Report and Recommendation of the President to the Board of Directors

Project Number: 51059-002
November 2019

Proposed Policy-Based Loan for Subprogram 2 and Technical Assistance Grant
Republic of Azerbaijan: Improving Governance and Public Sector Efficiency Program

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Asian Development Bank
CURRENCY EQUIVALENTS
(as of 29 October 2019)

Currency unit – Azerbaijan manat/s (AZN)

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<th>AZN</th>
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ABBREVIATIONS

ADB – Asian Development Bank
CAPE – country assistance program evaluation
CSO – civil society organization
CSFL – countercyclical support facility loan
EITC – Extractive Industries Transparency Commission
EITI – Extractive Industries Transparency Initiative
GDP – gross domestic product
MLSP – Ministry of Labor and Social Protection of Population
MOF – Ministry of Finance
MTEF – medium-term expenditure framework
MTFF – medium-term fiscal framework
PPEF – Post-Program Engagement Framework
PSM – public sector management
SECO – (Swiss) State Secretariat for Economic Affairs
SMEDA – Small and Medium Enterprise Development Authority
SMEs – small and medium-sized enterprises
SOE – state-owned enterprise
SOFAZ – State Oil Fund of Azerbaijan
TA – technical assistance

NOTE

In this report, “$” refers to United States dollars.
| Vice-President | Shixin Chen, Operations 1 |
| Director General | Werner Liepach, Central and West Asia Department (CWRD) |
| Director | Tariq H. Niazi, Public Management, Financial Sector and Trade Division, CWRD |
| Team leader | João Pedro Farinha-Fernandes, Senior Financial Sector Economist, CWRD |
| Team members | Çiğdem Akın, Senior Public Management Economist, CWRD |
| | Ethyl Bulao-Lorena, Senior Operations Assistant, CWRD |
| | Yuji Miyaki, Public Management Specialist (Taxation), CWRD |
| | Hanif Rahemtulla, Senior Public Management Specialist, Sustainable Development and Climate Change Department |
| | Lyle Raquipiso, Senior Economics Officer, CWRD |
| | Patricia Rhee, Principal Counsel, Office of the General Counsel |
| | Mary Alice Rosero, Social Development Specialist (Gender and Development), CWRD |
| | Laisiasa Tora, Economist (Public Finance), CWRD |
| | Nail Valiyev, Senior Economics Officer, Azerbaijan Resident Mission, CWRD |
| Peer reviewers | Matthew Hodge, Senior Country Specialist, Pacific Department |
| | Jurgen Conrad, Principal Financial Sector Specialist, South Asia Department |

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## PROGRAM AT A GLANCE

### 1. Basic Data

- **Project Number:** 51059-002
- **Project Name:** Improving Governance and Public Sector Efficiency Program (Subprogram 2)
- **Department/Division:** CWRD/CWPF
- **Executing Agency:** Ministry of Finance
- **Country:** Azerbaijan
- **Borrower:** Republic of Azerbaijan
- **Country Economic Indicators:**
  - Portfolio at a Glance: [https://www.adb.org/Documents/LinkedDocs/?id=51059-002-PortAtaGlance](https://www.adb.org/Documents/LinkedDocs/?id=51059-002-PortAtaGlance)

### 2. Sector

<table>
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<th>Subsector(s)</th>
<th>ADB Financing ($ million)</th>
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<tr>
<td><strong>Total</strong></td>
<td><strong>250.00</strong></td>
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</tbody>
</table>

### 3. Operational Priorities

- **Strengthening governance and institutional capacity:** Low

### 4. Risk Categorization:

- **Complex**

### 5. Safeguard Categorization

- **Environment:** C
- **Involuntary Resettlement:** C
- **Indigenous Peoples:** C

### 6. Financing

<table>
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<tr>
<th>Modality and Sources</th>
<th>Amount ($ million)</th>
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<td>0.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>250.00</strong></td>
</tr>
</tbody>
</table>

Note: An attached technical assistance will be financed on a grant basis by the Technical Assistance Special Fund (TASF-OTHERS) in the amount of $800,000.

**Currency of ADB Financing:** US Dollar
I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based loan to the Republic of Azerbaijan for subprogram 2 of the Improving Governance and Public Sector Efficiency Program. The report also describes proposed technical assistance (TA) for Improving Governance and Public Sector Efficiency, and if the Board approves the proposed loan, I, acting under the authority delegated to me by the Board, approve the TA.

2. The proposed program aims to strengthen governance in the public sector and the diversification of the economy by introducing rule-based fiscal planning in the budget systems of the Government of Azerbaijan, reforming the legal and institutional structures of state-owned enterprises (SOEs), and helping improve the business environment and access to finance for small and medium-sized enterprises (SMEs). This is the second of two subprograms included in the programmatic approach that was approved in November 2017.1

II. PROGRAM AND RATIONALE

A. Background and Development Constraints

3. Economic crisis and countercyclical policy response. After gaining independence in 1991, Azerbaijan registered rapid economic growth of about 11% per annum during 1995–2013 and transformed itself into a middle-income country—gross national income per capita increased from $610 in 2000 to an annual average of $5,850 during 2008–2016. The poverty rate in 2015 was a low 4.9%. This growth was largely fueled by hydrocarbon-related activities, which contributed 90% of the country’s exports and about 75% of gross domestic product (GDP) and government income. Construction activity and bank credit induced by foreign currency inflows also propelled the private economy forward till 2014. However, the real appreciation that accompanied this economic pattern also resulted in a gradual loss of competitive productive capabilities outside the extractive industry.2 The past buildup of vulnerabilities to volatility in oil production and prices revealed itself during 2015–2016. As oil prices plunged, the concomitant sharp devaluation of the national currency and the resulting distress in the asset quality of a banking system that had accumulated significant currency risk exposures sent Azerbaijan into a crisis.3 This led to a significant inroad into the sovereign wealth fund and a surge in nonmarketable public debt ratios.4 GDP contracted by 3.1% and poverty increased to 5.9% in 2016. The government (i) provided countercyclical fiscal stimulus; (ii) let the exchange rate float; and (iii) initiated institutional reforms of the finance sector and efforts to consolidate the banking system.

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2 Extractive industries still dominate the economy, contributing on average about 51% of GDP during 2013–2017, followed by services (36% of GDP) and agriculture (5.6% of GDP). Mining (90% oil and gas extraction) contributes about 80% of total industrial output and more than 50% of gross capital formation.
3 Remittances from Azerbaijani nationals living in oil-rich neighboring countries (mostly to rural Azerbaijan) also declined by one third.
4 The crash in the global oil prices from a high of $110 per barrel in 2014 to $50 in 2015 caused a significant fall in the country’s foreign revenues. Two waves of sharp devaluation of the Azerbaijan manat against the United States dollar in 2015, large state spending on the Shah Deniz II gas field, and the rescue of a major state-owned bank almost tripled the government’s foreign debt from 8.4% of GDP in 2014 to 22.8% of GDP in 2017. The fiscal balance of the central government budget shifted from a surplus of 2.9% of GDP in 2014 to a deficit of 4.8% in 2015. In 2016, without transfers from State Oil Fund of Azerbaijan (SOFAZ), the deficit was 13.4% of GDP.
Economic and financial vulnerabilities revealed. The Asian Development Bank (ADB) supported this short-term response through a $500 million countercyclical support facility loan (CSFL) in 2016.\(^5\) Countercyclical policy efforts and the recovery of the oil prices helped stabilize the macroeconomy in 2017: GDP grew by 0.1% in 2017 and by 1.4% in 2018 (non-oil GDP grew by 1.8%). The economy is now forecast to grow above 2.0% in 2019, driven by non-oil growth, reviving oil prices, a return to growth in key regional trading partners, and the start of production at the Shah Deniz II gas field.\(^6\) But the external shocks of 2014–2016 revealed key economic and financial vulnerabilities, institutional fiscal inefficiencies, and a need to accelerate economic diversification in Azerbaijan. Low economic diversification stems not only from the process of real appreciation and deindustrialization that accompanied Azerbaijan’s recent economic history but also from (i) an inefficient finance sector, (ii) a weak enabling environment for non-oil private sector development, and (iii) inefficiencies in the delivery of public services that the private sector depends on. Handicaps in fiscal management and public sector planning stood in the way of proper public policy responses to these challenges and actually generated fiscal procyclical biases that exacerbated macroeconomic vulnerabilities.\(^7\) The government’s response to the crisis laid the foundation for wider structural reforms. ADB’s CSFL, approved in 2016, formalized a commitment to a medium-term engagement with the government to: (i) strengthen fiscal management, by establishing medium-term fiscal and debt management frameworks; (ii) improve public sector efficiency and accountability, by developing a public investment framework as well as SOEs reforms; and (iii) deepen the finance sector and expand the role of the private sector by promoting the development of SMEs.

Azerbaijan’s development strategy. The recognition that the economy’s heavy reliance on hydrocarbon revenues posed a major risk to fiscal sustainability in the long run and masked deep weaknesses in fiscal and public sector management (PSM) triggered a longer-term reform effort. In December 2016, the President of Azerbaijan approved the country’s new development strategy, the Strategic Roadmaps on National Economy Perspectives and Main Sectors of the Economy,\(^8\) with three horizons: strategic vision for 2020, long-term vision 2025, and aspirational vision for post-2025. A key objective of the Roadmaps is to strengthen institutional mechanisms to deliver on policy.\(^9\)

Core development problem: Inefficient allocation of public resources and private savings.\(^10\) The complex set of challenges summarized below contributes to the underdevelopment of non-oil tradable sectors in the Azerbaijani economy and its significant vulnerability to external shocks. Root problems can be summarized in three policy areas.

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\(^6\) The development of the Shah Deniz II gas field is set to almost triple Azerbaijan’s annual gas production capacity.

\(^7\) Windfall oil revenues led to an unsustainable size of public expenditures and vulnerability of the budget to the fluctuation of global oil prices and production volumes. SOFAZ, a sovereign wealth fund established in December 1999, had assets totaling $39 billion (92% of 2017 GDP) in January 2019. During 2013–2017, SOFAZ transfers made up about 48% of total budget revenues. During 2015–2017, government expenditure in Azerbaijan averaged 36.7% of GDP, against an average of 27.3% of GDP for Caucasus and Central Asian countries. Expansionary budget spending during 2005–2014 contributed to real appreciation and therefore hurt the non-oil tradable sectors.

\(^8\) President’s Decree no. 1138 dated 6 December 2016 on approval of the Strategic Roadmaps on National Economy Perspectives and Main Sectors of the Economy. The main sectors are (i) oil and gas; (ii) agricultural production; (iii) SMEs; (iv) heavy industry and machinery; (v) tourism; (vi) logistics and trade; (vii) technical and vocational education; (viii) social housing; (ix) financial services; (x) information and communication technology; and (xi) utilities (electricity, water supply and sanitation, heating, and gas supply).

\(^9\) Among the new institutions are the Center on Analysis of Economic Reforms and Communication, Financial Market Supervisory Authority, Energy Regulatory Agency, Small and Medium Business Development Agency.

\(^10\) Sector Assessment (Summary): Multisector (accessible from the list of linked documents in Appendix 2).
7. **Root problem area 1: No medium-term fiscal policy or planning, and ineffective public debt management.** The budgetary practices of the government were largely driven by ad hoc spending decisions with no link to sector priorities. Fiscal policy lacked medium-term planning and had no long-term focus on reducing the fiscal dependence on oil. Azerbaijan displayed most of the classical symptoms of the “Dutch disease” that is common in countries with a large endowment of nonrenewable natural resources and procyclical budgets that exacerbate those. Mounting fiscal pressures and lack of a structured framework to manage government finances called for structural reforms to enable an increase in fiscal space and actual multiyear prioritization of expenditure allocations. It was also important to delink fiscal policy from the world price of oil. It was imperative to optimize the use of oil revenues by effectively implementing the recently approved fiscal rule and a medium-term fiscal framework (MTFF) to minimize sensitivity to oil prices, reduce macroeconomic procyclicality, and ensure a more efficient multiyear planning of public resources utilization. The oil price shock and exchange-rate effects also worsened the debt profile of the government. More than 70% of Azerbaijan’s public debt in 2016 was in foreign currencies, which, coupled with the currency devaluations and newly needed borrowings, put more stress on government finances. Unrecognized contingent liabilities, and implicit and explicit guarantees on SOE borrowings added to debt management challenges. Until 2016, Azerbaijan lacked a medium-term and long-term strategic debt management framework and a standardized information technology platform for recording debt transactions. Mounting public debt and doubts about the reliability of the manually assimilated data called for the implementation of a structured debt strategy and information technology solutions for data management. Fundamentally, a more comprehensive approach was necessary to strengthen the government’s capacity to meet its financing needs (by reducing costs and better managing risks) and develop effective control mechanisms for other indirect and/or contingent liabilities.

8. **Root problem area 2: Ineffective state-owned enterprises and private sector participation in infrastructure services.** SOEs play a dominant role in Azerbaijan’s oil and gas industry; electricity generation and distribution; water supply and sanitation; railway, road, and air transport; and telecommunication. Before the external shocks of 2015–2016, the management and pricing of these infrastructure services were generally not guided by (i) cost-recovery principles (or explicitly subsidized policy purposes, such as in public service obligation contracts); or (ii) financial sustainability and performance targets. This resulted in recurrent operational losses and significant underinvestment in service provision. Fiscally inefficient support to SOE operations in key sectors remained the rule. By having to operate under tariff policies and with surplus labor that did not allow for cost recovery, SOEs were, de facto, an integral part of the government’s employment and social policy implementation. When the sharp currency devaluation dealt a severe financial shock to currency-risk-vulnerable SOEs, their systemic role in the economy of Azerbaijan implied that the government had to step in with direct fiscal support or guarantees to

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11 Excessive reliance on hydrocarbons contributed to real appreciation during the oil boom, thereby undercutting the international competitiveness of the non-resource sectors and negatively affecting the export of non-resource goods.

12 As a result of exchange rate depreciation and an increase in the fiscal deficit stemming from a decline in oil revenues and the absence of fiscal consolidation, the stock of public debt also increased substantially. The nominal gross debt as a share of GDP increased from 11% in 2014 to 28% in 2015 and further to 38% in 2016.

13 This led to lack of coordination between cash management and debt management, manual collection and reporting of debt indicators, inadequate dissemination of information on debt, and data-integrity issues.

14 The government also had no objectives to gradually reduce the dependency on oil and exposure to currency risk.

15 Given the public-goods nature of these infrastructure services and their systemic role in the economy, inefficiencies and underperformance in service delivery affect most other private sector activities.

16 The consequent fiscal risks, and the periodic, ex-post, outright fiscal outlays that were necessary were mostly provided in incentive-incompatible ways (i.e., not ex ante, nor contractualized, nor performance-based). This perpetuated corporate management decisions that were inefficient (and, ultimately, fiscally more costly).
keep key SOEs operational as a going concern. This averted disruptions in key infrastructure service provision and worse consequences to the economy and population. But it also made clear that private sector development in Azerbaijan requires modern and sustainable provision of infrastructure services, and that the inefficient and mismanaged role of SOEs had to be rectified through policy reform. Corporatization reforms to modernize SOE management and legal ledgers and improving management control practices were identified as priority reforms, and so was the urgent establishment of centralized financial monitoring of SOEs. But as SOEs' recurrent operational losses were largely the result of ineffective policy setups and decisions, sector-specific reforms are key to lifting the financial performance and autonomy of SOEs. This makes it a medium-term agenda for fiscally paced and well-sequenced reform steps to solve a multitude of legacy issues in each sector. Fiscally sustainable and planning-relevant private sector participation in public services also required an effective operational framework.

9. Root problem area 3: Ineffective financial intermediation and policy support mechanisms to small and medium-sized enterprises. Bank credit to the private sector sharply declined in 2016–2017 as a result of the external shocks. A systematic effort to resolve nonperforming loans was crucial to avoid an overhang of nonperforming loans, as would be legal systems to handle insolvency, debt resolution, recovery, and restructuring. The development of the legal, regulatory, and informational underpinnings for financial and credit contracts became a clear policy priority for Azerbaijan. Even though 55% of SMEs voiced concern about the difficult access to finance, low perception of their creditworthiness by potential lenders remained the binding constraint. Azerbaijan's productive specialization is highly limited, and this affects the fundamental growth potential and creditworthiness of firms in non-resource tradable sectors. SMEs also faced high costs associated with entry and exit procedures, contract enforcement, property rights, and fundamental weaknesses in accessing technology. Setting up an effective institutional framework for private sector development was necessary to achieve the target, set in the Strategic Roadmap on SME Development, to increase the share of SMEs in the country's GDP from 4% in 2015 to 15% by 2020, and to 35% by 2025.

10. ADB's approach. In 2016, ADB provided short-term countercyclical support assistance to help mitigate the impact of the crisis in Azerbaijan. As formalized in the CSFL development policy letter, ADB assistance was also sought for the preparation and implementation of structural reforms related to fiscal management, for improving public sector efficiency and accountability, and for promoting the development of SMEs. ADB's TA added significant value to its response to the request. ADB's programmatic assistance was approved in November 2017, with subprogram 1, which supported 17 policy actions (across three reform areas). These provided...
the impetus for the subsequent reform efforts in subprogram 2. Assistance to these reform agendas is aligned with strategic pillar 2 of ADB’s new country partnership strategy for Azerbaijan, i.e., to boost public sector efficiency;\(^\text{21}\) and with ADB’s Strategy 2030 and its operational priority 6—strengthen governance and institutional capacity in Asia and the Pacific through public management reforms that improve financial sustainability, service delivery, capacity, and standards.\(^\text{22}\) ADB’s current two-pronged approach to SOE reform challenges in Azerbaijan combines the fiscal and cross-sector dimension embedded in the program (in policy reform area 2), with sector-specific reform support to SOEs in railways and energy.\(^\text{23}\)

B. **Policy Reforms under Subprogram 2 and ADB’s Value Addition**

11. **Policy reform area 1: Rule-based fiscal planning and debt management introduced.** To promote medium-term fiscal policy and planning, and put Azerbaijan on a path of fiscal consolidation, and eliminate detrimental procyclical biases, it was crucial to establish multiyear budget formulation and forecasting, and improve the management of public debt and fiscal risks. Under subprogram 1, the government formulated fiscal rules as the basis for the national budget formulation.\(^\text{24}\) Laws were amended to improve public financial management. The amended law on pensions reduced the quantum of deficit financing required for meeting pension fund liabilities and started to create fiscal room to prioritize the expenditure allocations to productive sectors.

12. Under subprogram 2 (details in Appendix 4, policy actions 1–9), the promotion of fiscal discipline and strategic resource allocation was made through (i) the formal approval of fiscal rules for budget making and medium-term budget planning that govern the upper limits of transfers from State Oil Fund of Azerbaijan (SOFAZ) and of public debt; (ii) the introduction of a medium-term expenditure framework (MTEF) for all ministries; (iii) preparation of the 2020 budget based on an enhanced MTFF that links macroeconomic performance with fiscal policy at the aggregate level and sets medium-term resource parameters for all government agencies; (iv) Ministry of Finance (MOF) submission for cabinet approval of a framework to govern tax incentives that integrates internal frameworks to estimate the impacts of foregone tax revenue (as part of the decision-making process); (v) establishment of a specialized group in the MOF with in-house skills for the regular preparation of MTFF and MTEF and for support to line ministries, and attribution to a high-level coordination council of the responsibility for coordinating line ministries’ implementation of these reforms; (vi) development and approval of an implementation plan for a financial management and information system and formulation of a request for proposals on a budget preparation and allocation module; (vii) establishment of a joint working group between MOF and the Ministry of Labor and Social Protection of Population (MLSP) to continue pension reforms; (viii) government restructuring of the Public Debt Management Agency


\(^{23}\) Two current projects are supporting Azerbaijan Railways and Azerishiq, the power distribution SOE. They aim to (i) strengthen financial management systems and practices, asset management, and corporate and debt restructuring at these SOEs; and (ii) support sector reforms, such as the introduction of public service obligation contracts, development of financial recovery plans, and proposals for cost-recovery tariffs. These activities will improve the performance of the SOEs and help reduce their reliance on the government.

\(^{24}\) An important advantage of a rule-based fiscal framework is a greater focus on medium-term budgetary forecasts, which in turn ensure better targeting of sector priorities. The MTEFs play an important role in improving budget and expenditure management processes to ensure better use of fiscal resources in line with government priorities. The MTEFs for the line departments, in conjunction with a top–down MTFF, are a prerequisite for effective implementation of expenditure rationalization.
by operationalizing a separate unit for debt recording and reporting in the debt management system, and expanding its mandate;\textsuperscript{25} (ix) approval of a new, comprehensive debt management policy with e.g. quantitative targets to ensure sustainability of public debt and a gradual reduction in the ratio of debt to GDP,\textsuperscript{26} explicit ceilings on foreign currency and variable rate borrowing, explicit objectives on the development of domestic debt securities markets, and significant restrictions on the issuance of loans and state guarantees to SOEs and financial institutions; (x) approval of a new Law on State Debt by Parliament to consolidate the legal framework on public debt management, including e.g. the creation of a separate safeguard fund within the state budget for meeting debt service obligations related to invoked guarantees, fixing of the upper limit for internal and external public debt and the amount of government guarantees to be paid over the year;\textsuperscript{27} and (xi) strengthening of public debt managers’ technical and functional capacity to record, process, monitor, report, disseminate, and analyze external and domestic public debt, by establishing the system and formalizing a service contract to operationalize it.

13. **Policy reform area 2: Reforms of state-owned enterprises undertaken.** Financially sustainable SOEs are a critical prerequisite for better public service delivery and more cost-effective fiscal support from the government. The actions under this output aimed to strengthen the corporatization efforts of SOEs and the standardization of financial control, allowing space for private sector participation in economic activities. Under subprogram 1, the government formulated an action plan to improve the transparency and financial reporting of SOEs across the board, including the activities to be undertaken and the role of various agencies responsible for the implementation of the action plan.\textsuperscript{28}

14. Under subprogram 2 (Appendix 4, policy actions 10–16), the government (i) undertook the legal transformation and corporatization reforms at eighteen major SOEs; (ii) implemented and further strengthened the centralized financial control of all major SOEs (which included the resolution of all mutual current accounts payable between SOEs and restructuring all debt-repayment schedules) and centralized monitoring of their financial performance; (iii) established a single database for all SOEs and implemented public disclosure requirements of financial audits; (iv) approved strategic reform plans of nine major SOEs, which are being implemented; (v) approved a modern set of standards of corporate governance for all SOEs, along with annual reporting requirements, and defined higher-level institutional roles for compliance monitoring and enforcement; (vi) operationalized international accounting standards across most large SOEs, and introduced international financial reporting standards; and (vii) introduced guidelines to ensure risk allocation transparency in all public–private partnership proposals.

\textsuperscript{25} The new public debt management agency now has an explicit role in monitoring SOE-related fiscal contingencies.

\textsuperscript{26} *Strategy for medium and long-term management of public debt in the Republic of Azerbaijan* approved by the President’s Decree No. 424 dated 24 August 2018. In 2019, the public debt ratio is expected to decrease to 19% of GDP, and then gradually to 12% of GDP by 2025. Most importantly, the government envisages to avoid new foreign borrowing for public investment projects in the short term. This is a key enabler of fiscal consolidation objectives supported by ADB’s ongoing programmatic assistance.

\textsuperscript{27} This was followed by (i) approval of implementing regulations (by presidential decree) setting the authority to borrow and procedures for negotiating and contracting external loans; (ii) government approval of regulations to strengthen institutional processes regarding contracting of loans and guarantees by the state; and (iii) government approval of complementing guidelines for SOE borrowings (on their own risk, without state involvement or guarantee), e.g., by setting out clear annual borrowing limits for each SOE, and specifying the approval process for SOE borrowings.

\textsuperscript{28} Centralized monitoring was introduced to closely oversee and report to the government the financial performance of SOEs and their utilization of funds. To ensure greater adherence of SOEs to international practices, the government drafted, consulted, and submitted for approval comprehensive corporate governance rules to guide the selection of directors, and internal audit, accounting, and financial reporting procedures for major SOEs. To reduce the footprint of the state in the economy, the government also stepped up privatization efforts for non-utility SOEs during subprogram 1.
15. **Policy reform area 3: Enhanced access to finance and improved business environment.** The interventions under this output aimed to diversify the economy by creating conditions for sustainable private-sector-led growth. Under subprogram 1, the government initiated preparations to improve the business environment, strengthened deposit insurance by recapitalizing the Azerbaijan Deposit Insurance Fund, and developed a model for risk-based pricing of premiums to be charged from banks. The government also provided budget support to the National Fund for Entrepreneurship Support to enable low-cost loans for entrepreneurs in agriculture, tourism, and services.

16. The government, under subprogram 2 (Appendix 4, policy actions 17–22), (i) passed amendments to enabling legislation related to encumbrance of movable properties, insolvency and bankruptcy law, and mortgage law; (ii) operationalized the Credit Bureau and a full-fledged secured transactions system; and (iii) amended the Law on Banks to make credit information reporting mandatory and compliant with financial privacy rules. The government also implemented significant legislative and technical reforms to improve the ease of doing business, and as a result it was rated by the World Bank as the world’s fourth-best reformer in 2018. The government also established an entrepreneurship development fund as a public legal entity to replace and resolve the shortcomings of the National Fund for Entrepreneurship Support. The new fund offers a broader range of services to promote entrepreneurs’ access to finance, and has stronger financial governance and risk management capacity. Finally, the government operationalized a new policy-setting public legal entity to coordinate and improve the mechanisms of support for entrepreneurship development activities in Azerbaijan, the SME Development Agency (SMEDA), and launched a full-fledged tax initiative to promote entrepreneurship.

17. **Subprogram 2 implementation challenges and adjustments.** At the time of the ADB Board approval of subprogram 1, 22 indicative reform objectives were set for subprogram 2. Some of these were refined further during subprogram 2 implementation, based on government capacity, reform circumstances, and the earlier feedback from the ADB Board. Nonetheless, subprogram 2 reforms progressed broadly as expected in terms of the indicative targets that were set in November 2017. The adjustments that were required to achieve the underlying policy objectives reflect concrete reform realities on the ground and are presented in a supplementary linked document. All subprogram 2 policy actions were achieved before end-September 2019. All subprogram 1 policy actions were sustained to date. No reforms were rolled back.

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29 This included (i) legislation to improve citizen’s access to financial services and credit consumer rights, and (ii) the setup of a credit guarantee fund for SMEs to facilitate credit access compliant with corporate governance.

30 This ensured that the Azerbaijan Deposit Insurance Fund remained operational encouraged local currency deposits.

31 These policy actions were complemented by (i) approval of the charter of a business environment commission serving as a collegial body to develop the necessary legislation and administration; (ii) operationalization of online single windows for electronic invoicing (e-invoicing), filing of tax returns for social security and corporate income tax, as well as application of licenses and permits; and (iii) significant reductions in tax compliance costs to promote formalization and introduction of tax ombudsmen concepts and institutions.

32 Board approval discussions of subprogram 1 had highlighted, in relation to subprogram 2, (i) areas where more granularity was necessary, (ii) reform targets in which sequencing and pace needed to be better adjusted to reform complexities, and (iii) reform areas where ADB and the government could be more ambitious.

33 Subprogram 2 Implementation Challenges and Adjustments (accessible from the list of linked documents in Appendix 2). In some areas, the effectiveness of the policy dialogue resulted in more concrete reform achievements and in new associated reform efforts. Some key legal reforms also progressed faster than originally expected. Others were only found necessary during implementation of subprogram 2, and were pursued henceforth. In two cases, the pace was slowed in recognition of the reforms’ size and complexity; for example, in the area of medium-term budgeting, international experience shows that it takes a minimum of three budget cycles to prepare an MTFF and sometimes take up to 10 years before the framework is fully operational and consistently applied. The original targets in this regard were clearly too ambitious.
18. **Post-program engagement framework (PPEF).** The policy dialogue under subprogram 2 was successful in charting several follow-up reform steps that are still crucial and could benefit from further ADB support. The ADB team and the authorities agreed on a PPEF through which the parties can jointly prepare proposals for the next phase of associated reforms, i.e., reforms that are in natural sequence or necessary for subprogram 2 reforms to yield their full impact. As reflected in ADB’s country partnership strategy, 2019–2023, a second ADB programmatic assistance engagement is being planned for 2021–2022. The PPEF (i) will thus help maintain the current reform momentum and feed into the design of that forthcoming processing effort, ad (ii) contains a non-exhaustive list of reform preparation activities to take place in 2019–2020.\(^{34}\)

19. **Evaluation of ADB engagement – lessons and value added.** The country assistance program evaluation (CAPE), 2011–2017\(^ {35}\) rated ADB support for public sector management (PSM) overall successful, with good scores on all evaluation criteria; its strengths (such as proactive engagement and support for macroeconomic policy reform) outweighed the weaknesses in other areas of ADB assistance in Azerbaijan.\(^ {36}\) The ongoing implementation of the program was a main element of this evaluation. The CAPE recommended that ADB continue to support policy reforms, since its past and ongoing successes could be credited to the iterative approach that proved valuable in areas such as fiscal and SOE tariff reforms.\(^ {37}\) It recognized that “ADB was one of the few development partners supporting the authorities’ structural reforms. ADB’s support focused on the necessary conditions for economic diversification, particularly the MTFF. While much remains to be done for these reforms to bear fruit, ADB’s presence has helped the government stay the course.” ADB assistance was deemed crucial in incentivizing “the government to remain constant in the implementation of reforms, even in trying times.”\(^ {38}\) ADB’s TA was also crucial in enabling subprogram 2 and the underlying policy dialogue to incorporate important lessons from experiences with fiscal and public financial management, finance sector, and SOE reform programs of other countries.\(^ {39}\) Lessons from the implementation of subprogram 1 were also key. The policy dialogue under subprogram 2 often emphasized the need to promote more context-specific solutions that only contemporaneous reform analysis can unveil.\(^ {40}\) This made full use of the flexibility and timeline advantages of ADB’s programmatic assistance. The experience of subprogram 2 confirmed the suitability of this modality to the nature of the multi-speed reform agenda in Azerbaijan. Pursuing realistic policy actions is critical to ensuring that the reform program can be carried out effectively and that implementing agencies’ officials remain...

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\(^{34}\) Post-Program Engagement Framework (accessible from the list of linked documents in Appendix 2).


\(^{36}\) The overall assessment of the PSM program was successful, with individual ratings of relevant, effective, efficient, likely sustainable, and an impact deemed satisfactory.

\(^{37}\) Para. 51 of the CAPE acknowledges that “to the extent that the PSM operations managed by ADB staff based in Manila are being supported by the resident mission, ADB remains in continuous contact with the government, especially with the two leading agencies in the reform effort—the MOF and MOE. This constant access has allowed ADB to address the issues that come up, as well as to provide sound advice when it is needed.”

\(^{38}\) Para. 58 of the CAPE acknowledges that “the policy matrix approved with the programmatic series for Azerbaijan is a good example of how incentives may be created, while framing the reform agenda within conditions that help the government stay its course.”

\(^{39}\) In addition to the TA approved with the CSFL, ADB supported reforms under subprogram 2 through various other TA initiatives, like a regional TA window in ADB. ADB, 2015. *Technical Assistance for Enhancing Governance and Capacity Development as Driver of Change.* Manila. Both the Financial Markets Supervision Authority and the SMEDA are still currently benefiting from parallel TA and staff consultancy. A new TA project will also be supporting the development of tax administration capacity of the government as well as MOF’s tax forecasting capacity. ADB. 2019. *Technical Assistance to Azerbaijan for Strengthening Tax Policy and Administration Capacity.* Manila.

\(^{40}\) Para. 59 of the CAPE recognizes that “The experience with the PSM program also suggests it is worthwhile buttressing some of the reforms with more capacity building, especially via TA. TA is the best instrument that ADB can use to help a reforming government team succeed.”
fully connected with the process. In fact, some indicative targets for subprogram 2 had directly incorporated some aspirations from the government’s own reform plans to promote formal ownership of reform targets which, in a few cases, proved too optimistic. In other cases, interim but crucial process-oriented milestones that were absent from official reform plans were still captured in the program, making the policy matrix de facto a more complete interim roadmap for and helped the formation of necessary interagency consensus. This enabled a more pragmatically paced and sequenced approach during the implementation of subprogram 2. This flexibility was only possible under the programmatic modality, which also helped catalyze assistance in specific reform efforts from other development partners, such as Switzerland’s State Secretariat for Economic Affairs (SECO).

20. **Development partner coordination.** Multilateral agencies such as ADB, the European Bank for Reconstruction and Development, the European Union, and the World Bank as well as bilateral donors such as SECO provide support to PSM, private sector development, and the finance sector in Azerbaijan. The European Union, for example, assists the revision of the public expenditure and financial accountability action plan. SECO provides technical support to MOF to run the modern public debt management system that ADB’s TA funded and helped set up. Partner activities are coordinated by the institutions themselves. For example, SECO coordinates private sector development assistance. In 2018, ADB initiated and now leads donor coordination efforts in PSM. Coordination with the International Monetary Fund also takes place regularly. Key recommendations of International Monetary Fund missions are aligned with the objectives of ADB’s programmatic engagement in Azerbaijan.

C. **Impacts of the Reform**

21. The effect of the reforms that the program helped achieve is improved allocative efficiency of public and private resources. Reforms under the program, sustained by the proposed PPEF, can produce tangible upgrades in resource allocation efficiency in Azerbaijan, i.e., strengthen its public policy capacity to promote the development of non-oil tradable sectors and reduce the country’s significant vulnerability to external shocks.

D. **Development Financing Needs and Budget Support**

22. The government has requested a regular loan of $250 million from ADB’s ordinary capital resources to help finance subprogram 2. The loan will have a 15-year term, including a grace period of 3 years, an annual interest rate determined in accordance with ADB’s London interbank offered rate (LIBOR)-based lending facility, a commitment charge of 0.15% per year, and such other terms and conditions set forth in the draft loan agreement. Based on the annuity method, the average maturity is 10.39 years and there is no maturity premium payable to ADB. The loan, to be disbursed in a single tranche to help meet the government’s development financing needs, is projected to be 12% of the total financing needs for 2019 (about $2.1 billion). The remaining gap will be filled by project loans and domestic bonds. The program has considered the recently approved fiscal rules, the estimated support from other partners, and debt sustainability.

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41 Para. 49 of the CAPE acknowledges that “anchoring the PSM program in the government’s own program created a deep sense of ownership.”
42 As often observed in other “post-transition” contexts, promoting analytical cooperation between agencies frequently requires setting formal requirements for it under a policy matrix to support continuity in policy dialogue.
43 Development Coordination (accessible from the list of linked documents in Appendix 2).
44 To rectify methodological inconsistencies, adjustments were made to performance indicators in the design and monitoring framework (Appendix 2).
Table 1: Fiscal Financing Needs

<table>
<thead>
<tr>
<th>Item</th>
<th>2017</th>
<th>2018p</th>
<th>2019f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central government overall deficit</td>
<td>0.790</td>
<td>0.131</td>
<td>1.190</td>
</tr>
<tr>
<td>Debt repayment(^a)</td>
<td>0.668</td>
<td>0.920</td>
<td>0.915</td>
</tr>
<tr>
<td><strong>Total financing needed</strong></td>
<td><strong>1.458</strong></td>
<td><strong>1.051</strong></td>
<td><strong>2.105</strong></td>
</tr>
</tbody>
</table>

\(^{p}\) provisional, \(^{f}\) forecast.
\(^{a}\) Official repayments of foreign currency debt principal.


E. Implementation Arrangements

23. MOF is the executing agency. The Central Bank of Azerbaijan, Financial Market Supervisory Authority, Ministry of Economy (and SMEDA), MLSP, and MOF are implementing agencies. The implementation period for subprogram 2 was from December 2017 to September 2019. The proceeds of the policy-based loan will be withdrawn in accordance with ADB’s *Loan Disbursement Handbook* (2017, as amended from time to time). The loan closing date for subprogram 2 is 27 December 2019.

III. ATTACHED TECHNICAL ASSISTANCE

24. The attached TA for Improving Governance and Public Sector Efficiency is estimated to cost $875,000, of which $800,000 will be financed on a grant basis by ADB’s Technical Assistance Special Fund (TASF-Others). The government will provide counterpart support in the form of counterpart staff, office accommodation, office supplies, secretarial assistance, domestic transportation, and other in-kind contributions. The TA is proposed to support the government in the implementation of the PPEF (summarized in para. 18), and in associated reforms. The sequencing of new reform efforts and TA activities will proceed along the same three policy reform areas of subprogram 2, i.e., supporting the implementation of rule-based fiscal planning and a public debt management strategy, assisting SOE reforms and private sector participation in infrastructure services, and enhancing access to finance and entrepreneurship. MOF is the proposed executing agency. The Central Bank of Azerbaijan, Financial Market Supervisory Authority, Ministry of Economy (and SMEDA), MLSP, and MOF will be the implementing agencies. The TA will also include resources to explore gender mainstreaming opportunities during the implementation of the PPEF.

IV. DUE DILIGENCE

25. **Safeguards.** Following ADB’s Safeguard Policy Statement (2009), subprogram 2 is classified category C for the environment, involuntary resettlement, and indigenous peoples. Program activities will be confined to policy and institutional reforms. No activity will result in or lead to involuntary resettlement, or negatively affect indigenous peoples or the environment.

26. **Governance.** Fighting corruption has been high on the government’s agenda since 2005, when Azerbaijan set up and operationalized the Commission on Combating Corruption. Regional anticorruption bodies reflect these efforts and suggest that fundamental improvements have occurred. Nonetheless, global indexes on perceived levels of corruption show the need to further enhance transparency and accountability in PSM and service delivery, strengthen the rule of law, and ensure equal treatment for all businesses. The program supports efforts to reduce corruption in the country in various indirect ways, and as a whole aims to create more transparency and a more conducive environment for private-sector-led growth. This will continue under the PPEF.
The government has made important progress in strengthening country systems for transparency and accountability in the extractive industries. Azerbaijan joined the Extractive Industries Transparency Initiative (EITI) at its inception in 2004 and was the first country to be validated as fully compliant with EITI standards in 2009. It withdrew from the EITI on 10 March 2017—1 day after it was suspended over complaints about national legal treatment of civil society organizations (CSOs)—noting that the EITI had shifted priorities away from its original mandate. Despite this withdrawal, high-level commitment to continuing revenue transparency in relation to Azerbaijan’s extractive industries remained in evidence. On 5 April 2017, the President of the Republic of Azerbaijan signed the decree “On additional measures to increase accountability and transparency in the extractive industries,” stating that all extractive industry information should be disclosed to its full extent in line with international standards. Pursuant to this, the Extractive Industries Transparency Commission (EITC) was established under the auspices of SOFAZ, which also houses the EITC Secretariat. This commission assumed its activities in April 2017 and agreed on a stakeholder engagement process that involves CSOs in reforms relating to extractive industry transparency, such as implementing the Roadmap for Beneficial Ownership Disclosure. ADB’s TA support for the latter is helping sustain this progress and the momentum generated by the leadership of SOFAZ. Under its official legal mandate, EITC established a new framework for the implementation of transparent reporting processes. All relevant parties, including CSOs, are actively involved. In late 2018, the EITI revised its requirements for CSO freedoms. ADB will continue to emphasize, through the ongoing TA dialogue, the overall benefits for Azerbaijan in rejoining the EITI.

27. **Poverty, social, and gender.** The majority of Azerbaijan’s people have to make do with very low incomes to provide for their basic needs. The welfare system is underfunded and largely vulnerable to external shocks, with state funds heavily relying on transfers from SOFAZ. However, the recent economic downturns did not lead to spending cuts on social protection, as could have been expected. The MLSP focused on raising the minimum wage, minimum pension, and social allowances in 2018 and 2019 to somehow offset the real value loss in social transfers caused by the crisis, and is preparing for social assistance reforms to be initiated in 2020. ADB’s TA played a part in this, and the MLSP is currently charting its reform approach. The program aims to improve long-term financing and create enough fiscal space for better-resourced and better-targeted public policy implementation. This is also expected to have a positive impact on employment creation for non-oil economic activity. Targeted expenditures based on the improved medium-term fiscal and expenditure frameworks can also improve and sustain health and

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45 Member countries implement EITI standards on a voluntary basis. If they fail to do so, no sanctions per se arise (other than downgrade or suspension). Disputes over the national legal treatment of CSOs in Azerbaijan led to the decision of EITI to suspend Azerbaijan on 9 March 2017.

46 As Azerbaijan still seeks to attract significant investment to further develop its extractive industries, it needs to meet growing global expectations of stronger governance, accountability, and transparency, including on beneficial owners of companies operating in extractive industries. Azerbaijan has been and will be in competition with many other countries over such financing, and countries that offer more transparency are likely to be more successful.

47 The EITC membership incorporated the social development minister recently.

48 The EITC has since produced annual reports to stakeholders following the standards of EITI reports.

49 ADB’s TA work with the EITC Secretariat and SOFAZ (reports are publicly available on the SOFAZ website) has included consultation exercises and events, the latest of which in February 2019 suggesting separate beneficial owner legislation that the President’s Office is expected to submit to Parliament for approval. Another broad-based public consultation is set to take place by the end of 2019 to finalize legal and regulatory proposals. ADB. 2016. *Technical Assistance to the Republic of Azerbaijan for Shah Deniz Stage II Investment Plan*. Manila.

50 Some ADB shareholders also expressed hope for such outcome during informal consultations about the program.

51 The minimum salary was raised from AZN180 to AZN250 (39% increase), effective since September 1, 2019. According to the MLSP, this will benefit 600,000 government employees and require an estimated additional $144 million-equivalent of fiscal resources for Sep-Dec 2019, and about $359 million-equivalent for 2020.
education outcomes and strengthen the social safety net. While women and other vulnerable
groups are expected to benefit through more employment and better health and education
outcomes, these are all indirect results of the program reforms. Subprogram 2 is categorized as
no gender elements as it includes only the setting up of resource centers for women entrepreneurs
in three more regions (under policy action 16). More gender mainstreaming opportunities will be
explored during the implementation of the PPEF and in subsequent subprograms. Initial
discussions with MOF resulted in the interest to consider gender-responsive budgeting and a
short-term TA has been designed towards this end.

28. **Risks and mitigating measures.** The risks to the program are discussed in the risk
assessment and management plan, along with mitigation factors and measures.\(^{52}\) Given that the
proposed subprogram 2 actions have been achieved already, and risks considered earlier did not
materialize, the overall risk assessment is *moderate* (pre-mitigation). Fiduciary arrangements for
budget support are acceptable, and the strengthening of public financial management is one of
the key objectives of the program. While no significant risks of mismanagement of resources at
the executing level are expected, related issues as identified in the assessment are also targeted
in the proposed loan and ADB’s ongoing TA. By default, this provides levels of engagement and
monitoring that, at this stage, deliver an important degree of fiduciary comfort. ADB’s
Anticorruption Policy (1998, as amended to date) was explained to and discussed with the
government and the different implementing agencies.

**V. ASSURANCES**

29. The Government of Azerbaijan and MOF have assured ADB that implementation of the
program shall conform to all applicable ADB policies, including those concerning anticorruption
measures, safeguards, gender, procurement, consulting services, and disbursement as
described in detail in the loan agreement.

**VI. RECOMMENDATION**

30. I am satisfied that the proposed policy-based loan would comply with the Articles of
Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the
loan of $250,000,000 to the Republic of Azerbaijan for subprogram 2 of the Improving
Governance and Public Sector Efficiency Program, from ADB’s ordinary capital resources, in
regular terms, with interest to be determined in accordance with ADB’s London interbank offered
rate (LIBOR)-based lending facility; for a term of 15 years, including a grace period of 3 years;
and such other terms and conditions as are substantially in accordance with those set forth in the
draft loan agreement presented to the Board.

Takehiko Nakao
President

6 November 2019

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\(^{52}\) Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).
# DESIGN AND MONITORING FRAMEWORK

## Country's Overarching Development Objective

Sustainable and broad-based economic growth facilitated (Strategic Roadmaps on National Economy Perspectives and Main Sectors of the Economy)\(^a\)

<table>
<thead>
<tr>
<th>Results Chain</th>
<th>Performance Indicators with Targets and Baselines</th>
<th>Data Sources and Reporting Mechanisms</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Effect of the Reform</strong>&lt;br&gt;Allocative efficiency of public and private resources improved</td>
<td>By the end of 2021:&lt;br&gt;a. Fiscal outlays to SOEs are reduced by at least 0.3 percentage points (2016 baseline: 1.1% of gross domestic product)&lt;br&gt;b. The World Bank Doing Business score of Azerbaijan improved to at least 80.0 (2016 baseline: 67.7)&lt;br&gt;c. Local currency lending outstanding by credit institutions (by banks and non-banks) increased by 20% (2016 baseline: AZN8.6 billion)</td>
<td>Annual report of the Central Bank of Azerbaijan; budget documents&lt;br&gt;Annual Doing Business reports</td>
<td>Commitment of the government to the reform momentum is not sustained because of geopolitical and macroeconomic risks.</td>
</tr>
<tr>
<td>Reform Areas under Subprogram 2</td>
<td>Key Policy Actions</td>
<td>Data Sources and Reporting Mechanisms</td>
<td>Risks</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>-----------------------------------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>1. Rule-based fiscal planning introduced</td>
<td>By the end of 2019, unless mentioned otherwise:&lt;br&gt;1.1 Government adopted fiscal rules for budget making and medium-term budget planning that govern upper limits of transfers from the State Oil Fund of Azerbaijan and of public debt, and the integration of these rules into the 2019 budget cycle (2017 baseline: no fiscal rules) (RFI 18)&lt;br&gt;1.2 Government prepared the 2020 budget based on an enhanced medium-term fiscal framework that links macroeconomic performance with fiscal policy at the aggregate level (2017 baseline: no medium-term fiscal framework) (RFI 18)&lt;br&gt;1.3 Road map for implementing a financial management information system approved and preparation for the procurement of a budget preparation and allocation module as a first step commenced (2017 baseline: No road map or preparation to procure modules begun) (RFI 18)</td>
<td>1.1–1.3 Annual report of the MOF; budget documents</td>
<td>Trained staff are not retained in the relevant departments during the entire period of the program, affecting the successful completion of various policy actions. Resistance to change inside SOEs derails reform processes.</td>
</tr>
<tr>
<td></td>
<td>By the end of 2020, integrated fiscal risk management is established at MOF (item 4 of the Post-Program Engagement Framework) (2019 baseline: no such formal functions exist)</td>
<td>-----------------------------------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>2. SOE reforms implemented</td>
<td>2.1 Government implemented items 1, 5, 6, and 7 of its approved action plan pertaining to full legal transformation of the 20 largest SOEs, full resolution of inter-SOE liabilities, formulation of a single database (with information about finance, accounting, and personnel records), and disclosure of annual audited financial statements (2016 baseline: no such implementation) (RFI 19)&lt;br&gt;2.2 Establishment of corporate governance standards for all SOEs (2017 baseline: no standards) (RFI 19)</td>
<td>Annual reports from the Ministry of Economy and MOF to the Special Committee (established by Cabinet Decree in December 2016)</td>
<td></td>
</tr>
<tr>
<td>Results Chain</td>
<td>Performance Indicators with Targets and Baselines</td>
<td>Data Sources and Reporting Mechanisms</td>
<td>Risks</td>
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<tr>
<td>2.3 Implementation of central asset register (as part of priority 7.1.3 for heavy industries), National Tourism Board (as part of priority 7.1.1 for tourism), and improvements to electronic database on retail and wholesale prices for agriculture products (as part of priority 7.6.1 for improving infrastructure for agriculture products) (2016 baseline: no implementation) (RFI 19)</td>
<td>By the end of 2020, the operational framework for promotion and monitoring of SOE corporate governance practices and compliance is established at MOF (item 8 of the Post-Program Engagement Framework) (2019 baseline: no such operational framework exists)</td>
<td>3.1–3.3. Annual report of the Central Bank of Azerbaijan; annual report of the Financial Markets Supervision Authority</td>
<td></td>
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<tr>
<td></td>
<td>3.2 Government operationalized the Credit Bureau to improve citizen’s access to financial services and credit consumer rights (2017 baseline: not operating) (RFI 18)</td>
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<tr>
<td></td>
<td>3.3 Parliament approved legal amendments to the Law on Banks to make reporting mandatory and in compliance with financial privacy rules (2017 baseline: no parliamentary approval) (RFI 18)</td>
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</tr>
</tbody>
</table>

**Budget Support**

Asian Development Bank: $250 million for subprogram 2 (regular ordinary capital resources loan) $800,000 from Technical Assistance Special Fund

Name of cofinancier: not applicable

MOF = Ministry of Finance, SOE = state-owned enterprise.

*a Strategic Roadmaps on National Economy Perspectives and Main Sectors of the Economy (President’s Decree no. 1138 of 6 December 2016). To be in line with the country partnership strategy for Azerbaijan, this was modified when compared with what was approved under subprogram 1. The previous reference was: Government of Azerbaijan, Office of the President. 2012. Azerbaijan 2020: Look into the Future Concept of Development. Baku. [http://www.president.az/files/future_en.pdf](http://www.president.az/files/future_en.pdf).
Contribution to the ADB Results Framework:

RFI 18: Measures supported in implementation to improve capacity of public organizations to promote the private sector and finance sector. Expected: 3 [approval of legal amendments on movable properties, insolvency and bankruptcy law and mortgage law; operationalization of the Credit Bureau; approval of legal amendments to the Law on Banks for mandatory reporting and compliance with financial privacy rules]

RFI 18: Transparency and accountability measures in procurement and financial management supported in implementation. Expected: 3 [fiscal rules for budget making and medium-term budget planning; medium-term fiscal framework linking macroeconomic performance and fiscal policy; approval of roadmap for implementation of financial management information system]

RFI 19: Measures to strengthen SOE governance supported in implementation. Expected: 3 [implementation of actions on legal transformation of the 20 largest SOEs; establishment of corporate governance standards for all SOEs; implementation of central asset registrar]

LIST OF LINKED DOCUMENTS
http://www.adb.org/Documents/RRPs/?id=51059-002-3

1. Loan Agreement
2. Sector Assessment (Summary): Multisector
3. Development Coordination
4. Country Economic Indicators
5. International Monetary Fund Assessment Letter
6. Summary Poverty Reduction and Social Strategy
7. Risk Assessment and Risk Management Plan
8. List of Ineligible Items
10. Approved Report and Recommendation of the President to the Board of Directors: Improving Governance and Public Sector Efficiency Program (Subprogram 1)

Supplementary Documents
11. Post-Program Engagement Framework
12. Subprogram 2 Implementation Challenges and Adjustments
DEVELOPMENT POLICY LETTER

MINISTRY of FINANCE
REPUBLIC of AZERBAIJAN

135, Samad Vurgun st., Baku AZ 1022
E-mail: office@mallyye.gov.az

Phone: (+994 12) 404 46 99
Fax: (+994 12) 404 47 20

September 13, 2019

To: Mr. Takehiko Nakao
President
Asian Development Bank
Manila, Philippines

Subject: Azerbaijan Improving Governance and Public Sector Efficiency Program – Subprogram 2 (SP2) – Development Policy Letter

Dear President Nakao,

We would like to thank you and the Asian Development Bank (ADB) for your continued support to development and reform efforts in the Republic of Azerbaijan. The ADB is a close and trusted partner of the Government of Azerbaijan, and we look forward to continuing this effective dialogue and joint work. With the current economic recovery now firmly established, I want to reiterate that the Government of Azerbaijan’s wide reform agenda is only deepening in its momentum and implementation efforts. The medium-term horizon of our reforms aims at accelerating economic growth and making it more board-based and inclusive.

As a result of the countercyclical and financial stabilization measures taken by the Government of Azerbaijan in 2016 and 2017, recessionary pressures were arrested and the Azerbaijan economy is now firmly recovering and is expected to grow at 2.3% this year and 2.4% in 2020. Our external buffers have reached USD 48.4 billion (official foreign-exchange reserves at CBA and the SOFAZ assets combined) and now cover more than three times next year’s projected imports. In line with our approved debt management strategy, our general government debt-to-GDP ratio is down to 20.7% of GDP and is only one fifth of the countries’ accumulated external buffers.

Our fiscal consolidation efforts initiated in 2019 will continue through 2020 and onwards and will remain growth-friendly (with more non-oil revenues and improved efficiency of public spending) thanks to the significant fiscal and public financial management reforms that we have been implementing since 2017. Some of these specific reforms have actually been implemented under the Improving Governance and Public Sector Efficiency Program (IGPSE Program) approved by the ADB Board in late 2017. The IGPSE Program was designed during early-2017 with the ADB staff support...
and a technical assistance project that was approved by the ADB Board in late-2016 together with the Countercyclical Support Facility Loan for Azerbaijan that helped the Government of Azerbaijan swiftly respond in 2016 and 2017, to the negative effects of the terms-of-trade and macroeconomic shocks of 2015 that hit our economy.

Dear President Nakao,

On November 8, 2017, I wrote to you (through a Development Policy Letter) in the context of the proposed approval of Subprogram 1 of the IGPSE Program. In that communication I conveyed that, with ADB technical support, the Government of Azerbaijan had “identified a few key areas of reform where multi-year engagement with the ADB would increase impact and effectiveness of reforms”, and that the Government of Azerbaijan “started to prepare and implement these reforms” along “three key and priority areas of reform”:

1. Introduction of Rules-based fiscal planning and Debt Management to Improve Aggregate Fiscal Discipline and Allocative Efficiency of Public Resources.
2. SOE reforms to improve financial control and transparency, and legal and institutional arrangements.

With your support, Subprogram 1 was approved in late 2017 by the ADB Board of Directors, after which we have continued to work closely with the ADB teams and technical assistance to achieve each of the reform milestones of the different institutional development processes charted by the scope of the IGPSE Program, with the objectives of Subprogram 2 insight.

I am delighted to communicate to you and to the ADB Board of Directors the significance of the reform achievements included in the accompanying Subprogram 2 proposal. The Government of Azerbaijan believes these reforms significantly contribute to the country development agenda, and that these will help maintain macroeconomic stability, improve public sector efficiency, strengthen fiscal management, ensure efficiency upgrades across our SOEs as well as improve access to finance and promote private sector's role as an engine of future economic growth. Let me summarize the achievements we bring to your consideration along the three main policy reform areas.

**Policy Reform Area 1: Rules-based fiscal planning and debt management.**
To promote medium term fiscal policy and planning, put Azerbaijan on a path of fiscal consolidation, and eliminate the detrimental pro-cyclical biases of the recent past, the Government recognized in 2017 the need to, under the IGPSE Program, establish multiyear budget formulation and forecasting, improve the management of public debt and fiscal risks. Under Subprogram 1, we formulated fiscal rules as the basis for the national budget formulation. The amended law on pensions reduced the quantum of deficit financing required for meeting pension fund liabilities and started to create fiscal room to prioritize the expenditure allocations to productive sectors.

Since late-2017 (i.e. under Subprogram 2), we continue to promote fiscal discipline and strategic resource allocation through: (i) the formal adoption of fiscal rules (by law) for budget making that ensure restrictive use of oil revenues, govern upper limits of consolidated budget expenditures and transfers from SOFAZ and aims to decrease non-oil primary deficit ratio to non-oil GDP; (ii) the introduction of a medium-term expenditure framework (MTEF) for all ministries; (iii) setting the preparation of the 2020 budget based on an enhanced medium-term fiscal framework (MTFF) that links macroeconomic performance with fiscal policy at the aggregate level and sets medium-
term resource parameters for all government agencies; (iv) Cabinet approval of a framework to govern tax incentives and internal processes to estimate tax revenue foregone impacts (as part of the final decision-making process); (v) establishment of a specialized group in the Ministry of Finance (MOF) with in-house skills for the regular preparation of MTFF and MTEF and support to line-ministries; (vi) approval of an implementation plan for a Financial Management and Information System and preparation of a request for proposals for the Budget Preparation and Allocation Module; (vii) establishment of a joint working group between MOF and the Ministry of Labor and Social Protection of Population to continue pension reforms; (viii) government overhaul of the Public Debt Management Agency and expanding its mandate, which is in progress and expected to be finalized soon; (ix) approval of new, comprehensive debt management strategy document; (x) approval of updated version of the Law on Public Debt by Parliament to consolidate the legal framework on public debt management; and (xi) strengthening public debt management's technical and functional capacity to record, process, monitor, report, disseminate and analyze (external and domestic) public debt, by establishing the system and formalizing a service contract to operationalize it.

Policy Reform area 2: State-owned enterprises reforms. The difficulties in 2016 and 2017 helped the Government of Azerbaijan recognize, as a policy priority, that (i) financially sustainable SOEs are critical prerequisites for improved public service delivery and more cost-effective fiscal support from the government, and (ii) that it was crucial to promote corporatization/modernization efforts at, and centralized financial control of SOEs, including the standardization of financial systems. Under Subprogram 1, the government formulated an action plan to improve the transparency and financial reporting practices of SOEs across the board, outlining the activities to be undertaken and the role of various agencies responsible for the implementation of the action plan. Centralized monitoring was also constituted to closely oversee and report to the government the financial performance of the SOEs, especially in terms of financial planning and utilization of funds. To ensure greater adherence to international practices in the functioning of the SOEs, the government also submitted for approval a set of comprehensive corporate governance rules to guide the selection of directors, internal audit, accounting, and financial reporting procedures for major SOEs.

Since late-2017, under Subprogram 2, we have achieved the following results: (i) legal transformation and corporatization reforms were undertaken at all but two major SOEs; (ii) centralized financial control of all major SOEs was implemented and further strengthened; (iii) public disclosure of financial audits was implemented across all major SOEs; (iv) strategic reform plans were approved at 9 major SOEs and are now under implementation; (v) a new set of modern standards of corporate governance was approved for all SOEs together with annual reporting requirements, and higher-level institutional roles for compliance monitoring and enforcement were defined; (vi) international accounting standards are now in use across most large SOEs and mandatory international financial reporting systems were introduced; and (vii) guidelines were introduced to ensure that any public-private partnership (PPP) proposals are transparent in the implied risk-allocations.

Policy Reform area 3: Enhanced access to finance and improved business environment. The Government of Azerbaijan’s current reform drive under the GSP and outside the ICPSE is very much linked to the objective of diversifying the economy by creating conditions for sustainable private sector-led growth. Under Subprogram 1, we initiated preparations to improve the business environment across the board and in all of its aspects, and deposit insurance was strengthened by a recapitalization of Azerbaijan Deposit Insurance Fund (ADIF). The government also provided budget
support to the National Fund for Entrepreneurship Support (NFES) to enable low cost loans for entrepreneurs in agriculture, tourism and service sectors.

From late-2017, under the **Subprogram 2**, the Government of Azerbaijan: (i) passed amendments to enabling legislation related to encumbrance of movable properties, insolvency and bankruptcy law and mortgage law; (ii) operationalized the Credit Bureau and a full-fledged secured transactions system; and (iii) amended the Law on Banks to make credit information reporting mandatory and in compliance with financial privacy rules. The government also established an entrepreneurship development fund (EDF) as a public legal entity to replace the NFES and (a) expand the range of services on offer to promote entrepreneurs access to finance, and (b) strengthen its financial governance and risk management capacity. Lastly, the government operationalized a new policy-setting public legal entity, to coordinate and improve the mechanisms of support for the entrepreneurship development activities in Azerbaijan (KOB/SMEDA), and a full-fledged tax initiative was launched to promote SMES/entrepreneurship.

The Government of Azerbaijan is interested in continuing this fruitful reform engagement with ADB. We agreed with the ADB team to chart a Post-Program Engagement Framework, so that both parties can lock-in a working-level commitment to jointly prepare proposals for the next phase of associated reforms, i.e., reforms that are a natural sequence or necessary for subprogram 2 reforms to come to full fruition in terms of impact. Also as reflected in the new ADB Country Partnership Strategy for Azerbaijan (2019–2023), a second ADB programmatic assistance engagement has been requested by the Government of Azerbaijan for 2021–2022, and agreed that this PPEF could help keep reform momentum and the close and trusted working relationship that we have developed with the ADB teams.

Dear President Nakao,

Results of the comprehensive reform effort described only partially above are already being achieved in key fronts and have been captured in international rankings. For example, as a result of reform efforts undertaken till early-May 2018 and already considered in the Doing Business 2019 report, Azerbaijan leaped 22 places from the year before to 25th among the 190 currently-ranked economies. This mostly reflected measured progress in four aspects of these international institutional comparisons:

- **Dealing with Construction Permits.** Azerbaijan streamlined its construction permitting process as construction permits are now solely obtained through the single-window of the Baku City Executive Office.
- **Getting Electricity.** Azerbaijan made getting electricity faster by allowing customers to choose private contractors to carry out the external connection works. Azerbaijan improved the reliability of power supply by investing in grid infrastructure and establishing a national regulator to monitor power outages. Azerbaijan also made getting electricity faster and less costly by establishing a single window.
- **Getting Credit.** Azerbaijan improved access to credit information by adopting a law allowing the establishment of credit bureaus. Azerbaijan strengthened access to credit by introducing a new secured transactions law and insolvency law, which implemented a functional secured transactions system, broadened the scope of assets that can be used as collateral and provided secured creditors with grounds for relief and time limits during an automatic stay. Azerbaijan also set up a unified, modern and notice-based collateral registry, and improved access to credit information by establishing a new credit bureau.
• Protecting Minority Investors. Azerbaijan strengthened minority investor protection by increasing shareholder rights and role in major corporate decisions, clarifying ownership and control structures and requiring greater corporate transparency. Azerbaijan strengthened minority investor protections by increasing shareholders’ rights and role in major corporate decisions, clarifying ownership and control structures and requiring greater corporate transparency.

Measured progress was also recorded in other dimensions of the Doing Business framework, such as in paying taxes, trading across borders, resolving insolvency, enforcing contracts and registering property. But the fundamental message I want to convey with these examples of achievements under the IGPSE and outside the IGPSE is that our Government’s broad-based effort to promote structural reforms and deliver inclusive and sustained growth is gathering momentum.

We would like to thank you Mr. President for your continuous support and the ADB team for working closely with the Government of Azerbaijan in developing and implementing Subprogram 2, and appreciate the commitment already anchored in ADB’s new country partnership strategy for turning Azerbaijan’s reform agenda ahead into a joint one.

Sincerely Yours,

Samir Sharifov
Minister of Finance and ADB Governor
### POLICY MATRIX

**Reform Output Area 1: Rule-based fiscal planning introduced.**

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<td>Improve multi-year budget formulation and forecasting</td>
<td>1. MOF strengthens the public financial management legal framework by drafting amendments to the Budget Systems Law incorporating clear fiscal rule guidelines, including for example, expenditure targeting, in budget making from 2019 onwards.</td>
<td>1. Government: (i) approves the fiscal rules for budget making; (ii) implements medium-term budget planning that ensures observance with new fiscal rules and includes information on four-years rolling medium-term fiscal projections (1+3), macroeconomic forecasts and fiscal management targets, (including key fiscal risk exposures), and National Spending Priorities, as part of 2019 budget documentation; (iii) approves non-oil budget deficit ratio targets (and calculation methodology); and (iv) adopts an enhanced MTFF for 2020 (e.g., new budgetary procedures for prioritization and fiscal resource envelope).</td>
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<td>2. MOF, on behalf of the Government, develops reform proposals on the preparation of MTEF and results-based budgeting including proposal of preparation and implementation of MTEF for one large spending ministry.</td>
<td>2. Government: (i) presents the annual budget for 2019 based on fiscal rules-compliant medium-term fiscal projections; (ii) initiates the preparation of the 2020 budget on the basis of the enhanced MTFF.</td>
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<td>3. Government: (i) approves the rules for MTEF preparation for all ministries, (ii) approves new functional, economic and administrative (and reporting) budget classification in line with international standards and starts applying it in budget documentation for 2020; (iii) issues guidelines for the development of sector strategic plans to strengthen the strategic planning/budgeting link; (iv) implements enhanced MTEF with budget documentation for 2021 utilizing sector strategic plans and resource envelope availability for 3 ministries (piloting); and (v) directs all</td>
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<td>Increase fiscal space by rationalizing public expenditures</td>
<td>ministries to prepare costed and time-bound action plans for the preparation of a MTEF.</td>
<td>3.b) MOF submits to Cabinet a proposal to establish a governing methodology for tax incentives that includes internal frameworks to estimate Tax Revenue and Revenue Foregone impacts of tax incentives.</td>
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<td>Improve management of public debt and fiscal risks</td>
<td>3. Parliament adopts amendments to the Law on labor pensions to exactly determine state budget’s liabilities on pension expenses and on this basis differentiate financial sources of the pension liabilities.</td>
<td>4. Government creates a specialized group in the Ministry of Finance with in-house skills for the regular preparation of MTFF and MTEFs.</td>
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<td>4.b) A high level coordination council is charged with the responsibility of ensuring coordination and the implementation of MTEF reforms.</td>
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<td>5. Government develops and approves a plan for implementing a Financial Management and Information System (FMIS) and prepares the RFP documents for procurement of a Budget Preparation and Allocation Module as a first step.</td>
<td>5. Ministry of Finance and the Ministry of Labor and Social Protection of Population establish a joint working group to exactly calculate state budget’s liabilities on pension expenses.</td>
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<td>6. MOF internally approves a medium-term public debt management strategy to serve as a framework for future borrowings incorporating ceilings on level of government debt and submits to the Cabinet of Ministers.</td>
<td>7. Government restructures the Public Debt Management Agency (PDMA) by operationalizing a separate unit for debt recording and reporting in the Debt Management System.</td>
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<td>5. Government adopts legislative amendments to keep public debt and fiscal deficit to manageable levels by: (i) amending guidelines to restrict utilization of the State Guarantee Fund (for state guaranteed debts) only for ‘A’ rated debt, (ii) framing of guidelines</td>
<td>8. On the basis of a comprehensive debt management strategic policy (e.g.: with quantitative targets to ensure sustainability of public debt; with explicit ceilings on foreign currency and variable rate borrowing to minimize related risks; with explicit</td>
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<td>Policy Objectives</td>
<td><strong>Policy Actions</strong></td>
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<td>for the borrowings of state owned enterprises by imposing an upper limit, and (iii) amending the legislation on the management of residual funds by transfer to single treasury account towards deficit financing.</td>
<td>objectives on the development of domestic debt securities markets; with significant restrictions on the issuance of loans and state guarantees to SOEs and financial institutions; etc.), an updated version of the Law on State Debt is approved in Parliament to consolidate the legal framework on public debt management (which includes creation of a separate Safeguard Fund within the state budget for meeting debt service obligations related to invoked guarantees, fixing of the upper limit for internal and external public debt and the amount of government guarantees to be paid over the year). Implementation regulations (by Presidential decree) set the authority to borrow and procedures for negotiating and contracting external loans. PA 8.b Government approves regulations to (i) strengthen institutional processes leading to the decision regarding contracting of loans and issue of guarantees by the state (ii) outline the processes involved in finding the right credit agency and subsequent negotiations of loans/guarantees leading to finalization of loan agreement and (iii) allocate responsibilities for various agencies once the loan is taken/guarantee issued. PA 8.c. Government implements and complements the guidelines for SOE borrowings (on their own risk, without state involvement or guarantee) by, e.g.; (i) setting out clear annual borrowing limits for each SOE, and (ii) specifying the approval process for SOE borrowings.</td>
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<td>6. MOF approves the design specifications of the Debt Management System to be procured for automating the public debt management processes.</td>
<td>9. To strengthen public debt management’s technical and functional capacity to record, process, monitor, report, disseminate and analyze (external and domestic) public debt (and promote operational reliability, data integrity, statistical reporting and effective analysis), Government formalizes a contractual arrangement with UNCTAD to operationalize the selected Debt Management System covering loan types, maturity, interest payments, guarantees and other relevant benchmarks.</td>
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Reform Output Area 2: State-owned enterprises restructured and private sector participation in economic activities strengthened.

- Strengthen corporate governance and standardize financial reporting and practices

  7. Government (i) mandates the overall direction of SOE restructuring and privatization and (ii) approves an Action Plan on increasing transparency and efficiency in the management of the 20 large SOEs including financial practices.

  10. Government implements the action item nos. 1, 5, 6 and 7 of the approved Action Plan for the large SOEs and submits an Action Taken Report on the same.¹

  10.b) Strategic plans for 9 SOEs are approved and implementation remains on track. Remedial actions towards the remaining SOEs are recommended by MOE to accelerate compliance with requirements under the December 2016 Cabinet Order.

  10.c) Government approves a complete set of standards to measure performance and monitor the financial efficiency of SOEs (introducing assessment criteria to assign ratings to the state-owned enterprises and link managerial remuneration to performance of the SOEs) and approves the high-level institutional division of responsibilities for setting efficiency targets for SOEs and monitoring their financial/corporate performance (for both financial and non-financial SOEs).
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<td>10.d) Government continues to establish underpinnings of corporate governance for all SOEs (in line with e.g. recommendations of the ‘Network on Corporate Governance of State-Owned Enterprises in Asia’) by e.g. requiring SOEs to engage certified chief accounting officers.</td>
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<td>8. Government establishes a Commission to monitor income and expenditure budgets of 11 large SOEs, amends the existing rules related to SOE budget preparation and submittal to the government and increases the monitoring of budget execution with a view to improve oversight and transparency in the large SOEs.</td>
<td>11. Commission annually monitors the budget of the selected SOEs and submits regular reports to the government with recommended actions. 11.b) MOF submits for interministerial consultations proposed amendments to the SOE Borrowing Control Guidelines to bring it in line with the quarterly reporting requirements of MOE and budget preparation processes.</td>
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<td>9. Government drafts and submits for Cabinet of Ministers approval a comprehensive Corporate Governance Standards/ Rules Framework covering selection of directors, internal audit, accounting and financial reporting for all SOEs; in alignment with the Order of the President No. 2300 dated 05.09.2016.</td>
<td>12. Government approves (i) the Corporate Governance Standards/ Rules for all SOEs (that are either JSCs and LLCs), and (ii) rules for performance-based remuneration (bonuses).</td>
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<td>10. Government approves a plan for implementation of international and national accounting standards to strengthen financial discipline in 20 large SOEs.</td>
<td>13. Government approves the institutional division of responsibilities for monitoring compliance with corporate governance rules for both financial and non-financial SOEs, including annual self-reporting requirements for SOEs.</td>
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<td>11. Government strengthens the institutional arrangement for preparation, execution and approval of PPPs and approved guidelines on the rules of</td>
<td>14. Parliament approves amendments to the law on accounting to bring it line with IFRS, and Government submits a compliance report on the implementation of international accounting standards in at least 20 large SOEs.</td>
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<td>Increase commercialization and private sector</td>
<td>15. Government: (i) Through MOE, submits a PPP policy/program to Cabinet to set high-level policy objectives and awareness; (ii) through SMEDA,</td>
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| Policy Objectives | **Policy Actions**  
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(by November 2017) | **Policy Actions**  
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<td>participation in the economy</td>
<td>compete among investors for build-operate-transfer (BOT) projects in PPP mode to improve transparency.</td>
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<td>12. Government to approve strategic roadmaps for key sectors such as heavy industries, tourism, agriculture, telecommunication and IT and financial services aimed at economic diversification.</td>
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<td>Reform Output Area 3: Enhanced access to finance and improved business environment.</td>
<td>Improve access to finance for the private sector by intervening through the banking system</td>
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<td>14. MOF (i) recapitalizes the Azerbaijan Deposit Insurance Fund (ADIF), and (ii) develops a model for a risk-based pricing methodology to price premiums to be charged from banks.</td>
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<td>18. Government submits a report on the number of credit guarantees provided for facilitating access to finance for SMEs.</td>
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<td>Improve business environment for private sector</td>
<td>15. Government passes the Law of Azerbaijan Republic on Credit Bureaus to establish the legal basis of creation and activities of credit bureaus for improving citizen's access to financial services and credit consumer rights.</td>
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<td>16. Government implements at least one significant reform based on the World Bank’s Ease of Doing business framework</td>
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<td>17. Government provides budget support to the National Fund for Entrepreneurship Support (NFES) to enable low cost loans for entrepreneurs in agriculture, tourism and service sectors leading to creation of at least 4,745 jobs in the program implementation period.</td>
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KOB/SMEDA), which ensures the official launch of a full-fledged tax initiative to support SMEs and entrepreneurial activity.


a Future reform directions and ADB engagement in each of the reform output areas is presented in the Post-Program Engagement Framework (accessible from the list of linked documents in Appendix 2).

b Future reform directions and ADB engagement in each of the reform output areas is presented in the Post-Program Engagement Framework (accessible from the list of linked documents in Appendix 2).

c Volume 1 Budget Documentation produced by MOE. Presentation of Projects on State and Consolidated Budget of the Republic of Azerbaijan published by MOF.

d Non-oil budget deficit in percentage of Non-oil Gross Domestic Product.

e This will include new circulars with explicit references to MTFF, as laid out in the Law on State Budget for 2020.

f Official Translations:

- Sl No 1 of Action Plan: To submit proposals on transformation of large state-owned companies into the organizational legal form defined by the legislation, as per institution
- Sl No 5 of Action Plan: To specify the current accounts payables of large state owned companies based on the acts of reconciliation, approval of payment schedule, making payments in accordance with the schedule and submitting the reports to the Ministry of Economy of the Republic of Azerbaijan and to the Ministry of Finance of the Republic of Azerbaijan, in this connection
- Sl No 6 of Action Plan: Formulation of a single database (finance, accounting, personnel records and etc.) in regard to large state-owned companies.
- Sl No 7 of Action Plan: Making the annual financial reports and the consolidated financial reports public, together with the audit opinion, in the cases determined by the law