SECTOR ASSESSMENT (SUMMARY): PUBLIC SECTOR MANAGEMENT AND FINANCE

1. Sector Performance, Problems, and Opportunities

1. Azerbaijan’s economy is poorly diversified, with hydrocarbons constituting over 90% of exports throughout 2009–2014 and the non-oil sector remaining underdeveloped. In terms of economic value added, the average share of mining and quarrying in total gross domestic product (GDP) remained about 26.4% in FY2015. Manufacturing value added, which is considered to be an engine of growth, constituted about 5% of GDP in 2015. The share of agriculture also remained low, at about 6.2% of GDP.

2. The crash in world oil prices in 2015 severely affected Azerbaijan’s economy—leading to a negative growth rate, a reduction in export revenues, and a contraction in public investment. Devaluation of the national currency, the manat, by 57% in 2015 and the consequent high inflation (about 13% in 2016) greatly increased poverty and unemployment. To mitigate the immediate substantial negative economic effects, the government put together countercyclical development expenditure programs. In addition to mitigating the poverty of vulnerable sections of the society, such programs will help Azerbaijan adopt a new economic development model by moving to an export-led growth paradigm and diversified economy in the medium term. The government development programs will need to (i) increase the sustainability of the non-oil fiscal deficit over the medium term, (ii) target the most critical areas for growth and the social safety net; and (iii) enhance the transparency and efficiency of publicly funded projects, removing constraints for infrastructure, employment, and a diversified economy.

3. Overall, Azerbaijan performs well in terms of comprehensiveness of the public financial management system. Budget comprehensiveness and transparency, as well as predictability and control in budget execution, have improved significantly since 2014. Major improvements have been made since 2014. All public finances in Azerbaijan are captured in the consolidated budget, which includes the state budget, the budget for the autonomous region of Nakhchivan, the State Oil Fund of Azerbaijan (SOFAZ), the State Social Protection Fund, and external borrowings. The legal framework for financial management is described in the Budget System Law, amended in 2012, with specific provisions outlined in the annual Budget Laws.

4. The measures implemented by the government are aimed at ensuring aggregate fiscal discipline, improving the effectiveness of allocations, and increasing the efficiency of operations. These measures include carrying out a transparent and well-functioning budgeting process, monitoring the budget execution of public companies, controlling the use of government guarantees in obtaining loans, periodic analysis of public debt sustainability, and complete inclusion of revenues and expenditures related to the public sector in the central government budget. All transactions related to the rayon (regional) and supplementary budgets are executed through the Treasury Single Account system. To integrate local budgets with the centralized budget, intergovernmental transfers were introduced.

5. Not all expenditures or fiscal activities related to the public sector are financed through the central government budget. Financing of some development programs occurs outside formal state budget planning and execution procedures, e.g., spending by the State Oil Company on health and education programs. Such quasi-fiscal sources need to be included in

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the budget for enhancing transparency and improving accounting of contingent liabilities, which will increase the accuracy of fiscal risk analysis. Improved budget transparency and better control of the non-oil budget deficit requires the delineation of oil and non-oil revenues and special treatment of SOFAZ expenditures in fiscal accounting.

6. Countercyclical fiscal policy to counter external economic effects is expected to expand the non-oil fiscal deficit further. The consolidated budget position changed from a surplus of 3.2% of GDP in 2014 to a deficit of 6.8% of GDP in 2015, and the deficit is expected to increase to 9.9% of GDP in 2016 despite an additional $1 billion transfer from SOFAZ. To achieve the benchmark target of a sustainable level of non-oil deficit of 5%–10% of GDP by 2030, the government intends to reduce the non-oil fiscal deficit of the consolidated budget by gradually decreasing SOFAZ transfers to the state budget and boosting non-oil sector revenues. Transfers from SOFAZ to the state budget fell from 50.7% of total revenue in 2014 to 46.5% in 2015, and decreased to 41.4% in 2016. In parallel, non-oil sector revenue is projected to increase by 9% in 2016 compared with 2015.

7. Internal audit and financial control capacities have been improved through government reforms. The State Financial Control Service of the Ministry of Finance (MOF) performs the internal audit function. The control service was established in 2009 to improve MOF’s financial management as an ex-post inspectorate for reviewing financial compliance. Procurement systems and legislation have improved, but problems remain. Public procurement procedures in Azerbaijan meet four of the six dimensions for transparency, comprehensiveness, and competition in the legal and regulatory framework. However, explicit identification of competitive methods as the default procedure must be improved along with establishment of a transparent and independent complaint review arrangements.

8. Many factors constrain the development of private sector activities in Azerbaijan. The main impediments include complex business regulatory systems, unofficial monopolies, limited access to finance, lack of a skilled workforce, and weak coordination in policy making among government departments. Limited availability of affordable sources of capital is a major constraint in the development of private business. Although credit has expanded significantly since 2005, financial intermediation is still low, with financial assets representing less than 35% of GDP. Government initiatives such as the Azerbaijan Investment Company and the National Fund to Support Entrepreneurship have been set up to finance priority projects supporting development of the non-oil sectors. The business environment for micro, small, and medium-sized enterprises is improving since 2010 but substantial barriers remain. The share of small enterprises in non-oil GDP is about 4.3% and employment is at 2.6%, while two-thirds of the internal market consists of large enterprises. Micro, small, and medium-sized enterprises continue to face barriers to business, including high taxation, lack of business sophistication, an unskilled workforce, and lack of access to affordable finance.

2. Government Strategy

9. In response to the economic crisis, the government has adopted a two-pronged strategy: (i) provide countercyclical stimulus to arrest the decline in growth while providing social safety net measures to moderate the adverse impact of lower incomes and higher inflation; and (ii) implement public financial management reforms and initiate the critical structural reforms to

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diversify the economy. To implement these programs, the government revised the budget for 2016 substantially. Total budget expenditure increased by 23.1\% from AZN19,906 billion to AZN24,566 billion. This increases current expenditures by 19\%, including a 42.3\% increase in social security and social protection expenditures. To enhance social protection, the following measures were introduced: (i) workers’ wages were increased by 10\% as of 1 March 2016 in a number of state budget sectors (social security, education, science, culture, and agriculture); (ii) the basic retirement benefits were raised by 10\% as of 1 February 2016 to AZN110 (about AZN140 million is projected to be allocated for this purpose); (iii) the amount of social benefits, invalidity worker’s benefits, and food allowance for refugees were increased by 10\% as of 1 February 2016; and (iv) an additional AZN20 million will be allocated from the reserve fund of the President to support social security for low-income families.

10. To stimulate business and help create jobs, as well as provide funding for loans to manufacturing and agriculture businesses, entrepreneurship support expenditures increased twice (from AZN66 million to AZN136 million) in 2016. In addition, the amount of taxable transactions on simplified tax increased from AZN120,000 to AZN200,000 to support small and medium-sized enterprises (SMEs). To support investment programs, expenditures increased by 42.1\% (excluding projects financed through foreign borrowing). Weaknesses in external and internal audit are being addressed through the Public Financial Management Action Plan developed and approved by MOF in April 2015. Guidelines on planning, managing, and performing state financial control have been established jointly with the European Union’s Twinning project. Important procurement reforms are under way. Proposed implementation of e-procurement is under review by the government. As one of the optimization measures, the State Procurement Agency has been abolished as a stand-alone agency and combined with the Ministry of Economy. The National Anti-Corruption Action Plan, 2012–2015 now includes improving public procurement and transparency, which is recognized as a positive step for enhancing transparency in public procurement.

11. The government plans to initiate and implement critical structural reforms in 2016-2020. A presidential advisor on economic reforms was appointed as a focal person and an interagency working group established to develop long-term strategic development plans for the national economy and its sectors. The government is in initial discussions with ADB to develop a policy-based program to enhance the effectiveness of government-initiated reforms. The objective of ADB’s planned Public Sector Efficiency and Management program is to strengthen fiscal and financial management, improve public sector performance, and facilitate development of the private sector. The program is expected to have three policy areas (paras. 12–14).

12. Policy area 1 will help strengthen macroeconomic and fiscal management. Policy actions may include (i) designing and integrating a rolling multiyear medium-term fiscal framework and medium-term expenditure framework in budget making; (ii) amending the Law on State Debt, 1992 and secondary regulations to consolidate the legal framework on government debt management; (iii) designing and adopting a medium-term debt management strategy covering the loan portfolio, goals and principles of incurring new debt, issues of debt sustainability, and development of the domestic government securities market; (iv) improving the analytical function of the Public Debt Management Office with an upgraded debt management and risk analysis system integrated with budget and treasury systems; (v) strengthening internal audit in the line ministries and MOF through the adoption of risk-based internal audit; and (vi) designing and enacting comprehensive amendments to the Budget System Law, 2002 and secondary

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legislation related to the medium-term fiscal framework, fiscal rules, and program-based budgeting.

13. Policy area 2 will improve public sector efficiency and accountability. Policy actions may include (i) designing and developing the public investment framework to introduce a formal and objective appraisal of state investment programs based on the project management cycle; (ii) ascertaining the fiscal position, audited financial position, and extent of contingent liabilities of state-owned enterprises (SOEs); (iii) on the basis of the fiscal position of select SOEs, putting in place a financial restructuring and debt restructuring plan for financial viability; (iv) developing corporate governance rules for better management of SOEs; and (v) introducing commercialization and private partnership in the delivery of services in select SOEs.

14. Policy area 3 will deepen the financial sector and expand private sector participation. Policy actions may include (i) adopting the Law on Full Deposit Insurance to generate confidence in the banking system; (ii) implementing the Law on Capital Markets and relevant by-laws to increase access to finance for businesses; (iii) developing and expanding the liquid interbank money market; (iv) developing and expanding the liquid government securities market; (v) increasing employment opportunities in the regions through financial inclusion and SME financing and skills building; (vi) establishing a single financial industry mega regulatory authority to strengthen financial sector regulation, stability, and the coordination mechanism; (vii) implementing steps to strengthen ease of doing business, including single-window clearance for SMEs; and (viii) adopting the Law on Funded Part of Labor Pensions and Law on Private Pension Funds required for the establishment of the funded component of the pension system and for the development of non-state pension institutions.

3. ADB Strategy

15. Through its sovereign and nonsovereign operations, ADB is supporting Azerbaijan’s transition to a diversified economy, facilitated by robust non-oil economic growth. To support this, ADB is prioritizing critical infrastructure sectors that include transport, urban infrastructure, and energy. Through its nonsovereign operations ADB is supporting the outreach of financial institutions to Azerbaijan’s rural and regional businesses, including farmers. However, this effort has been undermined by the difficult market environment in which banks lack access to local currency funding and have to scale back their lending.

16. The oil price shock that started in 2014 requires ADB assistance to help the country implement a countercyclical fiscal stimulus package to sustain broad-based and inclusive growth. This is expected to be followed by a policy-based loan in 2017 to help the government initiate critical structural reforms in the economy comprising governance reforms, development of non-oil export sector and improvement of the business climate.

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Azerbaijan’s economy is heavily dependent on hydrocarbon revenues, making it vulnerable to external price shocks, and limiting efforts to diversify the economy.

Institutional constraints—weak governance, accountability, and competition frameworks—create disincentives for entrepreneurship and innovation, which prevent the shift to a diversified economy.

Developments

**Problem**

- Absence of medium-term fiscal, expenditure, and debt management frameworks

**Causes**

- Insufficient supply and lack of access to affordable finance for small and medium-sized enterprises raise the cost of doing business in Azerbaijan
- Oversized and inefficient state-owned enterprises dominate large parts of the economy
- Weak anticorruption, judiciary, and regulatory capacity lead to rent-seeking behavior; and well-connected, large, domestic holding companies crowd out private initiative and entrepreneurship