

Literacy was high in 1989 at 97%; however, these figures do not reflect the rapid decline in the educational system. It is likely that the literacy rate will be significantly lower in 2001, given reduced spending on education leading to reduced access to, and quality of, education. The use of the Azeri language as the official language is causing problems, particularly in the business world where in pre-independence days technical and contractual documents were written in Russian.

The health sector has gone through the same process of decline experienced by education and other public social services.

- *Progress of reforms*

In some respects the reform process has been relatively successful. Agriculture is largely privatised, although the retreat from state control has not led to efficient new market structures. Virtually all small enterprises and some medium-sized enterprises have been privatised.

A reorganization and restructuring exercise has been initiated, whereby formerly independent bodies have become departments of the Ministry of Agriculture (e.g. Veterinary, Quarantine), although this has yet to be properly integrated into an overall policy for the sector, defining for example, specific roles, functions, duties etc. of each department. There is still a need to rationalize structures between the Land Amelioration and Water and Irrigation Committee and the Ministry of Agriculture.

With regard to agricultural reform and its relevance to food security, land has been privatised and owners have the right to land shares and to receive land titles/certificates. The support of the Food Security Programme (FSP) to the former Land Committee has been important and should be continued to the newly established State Committee of Land and Mapping to allow a proper monitoring of the development of land market.

Reform of government has been slow, although significant progress has been made in 2001. New ministries have been created, most notably that for Fuel and Energy, and new laws and codes are being adopted. Despite concerns remaining over the final implementation of the changes the Government appears to have committed itself irrevocably to reform. In addition to structural reforms of the administrative system, the Government is starting to address corruption. Presently, corruption pervades all aspects of life in Azerbaijan from government and state bodies to private enterprise. As a consequence the business climate is a strong disincentive for foreign and local investors outside of the oil sector Production Sharing Agreements (PSA).. The gradual process of improving transparency in all legislation and the consequent decisions taken by officials is beginning to have an impact. Top down efforts to improve dialogue between the business community and the highest levels of government shows that progress is being made, albeit slowly. The Presidential anti-corruption programme the establishment of a Chamber of Accounts, reform of the Civil Service law, increase in civil service salaries and the review of state procurement practices are important steps on the road. In 2001 Azerbaijan joined the Palermo Convention against corruption and organised crime following accession to the Council of Europe. This is a very positive development, although the real test will be the effectiveness of the Convention's implementation.

One of the remaining major obstacles to the transition to a market economy is the need to separate regulatory function of government from the commercial operation of state

enterprises. The new ministries are designed to ensure this separation takes place for example the establishment of the Ministry of Transport. However, it is too soon to make a final judgement on this matter.

At the local level, public resource management in the true sense is virtually non-existent. Existing local executive bodies at the district level, have neither a functional responsibility for local public services nor organisational support for these services. A Law on Municipalities was adopted in late 1999, which defines local responsibilities as including both local taxation and implementation of local programs for social protection, economic development, and environment rehabilitation. In practice, however, there are few activities to demonstrate these responsibilities.

- *Sustainability of current policies*

Without question the war with Armenia has impoverished the population. With 600-800,000 IDPs / refugees living in makeshift accommodation on marginal incomes, the pressure on the Government is great. Income distribution is polarised, both in terms of who has the wealth and between the regions of Azerbaijan. The Absheron Peninsula which has about 40% of the population, the oil and gas industry and what remains of industry also has the greatest concentration of wealth. Equally, it has some of the poorest groups in the country, notably the IDPs and refugees from the Nagorno Karabakh war. The apparent lack of equity in income distribution is therefore most marked in this region. Once a peace settlement is reached, the calls for increased economic prosperity for all will have a “legitimate” political platform, in that it will no longer be seen as an unpatriotic attack in the time of “war”.

In 2001 the government took the first decision to resettle Azerbaijani refugees who will be unlikely to return to their homes in Armenia.

In addition to the presence of Azerbaijani IDPs and refugees there are in 2001 estimated to be around 7,000 Chechen and 800 to 900 Afghan refugees. These populations on the whole do not create a drain on state resources as only a very limited number are “destitute” or without any support. However, their presence is a major concern for the government especially in the context of regional stability.

In macro-economic terms, the Government’s policies appear to be sustainable, if the Government is able to continue the implementation of the so far successful policy towards the oil and gas sector, reduce corruption, consolidate the processes of reform and start economic diversification. Improvement in tax and utility payments rates will also be required if the state budget is to be managed correctly.

In theory the environment is protected by law and pollution is controlled by regulations. In reality, concern for the environment has been secondary to economic exploitation of the land. Exploitation of oil reserves on the Absheron Peninsula, and industrial pollution from the petro-chemical and other industries at Sumgait just north of Baku has resulted in environmental devastation. The agricultural landscape is slowly recovering from overuse of pesticides and fertilisers, simply because they have not been available in sufficient quantities to the average farmer since independence. Azerbaijan is neither able to implement its own environmental legislation nor to clean up, in the short to medium

term, the devastation of the past. It is therefore important that the area of environmental legislation and management is given a higher priority to meet the future needs of Azerbaijan.

- *Medium term challenges*

The overriding political priority for Azerbaijan is the settlement of the Nagorno Karabakh conflict. It is widely recognised that the development potential of Azerbaijan and the region as a whole is being severely reduced by the conflict. The government strategy only calls for the return of occupied territories and presents no development scenario with the conflict resolved.

The second most important item on the agenda will be the improvement of the business climate through the fight against corruption, implementation of good governance and the adaptation of all government structures and systems to the needs of the market economy. The government development strategy addresses these issues both indirectly and directly. Azerbaijan recognises that reform will be critical if it is to reap the full benefit of its oil and gas wealth for the benefit of the whole population. Development of the non-oil economy is one of the major challenges facing the Government. Azerbaijan's oil wealth gives it the opportunity to diversify its economic base and invest in the human capital of the country. Apart from the challenge to diversify the economy, the Government of Azerbaijan needs to achieve its objective of maximising the benefits from the major investment in the oil and gas sector, through the creation of an internationally competitive oil and gas supply industry. Early signs coming from the accreditation of part of the oil tool manufacture to American Petroleum Industry standards (API) are good. That Azerbaijan is likely to be the last of the three Caucasus countries to join the WTO only adds to the pressures on the business community.

Resolution of these issues are critical to the need to address the overall issue of poverty reduction.

In its favour Azerbaijan has implemented an economic reform programme that has achieved macro-financial stability and increased economic growth. The convertibility and stability of the Manat is an indication of the relative strength of the economy. Inflation is under control, after near hyper inflation levels in the mid 1990s, and Azerbaijan is projected to continue to have inflation levels comparable to those projected for the EU in the medium term. The development of oil and gas resources is progressing relatively well, and there is good progress in the privatisation of small-scale enterprises. Political stability has been achieved, despite the conflict over Nagorno Karabakh, although the path to the adoption of the full spectrum of European values will undoubtedly cause some difficulties.

4. Overview of past, ongoing and planned cooperation issues

- *Past and ongoing EC technical assistance : a summary of the results achieved*

Since independence EU has given Azerbaijan €333.22 m of grant-based assistance which is summarised in the table below. See below for EU Member State activity.

1992 to 2001	Total €m	% of total	Status
Tacis National Allocations	72.50	21.7%	Current
Exceptional Assistance Tacis	30.00	9%	Ended 2000
ECHO	82.67	24.8%	Ended 2000
FEOGA food aid	65.65	19.7%	Ended 1996
Food security	57.00	17.1%	Current
Rehabilitation	18.374	5.5%	Ended 2000
Exceptional Humanitarian Aid ECHO	9.5	2.8%	Ended 1999
Total	335.69		

See annex for breakdown of EC assistance on an annual basis.

In the early years of independence Tacis concentrated on assisting the development and modernisation of the energy sector, including the distribution networks, development of the private sector, with special emphasis on the commercial banking sector and agro-processing and rural credit, and finally on the reform of the social security and pension systems and education system within the overall priority of human resources development.

The evaluation of the 1998/99 Tacis National Action Programme made the point that many of the Tacis initiatives in earlier programmes came too soon after independence and as a result many of the early projects remain on the shelf. Since the start of the 1996-1999 programme, better progress has been made, with projects being more fully integrated into the country's activities. Similarly, coordination between the EC's instruments has improved and has been used to help to resolve serious problems.

While making positive comments about the programme, the evaluation of the 1998-99 Tacis programme for Azerbaijan, recommended that greater consistency be applied to the selection of projects – building on successful projects rather than frequent changes of direction. Good governance should be a major target for future projects and the diversification of the economy should be given greater attention. All of these recommendations have been built into the 2000-2001 Tacis National Action Programme.

Tacis Regional programmes

The impact of regional programmes on Azerbaijan is difficult to evaluate. It is clear however, that the Silk Road project under the TRACECA regional programme has had and continues to have significant benefits for Central Asia and the Caucasus. Azerbaijan, which has the secretariat for the programme plays a pivotal role. Through TRACECA

Azerbaijan cooperates, admittedly at a low administrative level, with Armenia, which given the overall policy of non-cooperation with Armenia is a major achievement.

The regional programmes have both direct and indirect linkages to the mainstream Technical Assistance programme.

The regional dimension of energy is reflected in the work carried out under the aegis of the INOGATE programme. INOGATE was originally conceived to ensure continuity of supply of oil and gas to the EU through the promotion of multiple supply routes. The initiative has been successful in bringing the countries involved around the same table. However, it is debatable whether the programme has substantially influenced the major oil companies, especially in recent years.

There are strong linkages associated with the reform of the transport sector which is important for the economic diversification of Azerbaijan and the TRACECA regional transportation programme. Much of the work has been carried out in the context of the TRACECA regional programme, recognising the critical importance of the South Caucasus countries to the recreation of the Silk Route to Central Asia. The major lessons to be learned from the exercise is that regional co-operation is possible where there are sufficient national convergent interests.

The Regional Environment centre based in Tbilisi, Georgia is beginning to operate after a very difficult start. The refusal of the Azeri side to cooperate with Armenia almost led to the collapse of the project. The lesson to be learned is that with care and the correct choice of partners low level cooperation projects that are apolitical have some chance of success. Before a peace settlement is reached with Armenia, high-level cooperation will be impossible. In contrast, the Caspian Environment Project has had greater success, although the major lesson learned is that multi-donor programmes are very difficult to implement successfully. When these programmes are translated to a regional context the strains are even greater.

A Tacis regional cooperation programme for the fight against drug trafficking started in 2001. Linked to control of illegal drugs cross border control programmes need to be considered in Azerbaijan to ensure the optimum conditions apply. Improved border management can also contribute to increased regional security and confidence.

Tacis Exceptional Assistance Programme (EXAP)

While there are few formal linkages with the mainstream Tacis TA programme there are strong linkages with the rehabilitation programme and direct co-operation over one of the EXAP projects. The range of projects covers rehabilitation of energy infrastructures energy infrastructure; social infrastructure including schools, hospitals, prison hospital, orphanages; improvement of irrigation and drinking water supplies, nuclear waste disposal and projects in war damaged areas of Azerbaijan rebuilding houses and other social infrastructure.

The main lessons learned from this infrastructure investment programme are similar to those learned from the rehabilitation programme in terms of monitoring and project delivery. The major and beneficial difference from rehabilitation has been the way in

which financial payments have been handled. Each phase of the programme has been paid in full to Azerbaijan into a double signature account controlled by the Azeris and the Commission. This has allowed for correct and timely dispersal of resources on the ground.

The use of the Azerbaijani reconstruction agency to manage the programme allowed the EC monitors to concentrate on their tasks, rather than become involved in coordination between government departments and agencies.

The EXAP programme allocated €30m under the 1998-2000 Tacis budget will not be extended.

Humanitarian Assistance

ECHO has been present in the NIS region since the early 1990s, in accordance with its core mandate (humanitarian assistance in response to natural or man-made disasters). From 1993 to 1999, ECHO's operational funding in the southern Caucasus has been considerable, with 64.255 million Euro of humanitarian aid going to Armenia, 83.34 million Euro to Georgia and 82.96 million Euro to Azerbaijan.

From a humanitarian actor's perspective, however, it has to be observed that the limits of what can reasonably be provided to the target populations in the form of short-term relief projects have been achieved. The solutions for the persisting difficulties are to be identified by the local communities themselves and should to some extent be addressed by other types of external assistance. Therefore, ECHO's withdrawal from post-emergency programmes in the southern Caucasus started in 1996 and was completed in 2000 with a last allocation of 3.855 million Euro for the three countries.

Food Security Programme

The first Food Security Programme in Azerbaijan started in 1996 and implemented through the national budget since 1997. Initially the definition of a Food Security Policy was a major concern of the programme and resulted in the approval of the Azerbaijan National Food Security Policy Framework and Programme by the Government in March 2001. Increasingly the government is aware of food security issues.

Attempts have been made by the Ministry of Agriculture to develop policies and strategies though these are currently far from satisfactory. The Ministry has prepared an Agrarian Policy document, which should provide an integrated strategy for reform within the sector, including the link to food security. One of the difficulties is the spread of responsibilities concerning the agricultural sector through different institutions and that policy formulation in the Cabinet of Ministers is too distant from the line ministry and there is inadequate communication between institutions .

Rehabilitation

Rehabilitation of war-damaged areas has been an important programme to pilot reconstruction activities in the region. Working in parallel with other donors including the World Bank, UNHCR and UNDP the EC has rehabilitated water supplies both

drinking and irrigation, housing, schools, electricity supplies, rail communications, agricultural and other economic activity in Fizuli and Agdam districts of Azerbaijan.

The principal lessons learned so far are that it is essential to have a strong team of international and local monitors. The second lesson is that the Azerbaijani Reconstruction Agency (ARRA) has the capacity to organise reconstruction work efficiently, effectively and correctly. However, there is no spare capacity in the Agency and this would be an issue for the Government to address in the event of a peace settlement with Armenia. Demining will be an even greater problem, than it is currently, in the event of a peace settlement with resource and policy implications for both the Government and the international donor community. The pilot programme for reconstruction has also highlighted the need to be able to respond faster to the needs on the ground. This issue will be even more important should there be a peace settlement, given the higher expectations and political sensitivities that can be anticipated. Agriculture will likely play the driving economic force behind a post-conflict resettlement programme. Care will be needed to ensure the correct resources and EC instruments are deployed.

Rehabilitation actions have been funded under the 1997-2000 budgets. There are no allocations foreseen under the 2001-2002 allocations.

Demining actions will form an important element of reconstruction programmes in order to ensure restoration of normal living and working conditions.

Research and Technological Development

Azerbaijan is participating in the EU's Framework Programmes activities, in particular INCO-Copernicus, as well as in INTAS projects. With regards to the European Research Area and the new Framework Programme, the objective for the Newly Independent States (NIS) will be twofold: stabilise their research potential and tackle problems of mutual interest where research can provide appropriate solutions and responses (i.e. non-proliferation, health and environmental safety related to industrial changes). This objective can be achieved by strengthening partnerships and exchanges with the scientific communities of the European Union.

- *Cooperation with other donors*

See annex for table showing donor activity.

International Financial Institutions

The **International Monetary Fund (IMF)** in 2001 approved a three-year loan of SDR 80.5 million (about US\$100 million) under the Poverty Reduction and Growth Facility (PRGF) to support the Government's economic programme and effort to reduce poverty. IMF operations in Azerbaijan started in 1995 and in total the country has used \$197 million of IMF credits.

To date the **World Bank** has extended credit totalling \$411 million to Azerbaijan for projects ranging from humanitarian assistance, reform of agriculture, education, cultural heritage, water supplies and irrigation, gas rehabilitation, trade liberalisation, privatisation, legal and banking reforms and the encouragement for foreign private investment in the oil sector. Operations in Azerbaijan started in 1995.

EBRD assistance started in 1995 and has concentrated on SME development, development of the financial sector, energy, transportation, municipal and environmental infrastructure, telecommunications, natural resources (notably for the exploitation of oil reserves), privatisation and legal reform. It has allocated some \$351.5m of which \$220m have been for the development of oil and gas projects.

The **Asian Development Bank** (ADB) has just completed its assistance strategy for Azerbaijan although it has yet to allocate resources to the country. ADB's strategy is based on three objectives: (i) enhancing human development, (ii) promoting sustainable growth, and (iii) supporting good governance and institutional strengthening

Bilateral Donors

Japan recently became the largest bilateral donor to Azerbaijan with soft loans in excess of \$500 million for renovation of power plants as well as smaller grant assistance for agricultural equipment, equipment for a maternity hospital and sports equipment.

Germany is the largest EU member state bilateral donor in Azerbaijan with over 177 million DM in loans and grants and technical assistance principally in the fields of energy, SME / financial sector, municipal infra-structure, agriculture, legal reform and privatisation. Germany has just announced a new development strategy for Azerbaijan which envisages an annual allocation for the three Caucasus republics of some €50 million per year which will focus on regional cooperation objectives.

Data on Member State activity has been requested, however, these data are not complete presentation shall be available soon. The France, **United Kingdom, Italy, Greece** and the **Netherlands** are also active. **Denmark** has been active in the humanitarian field.

All **US** government-funded activities in Azerbaijan are subject to the provisions of Section 907 of the FREEDOM Support Act (FSA).. Exemptions to the ban on assistance that have been applied include: humanitarian assistance; democracy and governance activities; non proliferation or international border security programmes; Trade and Development Agency programmes; Overseas Private Investment Corporation programmes; Export - Import Bank programmes; and Foreign Commercial Service activities. The USA has allocated approximately \$257m to date to Azerbaijan.

Donor Coordination

The EU was one of the first donors to operate in Azerbaijan, preceding the IFIs by three years. The nature of the support for Azerbaijan has changed over time, with an early and necessary concentration on humanitarian assistance now giving way to technical and development assistance targeted on structural reforms. The Government has organised

donor coordination under the Cabinet of Ministers (the Tacis National Coordinator is responsible for overall donor coordination).

5. EC response strategy

- *areas of cooperation, priorities and objectives.*

Azerbaijan has reached a degree of economic and political stability that gives it the opportunity to address some of its serious structural problems. However, the seriousness of the problems requires the continuation of a strong EU engagement to ensure the reform policies are fully implemented. The EU's broad objectives focus on the implementation of the PCA, reducing corruption in part through improving governance, improving the business climate, stimulating regional cooperation and encouraging the settlement of the Nagorno Karabakh conflict with Armenia. All of these objectives have focus poverty reduction either directly or indirectly as their focus.

Good governance and a strengthened market economy are key objectives for the EU as these will provide the foundations for reducing poverty and the development of Azerbaijan. The EU has a comparative advantage in this context that comes from the credibility gained from long experience in assisting reform activities. The EU assistance strategy will support the Government's own poverty reduction strategy started with the preparation of the full NPPR. However, this commitment does not mean that the EU shall shoulder responsibility for the implementation of all aspects of the PRSP. Areas such as health and education are already the subject of investment programmes of other donors most notably the World Bank and it would be counter-productive to enter these very large sectors with the levels of resources likely to be available to Tacis within the lifetime of the Indicative Programme.

To enable a closer and more effective partnership to be created it will be necessary to more closely align the economic and social models of the EU and Azerbaijan. The EU/EC shall fully exploit the framework provided by the PCA in all areas, and technical assistance shall continue to be provided in this respect. In particular, the EU/EC will continue to work with a view to consolidate democracy, the respect of human rights and the rule of law in Azerbaijan, as well as to improve the business and investment climate and increase trade. Legislative approximation is the highest immediate priority for the PCA in this context.

The EU/EC shall, in the light of the General Affairs Council's conclusions of 26/02/01 and 09/04/01, continue to follow closely, with all interested parties, developments on the peace process concerning the conflict with Armenia over NK, including with a view to contributing further to post-conflict reconstruction. As stated in the Luxembourg Joint Declaration (and the conclusions of the general Affairs Council of 21 June 1999 and of the European Council at Cologne) the EU accords very high priority to measures which can both (a) underpin a peace settlement and (b) prepare Azerbaijan to derive maximum benefit from the ending of the Nagorno Karabakh conflict and the reopening of communications. In this context priority should be given to demining actions in war damaged areas adjacent to the cease fire line and in the event of peace settlement in what are currently occupied territories. The priorities established in this Indicative Programme are oriented towards (b). But it cannot be excluded that in the event of a comprehensive

peace settlement, resources made available under Action Programmes based on this Indicative programme could be reallocated to address the most urgent needs for assistance to the normalisation process and the return of refugees and IDPs to their homes. Close coordination will be required with other EC programmes and other donors.

The EU objectives outlined above are in line with the European Community's statement on Development Policy, which called for a focus on a few priorities (i) reinforcing the link between trade and development – this is a cross cutting priority; (ii) support for regional integration and cooperation; (iii) food security and sustainable rural development (provisional); (iv) institutional capacity building, particularly in the area of good governance and the rule of law. Azerbaijan already benefits from EU trade policy through Most Favoured Nation status treatment (MFN), the Generalised System of Preferences (GSP) and a textile agreement. Increased benefits would accrue if Azerbaijan were to adhere to International Labour Organisation standards (ILO). While there is no direct application of EU environmental standards to Azerbaijan it has joined the Regional Environment Centre based in Tbilisi Georgia.

The EC will take full advantage of all its policy and financing instruments in working towards meeting the objectives.

The TACIS programme will be used to improve governance, to assist the implementation of the PCA and support the government poverty reduction strategy by helping the development and implementation of investment and economic development policy where Azerbaijan has a competitive advantage. These objectives shall contribute to the overall improvement in the business climate for investors in Azerbaijan.

The Tacis programme will focus on

- Support for institutional, legal and administrative reform, which will build on work started in the 1998/99 and 2000/01 National Action Programmes, including assistance for the creation and reform of central government ministries and policies, measures to ensure the legal and judicial framework is well adapted to the needs of the market economy and environmental needs. PCA implementation both in the economic and democratic sphere will be targeted.
- Support to the private sector and assistance for economic development remains a key element of the reform programme. Improvement of the business climate, which currently depresses the level of inward investment outside of the oil and gas sector, and more focussed encouragement for economic diversification needs to be provided. Assistance with the privatisation programme will be left to other donors and the IFIs, as the EC has carried out its pilot activities in this field under previous programmes.

Other crucial transport, environmental, and justice and home affairs issues will be considered under the Cross-Border Co-operation and Regional Co-operation programmes. Owing to Azerbaijan's key role in opening up of oil and gas transportation routes from the Caspian Basin to Europe, the energy sector in the country requires particular attention.

Compared to the National Indicative Programme agreed in 2000 for Azerbaijan which included three priority areas (support for institutional, legal and administrative reform, support to the private sector and assistance for economic development, and development of infrastructure networks), it is proposed to delete the infrastructure priority as it is covered by the regional programme.

In parallel to the Tacis programme the Food Security Programme shall remain an essential instrument contributing to : the poverty reduction policy; land reform; the related market reform and information policy; support to the social sector; agricultural reform, including post-privatisation issues; good governance in public finance and public expenditure. The details of the programme are set out in Annex 6 to the Country Strategy Paper.

The development of civil society and democracy will be given priority under the EC's Democracy programme. The EC Democracy programme will concentrate on projects related to conflict prevention and improving the rule of law. In this context the promotion and protection of freedom of opinion combating racism and protecting minorities will be themes for assistance. The Democracy programme effectively complements the Tacis national programme, as well as addressing the issue on a broader regional scale. Work will be carried out by the Council of Europe and the OSCE/ODIHR.

Particular attention will also be paid to opportunities for achieving horizontal environmental benefits in the activities proposed below for the National Indicative Programme 2002-2003.

6. Tacis National Indicative Programme

The Tacis National Action Programme will seek to assist the implementation of the PCA and the National Programme for Poverty Reduction (NPPR) of Azerbaijan. As identified in the analysis above, the core issues of good governance, the fight against corruption and poverty, and the need to develop a diversified economy and improve the business climate have to be addressed.

Azerbaijan is undergoing radical administrative and political changes in 2001 in preparation for the increasing oil revenues in the next 3-5 years. The Tacis programme seeks to assist the Government of Azerbaijan meet these challenges in coordination with the assistance of the IFIs and other donors.

It will be important to ensure the visibility of Tacis and other EU funded programmes in Azerbaijan. This issue should be addressed in detail during the preparation of Action Programmes.

The proposed strategy is prepared in the context of the status quo with respect to the conflict with Armenia over Nagorno Karabakh and the occupied territories. In close co-operation with the parties, competent international organisations and the countries of the region, the EU will look for further ways in which it could support efforts to prevent and resolve conflicts as well as in post conflict rehabilitation in the region. A comprehensive needs assessment will be required before any budget allocation can be made. While priority will need to be given to the achievement of the objectives of the Indicative

Programme it cannot be excluded that in the event of a comprehensive peace settlement, resources made available under Action Programmes based on this Indicative programme could be reallocated to address the most urgent needs for assistance to the normalisation process and the return of refugees and IDPs to their homes. Close co-ordination will be required with regional Tacis programmes, rehabilitation programmes and the Exceptional Assistance programme for Azerbaijan.

Area of Cooperation 1: support for institutional, legal and administrative reform

- *Background and justification.*

In 1999 the World Bank and Azerbaijan agreed to embark on an ambitious public sector reform programme. While this programme has been superseded by the new approach of the NPPR, many of the reform measures remain to be completed under the NPPR. Up until the end of 2000 very little progress had been made. However, since then, some progress has been made with the merger of ministries and the creation of the Ministry for Fuel and Energy. Tacis is currently involved in a number of key reforms, in areas including pay policy, the pension system, the legal and judicial system and the establishment of the Ministry of Transport. EC assistance has established its credibility with the Government, giving it a comparative advantage over assistance from other donors with less experience in the area. The implementation of the PCA provides the policy framework for EC assistance, adding political weight to the technical assistance programme.

Environmental protection is an issue that needs to be addressed. Key to this will be the reform of environmental legislation under the Ministry for the Environment.

Without EC assistance it is very likely that the reforms of the public sector will be delayed and be to non-European standards when they are undertaken. The increase in oil and gas revenues expected in 4-5 years time makes it imperative that the Government has the capacity to manage these resources effectively.

Azerbaijan and the EU share a common interest in having a stable and well-run government, both for economic as well as wider political considerations. Implementation of the Partnership and Cooperation Agreement, which is the cornerstone of Azerbaijan EU relations, shall be underpinned by specific assistance. One of the core activities for PCA implementation will be work on legislative approximation to be carried out by the Azerbaijan Policy and Legal Advice Centre (AZPLAC).

Azerbaijan's accession to the Council of Europe in 2001 is an important step that flanks bilateral cooperation between the EU and Azerbaijan. Similarly membership of the OSCE opens other areas of cooperation particularly in areas of strengthening democracy and human rights.

In the event of a peace settlement with Armenia, there will be an even greater need to have a fully functional government in place to ensure that the path to peace and stability is maintained.

- *Specific objective.*

The programme shall aim to increase institutional effectiveness, improve management and strengthen democratic institutions in certain key economic and judicial and legal ministries.

- *Description of programmes*

It is proposed to take a top-down approach, with reforms concentrated in central government. This is a reflection both of the need to reform the central systems which controls all activity in Azerbaijan and of the fact that local administrations are currently empty shells.

Tacis assistance shall be provided for the (i) continued assistance for the reform of the legal and judicial system started under the 2000-2001 Tacis National Action Programme, including reform of the prison system and environmental legislation; (ii) continued development of the PCA through assistance to the Azerbaijan Policy Legal Advice Centre (AZPLAC) started under the 1998-1999 Tacis National Action Programme; (iii) reform of the statistical services (Eurostat programme); (iv) TEMPUS aims at supporting the reform and restructuring of the partner countries' higher education systems and their adaptation to the new socio-economic needs. It does so through interaction and balanced cooperation between institutions in the EU member States and the partner countries organised in consortia. Consortia create long term cooperation links between the partners which should evolved towards issues such as academic recognition, credit transfer and development of joint-curricula. Priority areas of TEMPUS activities are jointly defined by the European Commission and national authorities in line with the areas of cooperation in the mainstream Tacis programme.

The beneficiaries for the programme will be the Ministries for Justice, Foreign Affairs (PCA), Environment, the State Statistical Committee and various higher education institutes.

- *Expected results*

The interim targets and indicators reflect priorities of the interim NPPR and are (a) establishment of functional management systems in the ministries; (b) depending on the results of the previous Action Programme, judicial reform will continue to improve procedures, transparency, accountability and competence of the judiciary and its administrative personnel, including drafting of civil, criminal and administrative procedural codes, including implementation of the Civil Code and reform of the prison system, and the development of environmental legislation; (c) improved statistical services provided by the State Statistical Committee for central administration, in accordance with the work programme agreed with EUROSTAT; (d) implementation of the PCA, including the preparation of a national programme for legislative approximation including assistance for standardisation, conformity assessment and technical regulations (close cooperation with the Ministry of Economic Development will be required); (e) TEMPUS - Projects address in particular: (1) issues of curriculum development and renewal in priority areas; (2) reform and modernisation of the structure and management of higher education institutions in view of strengthening their role in the society; (3) development of skills-related training to address specific higher and advanced level skills

shortage during the economic reform, in particular through improved and extended links with industry; (4) contribution of higher education and training to citizenship and the strengthening of democracy. The State Programme for the implementation of the PCA was presented at the Cooperation Council in October 2001 which will need to be considered in future development work. Close cooperation with the Council of Europe and the EU Democracy programme will be required.

- *Indicators*

- Progress on implementing the State Programme for the PCA.
- Achievement and implementation of legislative reform and functional management of ministries.
- Achievement of TEMPUS programme objectives.

- *Key domains for conditionalities, risks and assumptions.*

- Reforms carried out under the 1998/99 and 2000/2001 Tacis national Action Programme to be completed successfully before start of second phase projects.
- The EU, with other donors, will be consulted and participate in the development of the PRSP / NPPR. This must include a comprehensive analysis of the problems and establishment of what tasks have to be achieved.
- Implementation of the PRSP / NPPR to be carried out by the Government with the assistance of other donors according to the established timetable, including sectors not prioritised by the EC such as finance, health and education.
- Progress under EC funded non-Tacis programmes e.g. food security programme will be taken into account when programming complementary Tacis actions.

- *Risks and assumptions*

- It is assumed Azerbaijan will continue to strive for a peaceful resolution of the conflict with Armenia and that a military solution to the recovery of the occupied territories will not be implemented. Both Presidents have expressed the desire to settle the conflict through peaceful means. The use of military action to recover the occupied territories would seriously threaten the government's ability to implement its reform programmes.
- The pace of government reform programmes have to be maintained in accordance with the national programme if they are to be effective. Any slippage in the timetable will have to be minimised.
- *Indicative budget for priority*

The total budget allocation will be approximately € 6.0 m.

Area of Co-operation 2: support to the private sector and assistance for economic development

- *Background and justification.*

Azerbaijan's exports to the EU are concentrated in the oil and gas sector, accounting for 29% of total Azeri exports, while imports from the EU account for 0.03% of EU exports in 2000. EC assistance is needed to ensure that the reform measures result in increased and diversified trade and a greater degree of harmonisation between Azeri standards and those of the EC, as is foreseen in the PCA. For the PCA to be implemented successfully, Azerbaijan will need to improve standards of governance, improve the business climate and economic performance of the non-oil and gas sectors of the economy, and increase the levels of trade between the EU and Azerbaijan.

The preparation of the government poverty reduction strategy has for the first time resulted in a clear set of policy guidelines for Azerbaijan that integrates economic and social development. In parallel the Government has started to reorganise central administrative systems to reflect the needs of a market economy and modern government. It is therefore appropriate for the Tacis programme to focus its activities to the best effect to assist the process of reform.

The creation of the Ministry for Economic Development in 2001, bringing together five ministries and state committees into the one body is a major administrative step towards the achievement of a coherent economic strategy. This ministry needs assistance for the preparation of detailed economic development strategies, as well as to be able to continue work on accession to the WTO. Similarly continued assistance for the newly created Ministry for Fuel and Energy (2001) will be required to ensure that the proper controls and policy management is developed. A key parallel element will be to ensure that the Azeri oil industry is able to operate to world standards.

The lack of a widespread adoption of international tendering standards and the introduction of the Azeri language for all contracts is proving to be a barrier to trade and investment, especially in the non-oil sectors of the economy. Experience gained through the Management Training Programme under Tacis indicates that good results have been achieved and the programme can build on this for the future.

Azerbaijan, along with the other Caucasian states, is in a key location for trade with Central Asia. The growth of transit traffic through Azerbaijan is already beginning to demonstrate the need for a well constructed economic development strategy and trade policy. Tacis is ideally adapted to providing such assistance.

As under priority one, the EU has a comparative advantage over other donors in the activities to be proposed in this priority. This comes from a relatively long experience in the field and the consequent ability to build on the lessons from previous projects.

- *Specific objectives*

The Tacis programme shall seek to support the government poverty reduction strategy by helping the development and implementation of investment and economic development policy where Azerbaijan has a competitive advantage; assisting Azerbaijan in becoming a member of the WTO and in acceding to the Government Procurement Agreement; and improving levels of business management competence. These objectives shall contribute to the overall improvement in the business climate for investors in Azerbaijan.

- *Description of programmes*

Assistance to the new Ministry of Economic Development will concentrate on the preparation of economic strategies primarily designed to ensure economic diversification, both in terms of sectoral and regional development. Complementary to these activities will be assistance that continues the work started under previous Action Programmes to assist accession to the WTO and GPA (assistance for standardisation, conformity assessment and technical regulations will need to be coordinated with AZPLAC in Priority 1). In response to the wishes both of the Government and the EU business community, assistance for improvement of tendering procedures, legislative reform and improvement of practice will be carried out supported by the preparation of a technical dictionary in Azeri, English and Russian, covering tendering, contracting and other technical definitions. Consideration also needs to be given to ensuring that the regulatory environment conforms with that of the EU to facilitate the export of Azerbaijani products including certain agricultural goods such as wine. The continued development of the Ministry of Fuel and Energy and oil industry certification process started under the 2000-2001 Tacis National Action Programme will be a priority for the programme. The outcome of the management review will help guide the continued reform of the Customs service to reduce what is perceived by investors to be a significant barrier to business. Management training remains a priority and the SPP will assist these and the customs activities.

The main beneficiaries of the programme will be the Ministries of Economic Development and Fuel and Energy and the Customs Service.

- *Expected results*

Membership of the WTO is expected within three years, accession to GPA is also expected. Preparation of economic development strategies at both national and regional levels in line with the NPPR. Improvement in tendering procedures. Continued improvement in the efficiency and effectiveness of the Customs service. Management training for an additional [target number to follow] managers in private enterprises in Azerbaijan. Certification of oil supply industry to API standards.

- *Indicators*

Development and implementation of sectoral strategies, implementation of functional management systems in newly created ministries, achievement of WTO accession targets.

- *Key domains for conditionalities, risks and assumptions.*

See Priority 1 para 7.1.5 for common conditionality. Risks and assumptions are the same as for priority 1.

- *Indicative budget for priority*

The budget allocation will be approximately € 7.2 m.

7. Budget

The indicative budget for Tacis assistance during 2002-2003 is €14m.

Priority	Indicative Programme activity	Indicative Allocation (€m)
Priority 1 Support for institutional, legal and administrative reform		6.0
	Implementation of the PCA (Azerbaijan Policy and Legal Advice Centre)	
	Reform Legal and Judicial Legislation and System	
	TEMPUS	
	Statistics	
Priority 2 Support to the Private Sector and assistance for Economic Development		7.2
	Support to the Ministry of Economic Development, Development of the Ministry for Fuel and Energy, Modernisation of the Taxation system	
	Institutional building (Customs, Policy Advice)	
	Management Training Programme	
Reserve		0.8
Grand Total		14.0

8. Conditionalities

Assistance in the period of 2000-2006 is provided on the basis of the existence of the necessary elements for the continuation of cooperation through assistance, in particular respect of democratic principles and human rights, as well as the obligations of Azerbaijan as set out in the Partnership and Co-operation Agreement.

Annex 1 Programmes of EU Member States and other donors

	WB	UNDP	IMF	EBRD	IDB	JICA	USAID	ADB	Tacis	Others
Macroeconomic Stabilisation, Structural Reforms and Public Sector Reform	x	x	x						GOA Reform (future projects)	UK Know How Fund
Agriculture and Irrigation	x	x		x	x	x	x		SRB (current + future projects)	IFAD EU (Food Security)
Basic Urban Social Infrastructure	x			x						Germany (KfW)
Education	x								Tempus (on-going)	UNICEF, Soros
Cultural Heritage	x									UNESCO
Health	x	x		x		x				UNICEF, WHO Germany (GTZ) UNFPA
Social protection/Pension Poverty Alleviation	x		x					X	Pension (current project)	ILO UNICEF
Assistance to Refugees and IDP	x	x					x			UNCHR WFP ECHO Japan, Germany (GTZ), Int. NGOs
Oil and Gas	x			x					Inogate (on-going), SCADA (current project)	USTDA
Energy	x			x		x			Oil Contaminated Land (current), Electricity sector restructuring (current project)	JBIC KfW EU/EXAP
Transport	x			x	x				Min. Transport (current + future) Traceca (on-going) Bridges (future project)	Kuwait Fund
Finance Privatisation/Private Sector Development	x	x	x	x			x		Bank Training Centre (current proj) IAS (future proj) Securities cmttee (future proj) SME Development (current proj) SME Sector future proj	
Environment	x	x				x			CEP, JEP (current projs) Kura river (future proj)	UNDP/GEF
Law and Development	x			x			x		AzPLAC (preparation)	Germany (GTZ) CE US Chamber of Com.
Gender and Development	x	x								UNIFEM UNFPA UNICEF NGOs

Annex 2 Selected economic and social indicators

AZERBAIJAN

GENERAL

Area (square km):	87,000
Population 2000 (million):	8.1
Urban Population (1999):	56.9 %
Life Expectancy (1999) :	71.6 years
Population growth rate (1990-99) :	1.2%
Fertility Rate per woman (1998):	2.0
Human Development Index (HDI) Rank:	79

ECONOMY

Nominal GDP 2000 (US\$):	5.3 billion
GDP per capita 2000 (US\$):	650
GDP Breakdown by sector value added (2000) :	
Agriculture:	19 %
Industry:	38 %
Services:	43 %
Real GDP growth rate (2000):	11.1 %
Estimated real level of 1999 GDP as % of 1989 GDP : 47 %	
Inflation:	
1997	3.7%
1998	-0.8%
1999	-8.5%
2000	1.8%
External debt stock (2000): US\$)	1184 million
Debt Service: (2000):	4.4 % of exports of goods and services.

(All figures for 2000 in million US \$)	(all figures in million euro for 1999, unless otherwise stated)
Exports of goods & services: 2.146	Exports to EC: 444
Imports of goods & services: 2.023	Import from EC: 214
Current account balance: -150	Trade balance with EC: - 230
FDI (1999) 510	FDI of European origin: NA

Social Development

Adult Literacy Rate:	97.0%
Primary Enrolment Rate (2000):	not available
Secondary enrolment rate (2000):	not available
Infant mortality (1999):	35 per 1,000 live births
Under 5 mortality (1999) :	45 per 1,000

Contraceptive prevalence rate:	not available
Access to essential drugs	66%
Access to safe water:	not available (Piped water 95.7% urban, 85.6% small towns, 11.5% rural)
Access to sanitation:	not available (Urban areas 49.3%, 31.8% small towns, 0 rural areas)
Under 5 malnutrition	10 %
Number of doctors/100,000 people	285

Sources: World Development Report 2000/2001; Human Development Report 001; UN Economic Survey of Europe 2001 (1); Transition Report 2000 (EBRD); IMF World Economic Outlook (May / October 2001), World Bank website; EUROSTAT COMEXT; Azerbaijan State Committee for Statistics Statistical Yearbook 2000.

Annex 3 Additional Basic Statistics

Population

Age structure: 0-14 years: 30% (male 1,172,944; female 1,127,624)

15-64 years: 63% (male 2,388,737; female 2,525,797)

65 years and over: 7% (male 210,774; female 322,287) (2000 est.)

Birth rate: 14.9 births/1,000 population (2000 est.)

Death rate: 5.9 deaths/1,000 population (2000 est.)

Net migration rate: -5.92 migrant(s)/1,000 population (2000 est.)

Sex ratio: at birth: 1.05 male(s)/female

under 15 years: 1.04 male(s)/female

15-64 years: 0.95 male(s)/female

65 years and over: 0.65 male(s)/female

total population: 0.95 male(s)/female (2000 est.)

Life expectancy at birth: total population: 71.6 years (2000 est)

male: 68.1 years

female: 75.1 years

Ethnic groups: Azeri 90%, Dagestani 3.2%, Russian 2.5%, Armenian 2%, other 2.3% (1998 est.). *Note:* almost all Armenians live in the separatist Nagorno-Karabakh region.

Religions: Muslim 93.4%, Russian Orthodox 2.5%, Armenian Orthodox 2.3%, other 1.8% (1995 est.). *Note:* religious affiliation is still nominal in Azerbaijan; percentages for actual practising adherents are much lower.

Languages: Azeri 89%, Russian 3%, Armenian 2%, other 6% (1995 est.)

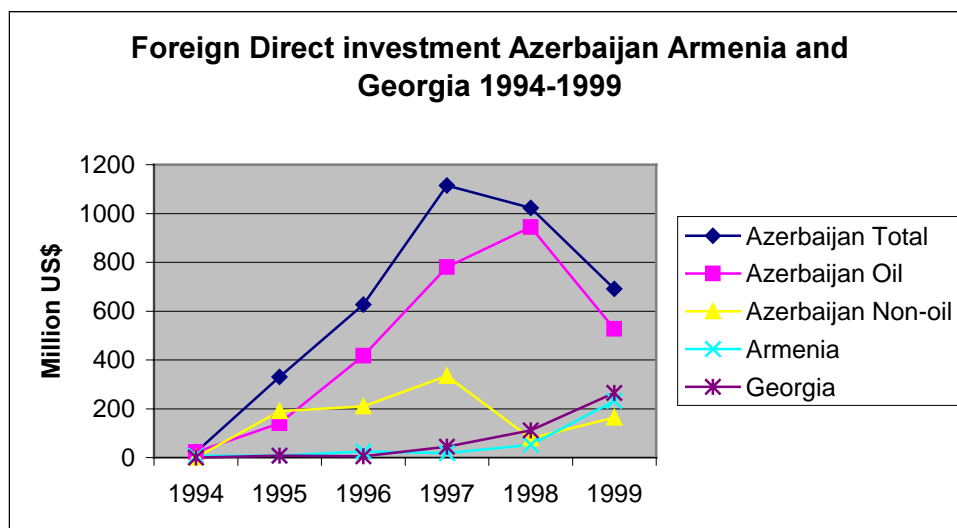
Source CIA Year Book 2000 and Azerbaijan National Statistics

Recent Trends and Prospects and basic statistics *Source iPRSP 2001*

	1998	2000	2005
GDP Total US\$ million	4,447	5,267	6,818
GDP per capita US\$	570	664	818
Real growth % (inc oil)	10	11.1	13
Real growth % (exc oil)	5.4	13.3	8.7
Population	7,793,000	7,926,900	8,331,000
Public Debt	NA	NA	NA
Inflation index	99.3	101.8	103

Foreign Direct Investment to Azerbaijan (US\$) Source DFID report 2001

	1994	1995	1996	1997	1998	1999	Total 1994- 99	FDI per capita \$US	FDI / GDP%
Total (\$m)	22	330	627	1115	1023	691	3808	82	15.5
Oil FDI(\$m)	22	140	417	780	944	527	2830	61	11.5
Non-oil (\$ m)	0	190	210	335	79	164	978	21	4.0



Annex 4**EC-assistance to Azerbaijan****(€ million)**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002/3	Total
Tacis												
National Allocations	12.5	4.00	4.00	6.00	8.00	8.00	8.00	8.00	7.00	7.00	14.00	86.5
Exceptional Assistance							10.0	10.0	10.0	0	0	30.0
ECHO		12.24	18.85	28.82	7.70	6.10	4.10	3.36	1.5	0	0	82.67
FEOGA				43.0	22.65							65.65
DG VIII												
Food security					15.0	16.0	14.0	12.0	0	0	20.0	77.0
Rehabilitation					3.00	4.00	4.50	3.20	3.674	0	0	18.874
Exceptional Humanitarian Aid		8.00						1.50	0	0	0	9.5
Total	12.5	24.24	22.85	77.82	56.35	34.10	40.6	38.06	22.17	7.00	34.0	370.194

Total 1992-2002/3: Million €369.694

Source EC DG RELEX

Annex 5 Tacis National Action Programme 2000-2001 categories of activity

Project	Government reform etc	Economic diversification	National Regional and development
COM Reform	X		
Pay policy	X		
Reform of the legal and justice system	X		
Rural credit		X	
Accountancy standards	X	X	
Agri processing		X	
Securities market	X	X	
Budget preparation Min of Agriculture	X		
Continuation of project to create a ministry of transport and development of the transportation sector	X	X	
Bridges on Baku Tbilisi road			X
TEMPUS	X		

Annex 6 Food Security Programme Indicative activity

Area of Cooperation 1: support for institutional, legal and administrative reform

- *Background and justification.*

The development of the non oil sector is still lagging behind and the contribution of the FSP is mainly to support a reform agenda that will boost investment and contribute to establish agricultural services with a clear definition of roles between the Public and the Private. In the agricultural sector the economic situation has worsened in spite of the growth of the sector in recent years. The dismantling of the soviet type structures happened at a faster pace than their replacement by a market economy leaving the rural areas without support services (management, marketing, input provision).

The agricultural production is done mainly in the irrigated plains in the arid and semi arid climatic conditions and in soils prone to salinity problems, this is a serious environmental problem with implications in the reduction of current and future productive potential of the country and loss of income by the poor who are more vulnerable to changes in the production system.

The support to the Social sector is a recent feature of the Programme and represents an evolution in the concept of food security from availability to access. This support will continue with the establishment of a policy unit co-funded by donors according to the PRSP to improve planning and monitoring of social policy.

Monitoring food security and vulnerability was part of the activities of the FSP since the inception of the programme and was achieved through the establishment of the Department Food Security Information System in the State Statistics Committee.

Specific objectives.

- To contribute to mitigate the risk on the most vulnerable and food insecure population of an unbalanced economy based on a single product export.
- To contribute to reduce poverty by promoting the development of the non-oil sector by focusing on redistribution of wealth and increased access to food and income, as well as on the promotion of adequate State reforms.
- To contribute to increase the preparedness for a post conflict scenario/perspective of rehabilitation of occupied territories, assisting IDPs and refugees by reforming the social sector and developing the economy of neighboring areas which have suffered the impact of the war.
- *Description of programmes*

The support to the reform of the Ministry of Agriculture will continue towards the rationalization of the agricultural services and institutional development.

The animal health situation is poor with a national epizootic plan poorly managed by the central services and lacking appropriate financial means. The support of the programme was targeted to the animal vaccination campaign which is a means to preserve the assets of the poor since the mountainous regions are amongst the poorest in the country and livestock is the main source of revenue, as well as it was for the displaced population of Karabagh therefore the support to the sector will be instrumental to help a future reestablishment of the livelihoods of internally displaced people.

The support to the State Melioration and Water Management Committee in the Cabinet of Ministers has contributed to the operation costs of the system. In the future this will be integrated in a comprehensive agrarian and irrigation strategy, adequate institutional reform and focused on environmentally sustainable interventions and promotion of an improved system for soil and water management.

Support to the child welfare budget will be carried out mainly through the Ministries of Education and Labour and Social Protection. It is important to reallocate resources from institutional care to family based care with increase targeting of the most vulnerable families as well as to promote a de-institutionalization policy. In the near future the FSP will support: the creation of a data base of vulnerable children who are institutionalized, preparation of a child protection strategy, extension of existing community and family based approaches to child welfare to all orphanages and boarding schools.

The budgetary support to the Food Security Information System (FSIS) is ongoing and it is important to define key indicators to improve the data collection system and strengthen the analytical capacity of the unit and the functioning of the inter-ministerial working group. Additionally this activity will benefit as well from the support of the EC funded project implemented by FAO to strengthen the early warning capacity in the CIS countries. It will be a preoccupation of the programme to integrate the FSIS activities within a broader framework of the poverty monitoring system to be set within the poverty reduction national strategy.

It is critical to widen the concept of the State to other democratic institutions (such as the parliamentary groups, the elected local bodies such as Municipalities amongst others) to achieve this it is important to improve the programming of Budgetary support to target these institutions. An essential part of this process will be the stimulation of a vigorous dialogue in policy formulation and support for initiatives involving representatives of the civil society, (such as NGOs or farmers' associations). This will be instrumental in diversifying the Commission's partners and to be effective in areas of intervention which fall out of the regulatory role of the State such as the establishment of farmers and water user's associations as well in child welfare in the social sector.

- *Expected results*

Number of people living in extreme poverty reduced with the participation of everyone in rising income and access to adequate level of food by the entire population at all times and access to sufficient level of public services in the social sphere.

Social protection policy strengthened and targeting of social protection system improved

Economically and environmentally sustainable utilization of the underdeveloped potential of the agricultural sector and its natural resource base promoted (as a main non-oil sector)

through increased investment, raising the employment opportunities for 40% of the nation's labour, increasing productivity and income from the sector.

Economic base for raising the income of the regions affected by the war developed and the process for facilitating the return of IDPs initiated.

State reforms promoted in order to create a National framework to reduce poverty and increase food security.

Effects of external shocks due to the fluctuation of the exchange rate and unstable oil price cushioned by reducing the State deficit.

Institutional and legal framework promoted in order to create an enabling environment for the development of the private sector and increasing employment opportunities.

Increase the emergency preparedness capacity through the establishment of a food security information system.

- *Indicators* (This section will be completed before submission to the iQSG.)

Level of extreme poverty and poverty from the poverty monitoring system and FSIS.

Level of access to the social protection from the most vulnerable part of the population.

Efficiency of targeting mechanisms of and number of people registered.

Level of implementation of reforms of social protection in the conformity with the adequate and improved legislation.

Growth in the level of investment in the agricultural sector.

Number of new agricultural enterprises or associations established.

Analysis of Agricultural statistics in average years.

Level of export of agricultural produce.

Level of implementation of institutional reforms in the agricultural sector.

Coverage and effectiveness of epizootic plan.

- *Key domains for conditionalities, risks and assumptions.*

Full implementation of PRSP in all sectors.

Definition of sector strategies.

Continuing the institutional reforms in the agricultural and social sectors.

Support and implementation of an integrated food security and poverty monitoring system.

Improving transparency and management of public expenditure.

- *Risks and assumptions*

Poverty reduction strategy formulation is delayed and the policy and implementation matrix is insufficiently developed.

Budgetary allocations to the National Poverty reduction Programme do not match expected results.

Peaceful resolution of the conflict with Armenia and Regional stability in the neighboring countries.

Azerbaijan

