

# AZERBAIJAN SYSTEMATIC COUNTRY DIAGNOSTIC

South Caucasus Country  
Management Unit (ECCU3)

Europe and Central Asia

June 3, 2015



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**Azerbaijan Systematic Country Diagnostic**

June 3, 2015

**South Caucasus Country Management Unit (ECCU3)  
Europe and Central Asia Region**

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## CURRENCY EQUIVALENTS

(Exchange Rate Effective January 12, 2015)

Currency Unit = AZN

AZN 0.78 = US\$1

## FISCAL YEAR

[January 1 – December 31]

## ABBREVIATIONS AND ACRONYMS

ACG	Azeri–Chirag–Guneshli	PI	Permanent Income
BEEPS	Business Environment and Enterprise Performance Surveys	POS	Points of Service
CBAR	Central Bank of the Republic of Azerbaijan	PISA	Program for International Student Assessment
CSO	Civil society organization	PEFA	Public expenditure and financial accountability
CCC	Commission on Combating Corruption	PFM	Public financial management
CPF	Country Partnership Framework	PIM	Public investment management
ECA	Europe and Central Asia	REER	Real Effective Exchange Rate
EBRD	European Bank for Reconstruction and Development	R&D	Research and development
EFTA	European Free Trade Association	RAI	Rural Access Index
EU	European Union	STEPS	Skills Towards Employment and Productivity Survey
EITI	Extractive Industries Transparency Initiative	SOFAZ	State Oil Fund of Azerbaijan
HBS	Household Budget Survey	SOE	State-owned enterprise
IDP	Internally Displaced Person	SCD	Systematic Country Diagnostic
IAB	International Bank of Azerbaijan	TFP	Total factor productivity
LFS	Labor Force Survey	TIMSS	Trends in International Mathematics and Science Study
LiTs	Life in Transition Survey	UNECE	United Nations Economic Commission for Europe
LPI	Logistics Performance Indicator	UMIC	Upper-middle income country
MSME	Micro Small and Medium Enterprises	WUA	Water Users Association
NCD	Non-communicable disease	WBG	World Bank Group
OBI	Open Budget Index	WDI	World Development Indicators
OGP	Open Government Partnership	WGI	World Governance Indicators

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# Executive Summary

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## *Progress toward the twin goals*

1. **Between 1995 and 2013 Azerbaijan has made substantial progress towards the World Bank Group's twin goals.**<sup>1</sup> In particular, over the last decade, the nation's strong economic performance has been matched by a positive track-record in terms of poverty reduction, shared prosperity and middle class growth. The national poverty rate declined from close to 50 percent in the early 2000s to 6 percent in 2012, while extreme poverty fell from levels above 20 percent to under 3 percent during the same period. At the same time, households in the bottom two quintiles of the distribution (i.e. 'the bottom 40 percent') experienced consumption growth of over 2 percent per year between 2007 and 2012, over twice the rate of the top 60. This growth rate is positive, although it lies below the regional Europe and Central Asia (ECA) average of 3.8 percent per year. Ultimately, improvements in living standards, particularly among those who were initially worse-off, have been accompanied by the emergence and growth of the middle class in Azerbaijan, in line with the country's middle income status.

2. **Natural resource-based economic growth has been driving Azerbaijan's progress on the twin goals, alongside wage increases and fiscal transfers.** The remarkable growth of the economy is the main contributing factor. Between 2002 and 2013, growth averaged 12.6 percent a year, boosted by high foreign direct investment in the oil sector and then by growing oil production, exports, and prices. Over this period, per capita GDP nearly tripled and large increases in public spending fuelled significant economic expansion, largely driven by an ebullient construction sector. Wage increases and rising employment have also contributed to the country's progress on the twin goals. The government raised the minimum wage, from 1.1 to 105 Manats from 2000 to 2013; while real wages increased by 11 percent yearly over the same period. To a lesser extent, the increase in transfers, including pensions and other social assistance (adding up to 5.4 percent of GDP in 2013), has also driven progress on the goals. These transfers have become an important part of the non-market income of the bottom 40.

3. **However recent macroeconomic and geo-political developments suggest that new sources of shared growth will have to be tapped into going forward.** The impact of the shock to oil prices, which has led to an oil price forecast of \$53 in the revised WB baseline for 2015, and the situation in Russia has led to downward revisions in growth projections for many countries in the region including Azerbaijan. Russia's GDP is expected now to contract by 3.8 percent in 2015.

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<sup>1</sup> The World Bank Group (WBG) recently defined two strategic goals: ending extreme poverty and boosting shared prosperity. The goals are to be measured by the reduction in the share of people living on less than \$1.25 a day—to 3 percent globally by 2030—in the first case; and as fostering the income growth of the bottom 40 percent of the population (the "b40") in the case of the second. Both goals are to be pursued with a concern for sustainability.

Azerbaijan's GDP growth forecast has been revised from 4.4 percent in 2015 to 1.4 percent, a 3 percentage point decrease. The policy framework in Azerbaijan had been defined by a de facto exchange rate peg to the US dollar since 2009, and was supported by Central Bank interventions of approximately \$3.4 billion that led to a draw down in reserves from \$15.2 billion to under \$12 billion and a 33.6 percent devaluation of the manat. This needed adjustment has aligned the exchange rate better with new economic fundamentals including falling oil prices and depreciation in trading partners' currencies. While fiscal dominance, a high share of cash in circulation, dollarization, limited capital market development and the absence of an interbank money market all undermine the monetary policy transmission mechanism, maintaining pressure on the state budget and on transfers out of accumulated savings in the Oil Fund, the manat depreciation will provide some mitigation. Fiscal consolidation and a more competitive exchange regime are both needed to complement the deep structural reforms that are essential for developing new and resilient sources of growth and revenues.

4. **Focusing on the transition from vulnerability into the middle class is important since, in spite of the progress achieved in reducing poverty and boosting shared prosperity, there are underlying nuances to the story.** If the share of people entering the middle class were proportionate to the share of people leaving poverty, the vulnerable group would not change in size. The increase in the size of the vulnerable is the result of a successful pattern of people being lifted out of poverty, but also the result of people not entering the middle class at the same pace. There is some threshold level of income/productivity of households beyond which a more diversified assets base and use is needed at the micro level.

5. **Gains are geographically uneven (across territories and urban/rural areas).** While this is not unusual in transition economies, it suggests strains on growth, inequality and social sustainability going forward. Additionally, although the largest share of the bottom 40 households in Azerbaijan are not poor, they have not yet joined the ranks of the middle class, and are still vulnerable to shocks and potential fallbacks into poverty. These households remain reliant on social safety nets or on lower wage employment. Social inclusion also remains a distant reality for Internally Displaced Persons (IDPs), who are at the core of the vulnerable and bottom 40, nearly 13 percent of which are IDPs.

6. **Moreover, while oil and gas will continue to play an important role in Azerbaijan's future, the downside risks to production and prices underscore the challenges to sustainability of growth and fiscal trends.** Outside the extractive industries, productivity has mainly grown in the non-tradable sectors. After oil production peaked in 2010, non-tradables, especially construction and services, emerged as the dominant sectors with steady increases in public spending – supported by booming oil prices - emerging as the driver of growth overall. This has also led to real exchange rate appreciation with adverse implications for non-oil competitiveness. However the declining price of oil – forecast to average 53 per barrel in 2015

compared to \$112 in mid-2014 – and the appearance in 2015, for the first time in a decade, of a consolidated fiscal deficit (that is likely to be significant, at nearly 11 percent of GDP), paint a picture of an economy that needs a new growth model and also needs to address structural challenges that hinder the development of new sources of growth. This will help ensure continued progress on the twin goals given that the current trends are clearly not sustainable.

7. **It is clear that the existing dynamics of the economy cannot fully support the aspirations of the growing middle class and of the bottom 40.** Ensuring sustainability going forward implies satisfying the demands of the growing middle class and of the bottom 40 for relevant education and affordable and quality health care; for better jobs and more opportunities outside of subsistence agriculture; for strengthened connectivity, and access to reliable and cost effective services including water, sanitation, and energy; and for greater voice.

### *The framework*

8. **This Systematic Country Diagnostic (SCD) identifies the most important binding constraints that the country faces going forward to sustain and even-out progress on the twin goals; providing value added in three aspects.** First, the SCD presents a diagnostic analysis of past trends to assess: (i) if the drivers of growth are sustainable; (ii) whether the bottom 40 percent are able to benefit from growth and to participate more productively in the economy over time; and (iii) what are the most binding constraints going forward to build the asset endowment and productive capacity of these households to strengthen their income generation capacity and support a sustainable transition out of vulnerability and into the middle class.

9. **As economic growth is jointly determined by both macro and microeconomic drivers, an assets-based framework is used in this SCD to understand the constraints to progress on the twin goals, and to identify key challenges going forward to ensure sustainable and inclusive growth.** The framework illustrates how the accumulation, intensity of use, and returns to assets—including human, physical, financial, natural, social, and institutional capital— influence the income generation process of the people of Azerbaijan. Here, the analysis pays special attention to the bottom 40 percent of the welfare distribution. The approach incorporates the market and institutional factors that affect the accumulation, intensity of use and returns to assets over the economic cycle (the top-down story), as well as the long-term productive capacity of households to contribute to growth (the bottom-up story).

10. **In this sense, it is not only the availability of resources but also the distribution across households that determine the progress towards a sustainable and inclusive growth model.** Sustainability is a key element of the framework in every sense: fiscal, social, and environmental. This integrated analysis on constraints and challenges enables us to identify key priority issues that are cross-cutting and that potentially will have the greatest impact on the twin goals. This approach

is consistent with the framework developed by the World Bank in Diversified Development (World Bank 2013), which emphasizes that the path to stable, sustainable and inclusive growth is through the building of a diversified portfolio of assets.

### *Challenges and Constraints*

11. **The analysis of the patterns of growth motivates a wide range of constraints that Azerbaijan faces in making fiscally, socially, and environmentally sustainable progress toward the twin goals.**<sup>2</sup> These constraints are summarized in four key challenges that will be crucial to overcome in order to achieve sustained progress on the twin goals. From the top-down perspective, overall growth is unbalanced and slowing down alongside troubling fiscal imbalances and limited employment creation. In order to maintain growth in the coming years, Azerbaijan faces two key challenges: (i) the strategic use of oil rents and more effective public expenditures to promote the accumulation of a diversified asset-base in the economy; and (ii) promoting productivity growth to foster long-term private sector growth and economic competitiveness, strengthening the intensity of use and returns to assets. From the bottom-up perspective, households will need to be better equipped to participate in this new economic environment. In order to ensure *inclusive* growth in the coming years, Azerbaijan faces two additional challenges: (i) fostering the accumulation of diversified assets for all households in the country (in particular those in the bottom 40); and (ii) enhancing opportunities for households to use their assets more intensively.

12. **Progress towards the twin goals will thus require addressing challenges and constraints related to both sustainable growth as well as inclusive growth.** Solutions to removing the top-down and bottom-up constraints will reinforce each other toward overcoming these challenges and moving the economy toward a new growth trajectory that will ultimately better enable Azerbaijan to achieve the twin goals.

### *A view from the top-down*

13. **Ensuring the accumulation of a diversified asset-base in the economy is the first challenge to overcome.** Per capita income doubled in less than 10 years and was supported by large increases in public spending made possible by growing oil production (until 2010) and booming oil prices (until the second half of 2014). Looking forward to the medium-run in fact, annual GDP growth is projected to average 2.3 percent (2014-2017). This projection breaks down into oil GDP shrinking without the non-oil sector being able to accelerate sufficiently to offset.

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<sup>2</sup> Note the distinction between constraints and challenges identified in this report. *Constraints to achieving the twin goals* reveal key challenges areas for Azerbaijan moving forward. That is, constraints refer to the specific obstacles—for example, insufficient accumulation of quality human capital, or elevated transport costs—which are preventing overcoming the challenge of promoting productivity growth. In looking at the constraints, it is important to understand *why* they persist (which is often related to structural issues and surrounding institutions/decision-making processes).

Deteriorating fiscal trends suggest that the high and pro-cyclical public spending that drove non-oil growth in the past is not sustainable. Rather, the experience of other resource-rich developers suggests that managing oil revenues to support the accumulation of a diverse portfolio of assets, namely built capital – both human and physical – and institutional capital is the only means to ensuring stable, sustainable, and shared growth. Azerbaijan has made progress on institutional asset accumulation – for example through efforts to accumulate reserves in the state oil fund (SOFAZ), modernize the judicial system and provide a one-stop-shop for several kinds of public services – but there is a significant pending structural reform agenda to be addressed. In particular, closing the infrastructure deficit efficiently while strengthening focus on human capital accumulation will be essential if conditions are to be created for greater geographic and demographic inclusion. Ultimately this asset diversification is also the best way to ensure at the macro level that oil wealth is shared with future generations.

**14. Asset diversification will only be possible with strategic use of oil rents through effective fiscal management.** The deterioration in fiscal trends implies two immediate priorities: (i) creating fiscal space through efficient public spending, particularly investment, which is performance-oriented and prioritized based on transparent monitoring, information sharing, and impact evaluation; and (ii) strengthening governance by building credible and accountable institutions with the capacity to enforce fiscal rules and a medium term fiscal framework while planning for sustainability. This will allow effective fiscal management directed at macroeconomic stabilization and economic efficiency, and will ensure the channeling of public expenditures towards the provision of accessible and quality infrastructure and social services. Currently the State Oil Fund is mainly a stabilization fund and source of transfers to the state budget, which satisfies part of the requirements of fiscal responsibility but is not sufficient to ensure that oil wealth is genuinely shared with future generations or put to best use. For this it needs to be complemented by institutions that will ensure sound governance and strategic and transparent fiscal planning, prioritization and execution.

**15. The second structural challenge to accelerating and sustaining progress on the twin goals is bringing the private sector to center-stage as the main driver of growth, especially in light of important emerging macroeconomic risks that have already led to the 2015 growth projection falling to under a third of the level forecasted earlier.** Growth over the past decade or so was largely driven by increases in oil production and prices, and, especially after the crisis and peaking of oil output, by the non-tradables sectors, mainly construction and services, also supported by high public investment fuelled by oil revenues. With non-oil exports at 6 percent of total merchandise exports in 2013, the tradables sectors are clearly not quite taking off. This is not sustainable in the current macro-structural context. The roles of the public and private sectors need to be rebalanced, with the former becoming a facilitator rather than the main driver of growth. This is also important to create space in the budget for more investment in priority areas while ensuring fiscal sustainability. In other words, private investment needs to start replacing public investment,

which would also take the pressure off the budget, leaving room for higher spending on human capital and infrastructure and encouraging growth in non-oil revenues. The transition of the private sector to front and center and from non-tradables dominance to export-led growth will be the two important components of a new and sustainable growth model. Unleashing productivity growth will be critical for new sources of growth to develop. And this will only be possible with asset diversification and accumulation.

**16. Unleashing productivity growth for economic competitiveness is already a stated priority of the Government and will call for comprehensive reforms to tackle a wide range of constraints.** There are several constraints on the asset diversification needed to achieve non-oil competitiveness. Productivity levels have not been increasing, especially in the sectors that seem to employ the largest shares of the work force. There is limited churning of firms from low productivity to higher productivity industries. The skills gap affects labor mobility and therefore is a constraint on productivity growth as is informality, which remains widely prevalent with only 30 percent of workers under contract. The high degree of informality may be overstating the share of workers in agriculture, understating the role of construction in generating jobs, distorting investment incentives – including in worker training – and undermining fiscal revenues. There is a marked gap in terms of market institutions, especially those needed to ensure a level playing field, transparent and enforceable property rights, and well-regulated private sector, all critical for private investment and entrepreneurship, and for supporting an SME sector that can grow and create better jobs. Also innovation is constrained as is financial access, while weak competition and governance in the financial sector hinder the intermediation of capital to its best potential use. Finally global integration through strengthened trade links and greater focus on trade facilitation and efficient and accountable border management and customs services will be necessary if non-oil growth is to be rebalanced from domination by the non-tradables sector to being driven by exports.

**17. A particular challenge is low agricultural productivity.** Agriculture produces less than 10 percent of GDP but officially absorbs nearly 40 percent of the work force. Productivity growth in the agriculture sector is critical for supporting real income and consumption growth in rural areas, where the b40 are concentrated, and for reducing inequality and supporting further the demand for improved public service delivery outside Baku. Growth in agricultural exports and value-added processing through investments in agriculture and irrigation, and improved rural connectivity could contribute to stimulating the sector and the rural economy.

*A view from the bottom-up*

**18. Fostering the accumulation of a diversified asset-base in Azerbaijan is a key challenge to be addressed in order to enhance households' access to economic opportunities and protection against shocks.** The evidence suggests that, currently, the poor and bottom 40 have

fewer opportunities to accumulate assets. In terms of human capital, these households present lower levels of education, a higher dependency rate and inferior health outcomes vis-à-vis the middle class. Access to tertiary education, for instance, is not only limited at the national level, but it is also inequitable across regions, and urban/rural areas; while social norms influence its access according to gender. On the other hand, gaps persist in health outcomes across the welfare distribution, where the heavy reliance of the health system on private out-of-pocket expenditures affects bottom 40 households particularly. In addition to human capital constraints, poor connectivity in certain regions and rural areas remains a major restriction affecting more adversely the more vulnerable groups. Additionally, the level of financial inclusion and outreach remains insufficient, especially among micro, small and medium enterprises and households.

**19. Azerbaijan also faces the challenge of enhancing opportunities for households to use assets more intensively.** The analysis indicates that the bottom 40 have fewer opportunities to use their assets productively, as these households face higher unemployment than their middle class counterparts, while the employment they do obtain tends to be low-quality—concentrated in low-productivity low-wages sectors. Economic growth in Azerbaijan has been accompanied by a growing degree of labor informality, which disproportionately affects the poor and lagging regions. On the other hand, women lag behind men in employment rates, while a gender divide persists in terms of sectoral, occupational, and wage gap in the labor market. IDPs are another group that displays lower employment rates and higher work inactivity than the non-displaced. Access to productive opportunities is also influenced by social networks and access to markets. In this sense, the analysis indicates that having connections in Azerbaijan is very important to obtaining quality jobs, while the presence of an uneven playing field may be dampening expectations of future social mobility in the country.

#### *Key binding constraints*

**20. The set of constraints faced to address the stated challenges includes several actions, but a prioritization is needed to tackle those that can have the largest impact.** Such an exercise is limited by the availability of information, which leads to the use of second-best criteria. The prioritization exercise, which derives from the analysis, relied on three key elements: (i) benchmarking whenever data allowed (ii) expert advice and verification, and (iii) an emphasis on constraints that are likely to impact several factors at a time, showing an effect that overlaps across challenges. The latter element, namely the high weight imposed on cross-cutting constraints, implies a more systemic approach—rather than project or sector-based approach.

**21. Bearing in mind the above, selection criteria focused on those constraints that would have the greatest impact on the twin goals; cross-cutting factors underlying the removal of the constraints (i.e. decision-making processes); impact on both top-down and bottom-up challenges, as well as the potential time-horizon of expected impacts.** After a systematic review



of the identified constraints through this lens, the SCD proposes the following as the most binding—those whose removal in the next years would enhance the potential for Azerbaijan to overcome its pending challenges and continue on a path toward sustainable and inclusive growth.

### *1. Intangible capital: Governance and institutions*

**22. An important lesson from international experience is that resource-based development is intensive in institutions, where institutions refer to fair and accountable governance, the management of volatile natural resource revenues, provision of essential social services, and regulation of private enterprise.** From the top down perspective, a comparison of the development experiences of the upper middle and upper income countries in North America, Europe and East Asia undertaken for the Diversified Development flagship<sup>3</sup> suggests that resource-rich countries find development institutionally more challenging, partly because of the macro-fiscal pressures imposed by volatile natural resource rents and the difficulties in many countries of ensuring a level playing field through effective, transparent and accountable governance. The difference between Chile and Venezuela, or between Canada and Norway on the one hand and Nigeria on the other, would suggest that the soft side of the national asset portfolio is indeed critical.

**23. Institutional capital determines how a country governs, and its effectiveness, through regulatory bodies, mechanisms, and norms.** The quality of institutional capital influences the possibility of more dynamic private and external sectors (rule of law, lower ownership concentration and bureaucratic capacity); also, it influences the potential to tackle territorial disparities through the bureaucratic ability to deliver quality services and by strengthening accountability, and influences financial inclusion and social capital through regulatory environments. Thus, reflecting on the constraints discussed in previous sections, both from the top-down (competitiveness concerns, private investment-related restrictions, limited human capital, etc.); as well as from the bottom-up (such as issues related to education, health, water, infrastructure), it becomes clear that a key underlying common theme behind these constraints—or symptoms—relates to four key aspects of governance: (i) fiscal management; (ii); service delivery (iii); rule of law; and (iv) data. In the context of Azerbaijan, these aspects of governance need to be addressed in particular with a focus on shifting toward (i) a longer term perspective (ii) a more local perspective; (iii) greater transparency and accountability, and (iv) and more evidence-based decision making.

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<sup>3</sup> I.Gill, I. Izvoski, W.Van Eeghen, D.De Rosa (2014), *Diversified Development : Making the most of natural resources in Eurasia*

## *1.1 Fiscal management*

### **24. Strengthening fiscal governance is paramount, particularly in terms of the planning and execution of natural resource-related revenues and the creation of fiscal space.**

Azerbaijan has made progress towards credible, accountable and transparent fiscal management but progress needs to accelerate, especially in the light of deteriorating growth and fiscal trends and the urgent need for budgetary adjustment. Stabilization is a priority because it is a necessary condition for maintaining economic health. Azerbaijan has accumulated nearly half of GDP in reserves, which has helped take the edge of real exchange rate appreciation and will also provide a buffer to smooth spending as oil prices fluctuate. However in the absence of effective fiscal rules and governance norms that assist in an objective prioritization of expenditures and guard against pro-cyclical spending, SOFAZ is not enough. The State Oil Fund has financed a public investment program supporting both immediate needs and long term development goals, however to ensure that oil wealth benefits future generation in a sustainable way, further institutional building is needed for transparent project identification, planning, prioritization and execution. The main areas where further effort is needed to strengthen capabilities include independent scrutiny and oversight in relation to tax administration, procurement, internal audit and external audit.

## *1.2 Service delivery*

**25. Strengthening the State's capacity for delivery of quality services is a key binding constraint, with a particular focus on improving accountability and transparency.** It is specifically suggested that local capacity and accountability are strengthened by empowering local government structures. This would be require measures both politically and in terms of budget execution. Citizen engagement and customer feedback for monitoring delivery will be an important aspect to ensuring accountability as well as demographic and geographic inclusion- especially in terms of gender, IDPs, and the rural poor. While ASAN has made significant progress in expanding service delivery throughout the country; additional review and evaluation are needed to ensure the accountable governance of the program as well as reforms to improve the efficiency and scope of its programs. Reforms in areas such as customs services and tax administration could have significant impacts on the business environment, for example by helping to promote cross-border trade and reducing labor informality - ultimately improving productivity and fostering private sector led growth. It would be also important to further strengthen environmental aspects of public service provision, given the importance of sustainable land use for the bottom 40 and the overall risks imposed on health, especially of the demographically and geographically vulnerable, of environmental damage and chemical pollution.

### *1.3 Rule of law*

26. **Enhancing the technical and administrative capacity of the judiciary, as well as its autonomy from the executive, both in terms of civil and corporate matters, will be key for Azerbaijan.** Promoting rule of law will be fundamental for addressing the challenge of unleashing productivity growth and shifting the private sector into a key driver of growth. The application of legal norms and the arbitration of disputes in courts has to be impersonal, in the sense that rules should apply equally for all. This is a foundation for the development of sound market institutions and a business environment capable for promoting private sector investment and fostering competition. Without the mechanisms in place to ensure an even playing field for all firms, well defined enforceable property rights, and a lower concentration of ownership in financial, manufacturing and key service sectors– other private sector reforms may have limited impacts. Moreover, the importance of a level playing field cannot be overstressed in the context of inclusion. Access to productive opportunities is influenced by social networks and access to markets. As discussed, analysis reveals high perception of the importance of having connections to obtain quality jobs in Azerbaijan, and indicates that the uneven distribution of social capital may be dampening expectations of future social mobility in the country.

### *1.4 Data*

27. **Improving systematic data collection and analysis to strengthen the provision of public services and improve the design and effectiveness of policy interventions targeting private sector competitiveness.** This allows for evidence-based policy making which is fundamental to (i) improving bureaucratic capacity and service delivery, facilitating focus on performance, enhancing monitoring and evaluation and enabling course correction where needed; (ii) early identification of emerging disparities and observation of progress to improve design of inclusive development policies; (iii) fostering transparency and accountability by providing the basis for informed feedback into the decision making process. The knowledge gaps evidenced throughout this report underscore the need for improved data collection and analysis.

## *2. Human capital: Skills and health care*

28. **No diversification strategy can be successful without a more solid human capital base – the link between education and employment – as well as innovation, productivity, competitiveness is well established.** This is especially relevant for Azerbaijan, where the skills gap is a significant constraint on private sector competitiveness. Increasing the coverage of and access to tertiary education is especially important. In particular, reforms should include a focus on closing the gap in higher educational attainment across regions, rural/urban areas, as well as across income groups as this is fundamental for building the skills base needed for these groups to participate more actively and productively in the labor market. Moreover, it is important to improve quality of secondary education, where significant gaps are seen in student performance

between Azerbaijan and other upper middle income countries. Reforms to tertiary education are essential, but will have limited impact without a stronger foundation of quality secondary education. In terms of health care, it is important to ensure access and quality of healthcare as well as investment in public health infrastructure such as improved water and sanitation services. More data must be made available for performance based decision making in the provision of both education and health services. Azerbaijan should be benchmarking itself regularly through participation in international tests for example.

### 3. Connectivity

29. **Improving connectivity, particularly in terms of local roads that reduce transport costs for products and people, a key input to promote private sector investment, rural productivity and access to economic opportunities, is a priority.** The development of main transport corridors, along with relevant logistical services, will improve connectivity and open way for producers to reach out to local and international markets in a faster and cheaper. Greater access to markets through improved local connectivity is important for promoting labor mobility and creating more opportunities for the poor and the bottom 40 to use their assets more productively. In particular, investment in local connectivity is key in terms of increasing productivity in the agricultural sector where increased access to markets could have long term impacts on stimulating rural incomes which will directly benefit the bottom 40. Finally, improved connectivity also impacts human capital accumulation – a key constraint discussed in the previous section- as it influences the demand for education and health services. Investments in connectivity, however, must be made with a concern for sustainability.

A summary of the above priorities is shown in the next table:

<p>Short-term ( <math>\leq</math> 3 years)</p> <p><b>Challenges:</b>  <b>Top-down</b> <i>Ensuring fiscal trends are sustainable and growth is stable, sustainable and shared</i></p> <p>Sustainable asset diversification and productive use at the macro-level through</p> <ol style="list-style-type: none"> <li>1) Strategic use of oil rents and effective fiscal management;</li> <li>2) Unleashing Productivity Growth (Private Sector Including Agriculture); Trade and Trade Facilitation</li> </ol>	<ul style="list-style-type: none"> <li>• Creating fiscal space through strengthened accountability, transparency and efficiency of public spending by instituting credible fiscal rules of the game, implementing PEFA recommendations, the Government's own national anti-corruption strategy, and developing the institutional capacity and mechanisms needed for results-based programmatic budgeting.</li> <li>• Strengthening of local authorities as a decentralization strategy established and implemented.</li> <li>• Strengthening governance of private sector to ensure even playing field, well defined property rights, facilitate financial</li> </ul>
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<p><b>Bottom-up: Sustainable accumulation of human, physical and financial capital</b></p>	<p>inclusion, and support integration and trade facilitation.</p> <ul style="list-style-type: none"> <li>• Completing roll-out of ASAN, review and evaluation to ensure governance accountable of the program, customs reforms completed and customs services integrated into ASAN; tax administration integrated into ASAN.</li> <li>• Continued investment in irrigation, boosting agricultural productivity to address rural income inequality and roads infrastructure; other key public services including housing, water and sanitation, and social services, particularly targeting IDP communities.</li> <li>• Capacity building and autonomy of judiciary.</li> <li>• Strengthening data collection and use relating to public spending, especially public investment, and public services with a view to strengthening monitoring and evaluation of impact on b40 and facilitating evidence based decision making and course correction where needed.</li> <li>• Education policy established and implementation initiated for quality improvement at secondary level and strengthened access and coverage at tertiary level.</li> <li>• Risk pooling in health care and reforms to support autonomy, standards and quality; establish protection against impoverishing health expenditures by strengthening access and quality.</li> <li>• Programmatic budgeting established and disaggregated data published; preliminary performance indicators established.</li> <li>• Review of data management and publication practices completed at both macro and micro level and reforms implemented.</li> <li>• Drafting of PPP framework, public investment management methodology and piloting.</li> </ul>
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	<ul style="list-style-type: none"> <li>• Time-bound strategy for environmental sustainability incorporating integrated landscape management and cleanup of contaminated land; wastewater management and improved local environmental services established.</li> </ul>
Longer-term (3+ years)	<ul style="list-style-type: none"> <li>• Overhaul local connectivity.</li> <li>• Implement education policy focused on access to tertiary and quality of secondary.</li> <li>• Continue to strengthen access and quality of health care while ensuring adequate financing mechanisms.</li> <li>• Performance-based programmatic budget established and implemented.</li> <li>• Capital budgeting methodology established and implemented.</li> <li>• PPP framework established and functional, both in terms of financing of and provision of infrastructure and social services;</li> <li>• Irrigation overhauled.</li> <li>• First phase of strategic plan for environmental sustainability implemented; with next phases for medium and long term actions defined.</li> </ul>

# 1 Introduction

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*Azerbaijan's performance on the twin goals has been commendable. The middle class has doubled in size and extreme poverty has almost been eliminated in the space of a decade. At the same time, regional differences persist, with significantly higher poverty rates in lagging regions, and Baku dominating overwhelmingly in terms of share of GDP. Disparities in welfare also persist between rural and urban areas as well as across social groups. As the share of the poor fell in the bottom 40 percent of the welfare distribution, the share of the vulnerable has increased. All of this suggests taking a closer look at the challenges facing Azerbaijan as it seeks to sustain and "even out" progress on the twin goals.*

## 1.1 Motivation

30. **The Systematic Country Diagnostic (SCD) is a diagnostic exercise designed to identify the most critical binding constraints and opportunities facing a country in furthering its advancement and making sustainable progress toward the World Bank Group's (WBG) twin goals of ending extreme poverty and boosting shared prosperity.** The exercise is conducted in close consultation with national authorities and other stakeholders and is based on the current available body of knowledge. A greater analytical understanding of these priority areas will help to inform the preparation of the World Bank Group Country Partnership Framework (CPF), alongside national development strategies and government identified priorities.

### Box 1: The WBG Twin Goals at a Glance

#### Goal 1: End extreme poverty

The WBG aims to reduce the number of people living on less than US\$1.25 per day, an internationally established measure of extreme poverty, to no more than 3 percent globally by 2030.

#### Goal 2: Promote shared prosperity

The WBG seeks to foster the income/consumption growth of the population in the bottom 40 percent of the welfare distribution in every country. This goal requires the rapid and sustained expansion of the national economy, but also requires that this growth benefits the less-well off. Unlike the first goal, this goal does not have a specific target and is measured at the national (not global) level.

**Sustainability is an overarching theme that frames the twin goals.** The goals must be achieved in an environmentally, socially, and fiscally sustainable manner. A sustainable path of development and poverty reduction would be one that: (i) manages the resources of our planet for future generations, (ii) ensures social inclusion, and (iii) adopts fiscally responsible policies that limit future debt burden.

*Source: The World Bank Group Goals: End Extreme Poverty and Promote Shared Prosperity.*

31. **In this SCD for Azerbaijan, we analyze past trends to understand historical drivers of growth and identify key challenges and constraints to make certain that the drivers of growth continue to be sustainable and inclusive.** Doing so aims to ensure that all individuals, in particular those in the bottom 40 percent of the welfare distribution, are able to benefit from and contribute to the growth process. Identifying the most binding constraints can contribute to build the productive capacity of these households going forward, strengthening their ability to provide for themselves and lay the pathways to a growing middle class.

## **1.2 How has Azerbaijan fared in terms of poverty reduction and shared prosperity?**

32. **In 1995, a few years after gaining independence, Azerbaijan faced major social and economic challenges.** Following a period of decline in oil production and overall contraction of economic activity, the country confronted widespread poverty, whereby almost 60 percent of the population was considered poor, while GDP per capita represented about 31.7 percent of its 1989 level (World Bank, 1997). In response to these social and economic challenges, the country engaged in a strategy to revamp oil production through an ambitious investment plan.

33. **Almost twenty years later, the economic advancement of Azerbaijan is unquestionable.** Oil wealth has served Azerbaijan well, helping the country achieve high growth rates, accumulation of large foreign exchange reserves, and reduction in debt levels. Economic growth averaged 12.6 percent per year during the period 2002-13, as Azerbaijan transitioned into middle-income status, bolstered by high foreign direct investment in the oil sector and then by growing oil production and exports, and prices. This has been accompanied by significant reductions in poverty as well as by positive consumption growth of the bottom 40 percent of the welfare distribution.

### *Poverty Reduction*

34. **Alongside its economic advancement, Azerbaijan has experienced significant and steady poverty reduction over the last decade.** Poverty declined from 49.0 percent of the population in 2001 to 15.8 percent in 2007, and then to 6.0 percent in 2012 (Figure 1).<sup>4</sup> Moreover, extreme poverty, measured by the international poverty line of US\$1.25 a day, is already well below the global target of less than three percent by 2030.<sup>5</sup> As discussed throughout the report, there are important data limitations that prevent us from going into an in-depth analysis of the microeconomic trends. However, the SCD exploits existing data as much as possible to shed light on the drivers, challenges and constraints.

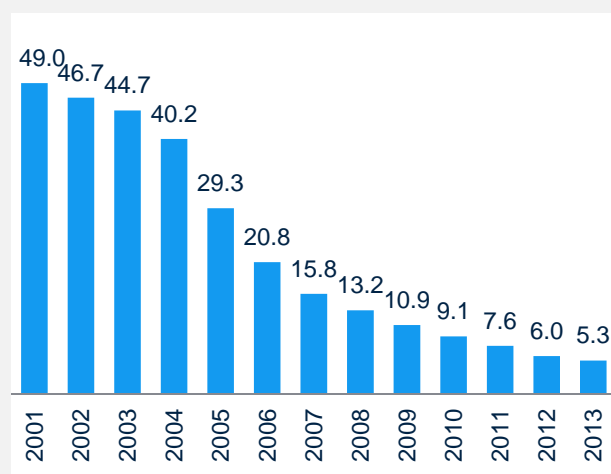
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<sup>4</sup> The poverty rate refers to individuals with a per capita consumption below the national poverty line. Poverty lines are set each year through an administrative process. The nominal lines in 2007 and 2012 refer to AZN 64 and AZN 119, respectively.

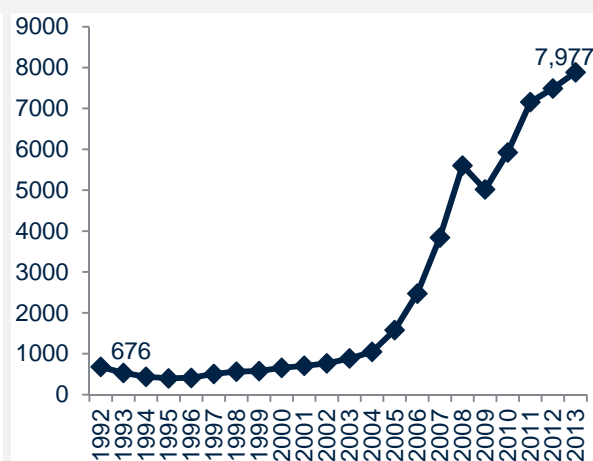
<sup>5</sup> Extreme poverty relates to the share of people living on less than \$1.25 PPP a day. In the case of Azerbaijan this indicator has been calculated the last time in 2005 when extreme poverty was 0.0 percent.



**Figure 1: Poverty headcount rate at the national poverty rate in Azerbaijan, 2001-2013**



**Figure 2: Evolution of GDP per capita**



Source: World Bank staff calculations based on Statistical Committee data. Notes: Poverty lines are set each year through an administrative process. The nominal lines in 2007 and 2012 refer to AZN 64 and AZN 119, respectively. Individuals with a per capita consumption below the poverty line are considered poor.<sup>6</sup>

35. **While poverty has declined significantly in Azerbaijan, national averages mask important welfare disparities between rural and urban areas as well as across regions.**<sup>7</sup> Although between 2007 and 2012 poverty has declined in both rural and urban areas (by 10.8 and 8.5 percent respectively), the majority of the poor (61 percent) live in rural areas (Figure 3). In 2012, the rate of poverty in rural areas was nearly twice that of urban areas (8 percent vs. 4.5 percent). At the same time, poverty varies widely across regions: from over 14 percent in Lankaran to two percent or less in Baku and Nakchivan (Figure 5). Indeed, Lankaran is the only region where poverty increased between 2007 and 2012.

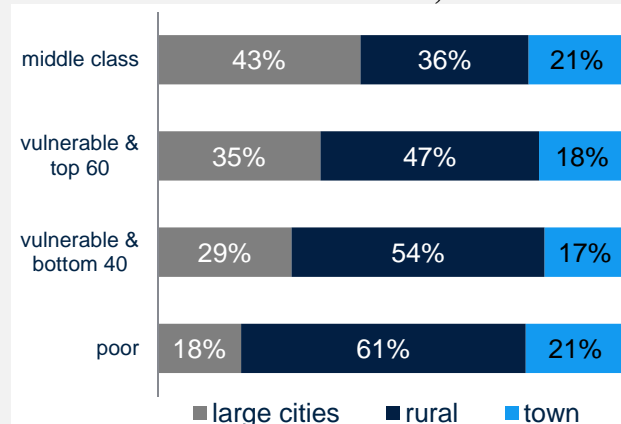
36. **National averages also mask significant disparities in welfare across social groups, such as internally displaced persons (IDPs).** Approximately 7 percent of Azerbaijan's population (around 595,000 people) is displaced—forced to leave their homes in response to the political conflict with Armenia—making it one of the countries with the highest number of IDPs per capita in the world. This group is particularly affected by circumstance-driven inequalities. In 2011, the World Bank estimated the poverty rate of IDPs to be 25 percent, compared to 20.1 percent among the non-displaced. The most recent government estimates state the IDP poverty

<sup>6</sup> The official national poverty rate for 2013 has not been verified by the World Bank.

<sup>7</sup> There are no regional price indices to correct for differences in cost of living. Correcting for those differences, arguably, would result in higher levels of poverty in the Baku metropolitan area and lower levels of poverty in the rest of the country.

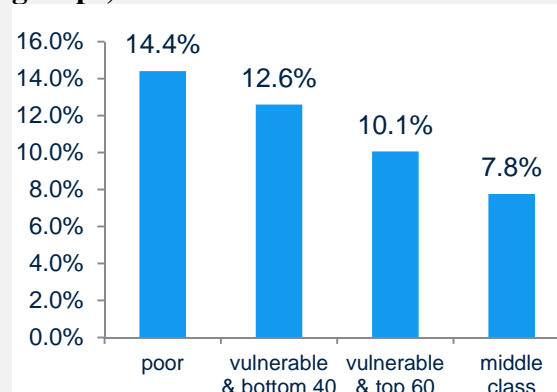
rate to be around 18 percent. IDPs remain a core stratum in the bottom 40, in spite of public investment, which has helped relieve living conditions through improved housing and infrastructure. Figure 4 illustrates that within the group of poor households, 14 percent are considered IDPs; the share of this group decreases among the higher income groups.

**Figure 3: Poverty shows a clear divide between urban and rural areas, 2012**



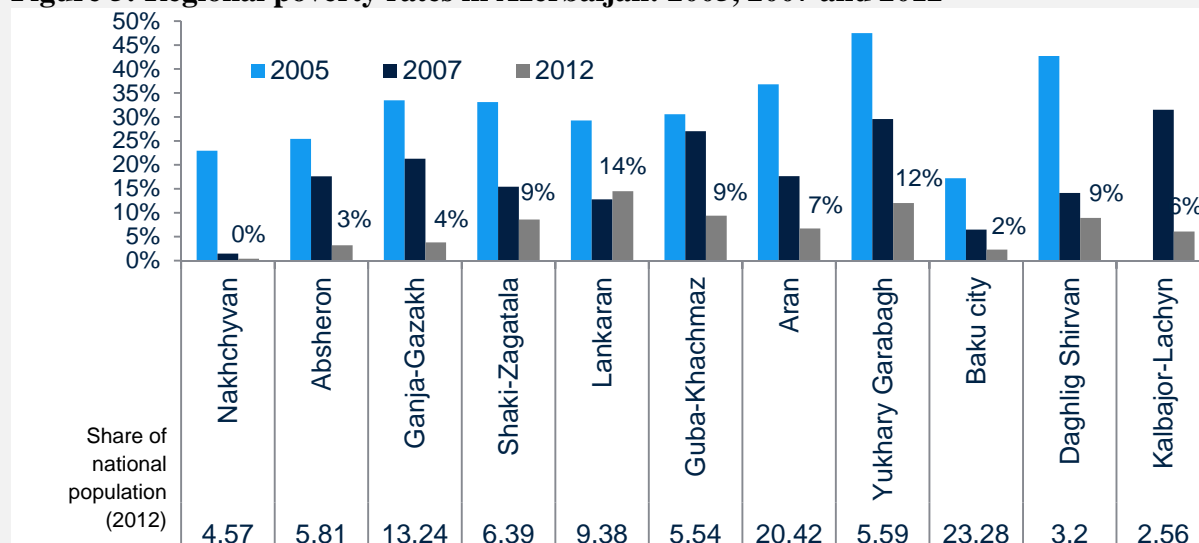
*Note: Poverty estimates based on the national poverty line and methodology. The threshold which separates the vulnerable from the middle class is the 10 USD PPP line. Source: State Statistical Committee and World Bank staff calculations, based on data from HBS Azerbaijan 2012.*

**Figure 4: Share of IDPs within welfare groups, 2012**



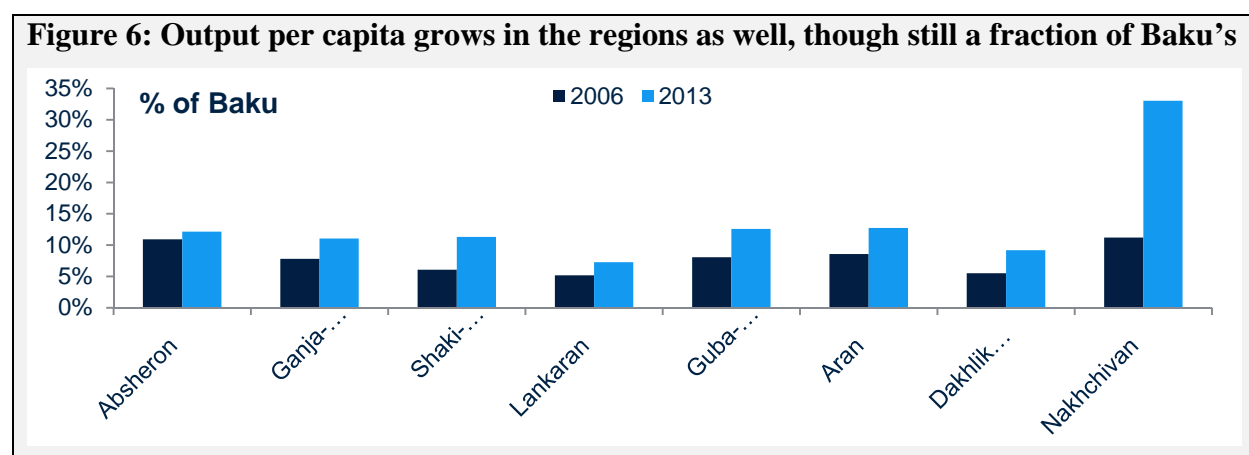
*Source: State Statistical Committee and World Bank staff calculations, data from HBS Azerbaijan 2012.*

**Figure 5: Regional poverty rates in Azerbaijan: 2005, 2007 and 2012**



*Note: Poverty estimates based on the national poverty line and methodology. Source: State Statistical Committee and World Bank staff calculations, based on data from HBS Azerbaijan 2005, 2007 and 2012.*

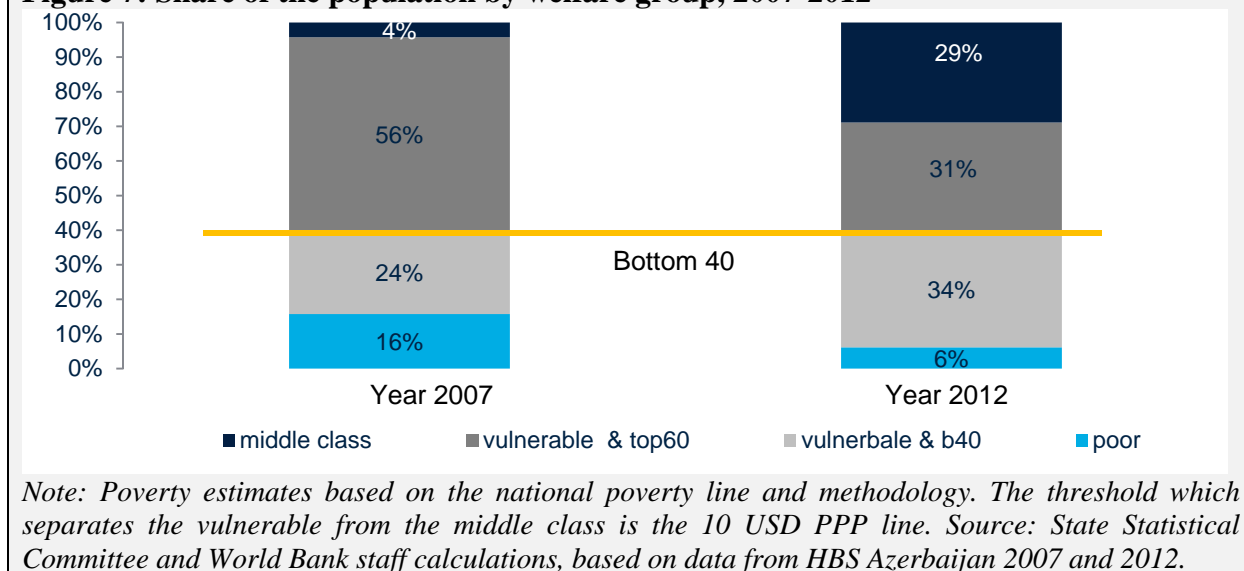
37. **The nature of income disparities across regions is consistent with these findings.** Output per capita in Baku is nine times higher than the average of all other regions. The poorest region in Azerbaijan in terms of output per capita is Lankaran with per capita output at 48 percent of the national average. Excluding Baku, the average output per capita falls to AZN 2,351 relative to AZN 8,553 for the whole country and AZN 20,163 for Baku. In the period of 2006-2013 cumulative output growth in Baku was 217 percent. Several regions such as Nakhchivan, Shaki-Zagatala and Guba-Khachmaz outperformed Baku in this respect (Figure 6). The poorest region in terms of output per capita, Lankaran, also showed the lowest growth in this period, of 176 percent.



38. **Alongside gains in poverty reduction, the middle class increased in Azerbaijan from 4.26 to 28.89 percent of the population between 2007 and 2012—almost a sevenfold increase** (Figure 7).<sup>8</sup> Yet, the share of households belonging to the middle class also differs systematically across regions in the country. For instance in the year 2012, around 44 percent of households in Baku lived above the threshold of 10 USD PPP; compared to 21 percent in Aran, or the national average of 29 percent.

<sup>8</sup>The middle class is defined in this context as households with a per capita consumption above 10 USD PPP.

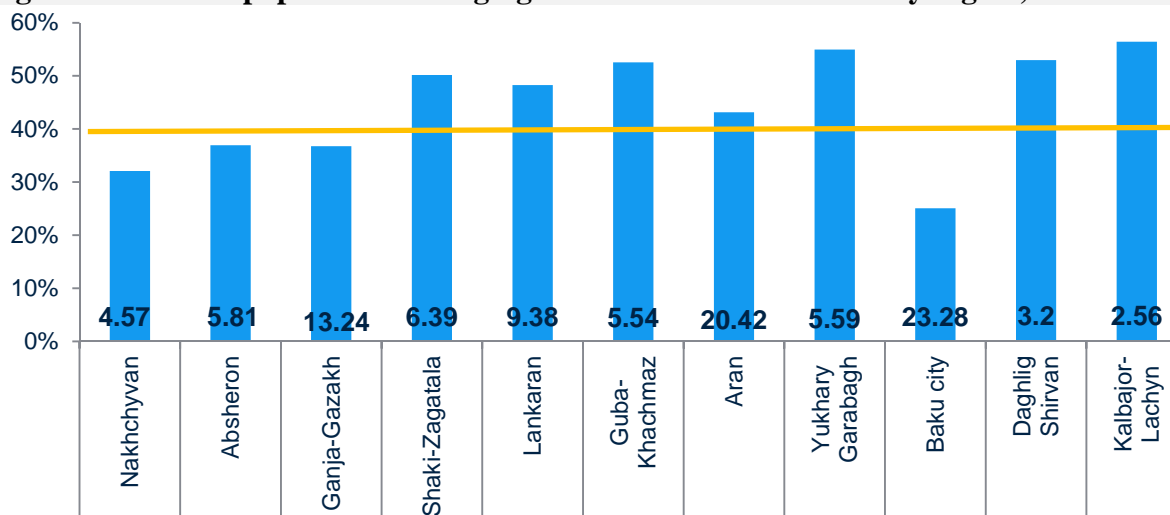
**Figure 7: Share of the population by welfare group, 2007-2012**



39. While poverty has decreased rapidly and the middle class had indeed expanded, numerous households remain who are no longer poor but who are not yet middle class: *the vulnerable*.<sup>9</sup> This group, as the name suggests, remains vulnerable to shocks and of potentially falling back into poverty. In 2012, an estimated 65 percent of the population belonged to this group. Within the bottom 40 percent of the welfare distribution in Azerbaijan, more households are vulnerable (34 percent) than poor (6 percent). The distribution of these households follows the regional pattern: the first and second quintile of the welfare distribution concentrate in Shaki-Zagatala, Lankaran, Guba-Khachmaz, Aran, Yukhary Garabagh, Daghligh Shirvan and Kalbajor-Lachyn (Figure 8). At the same time, Baku and its surrounding regions (including Absheron, Nakhchyvan and Ganja-Gazakh) report a share of households in the bottom 40 below the national average.

<sup>9</sup>The vulnerable in this context are defined as those households with a per capita consumption between the national poverty line and 10 USD PPP.

**Figure 8: Share of population belonging to the national bottom 40 by region, 2012.**

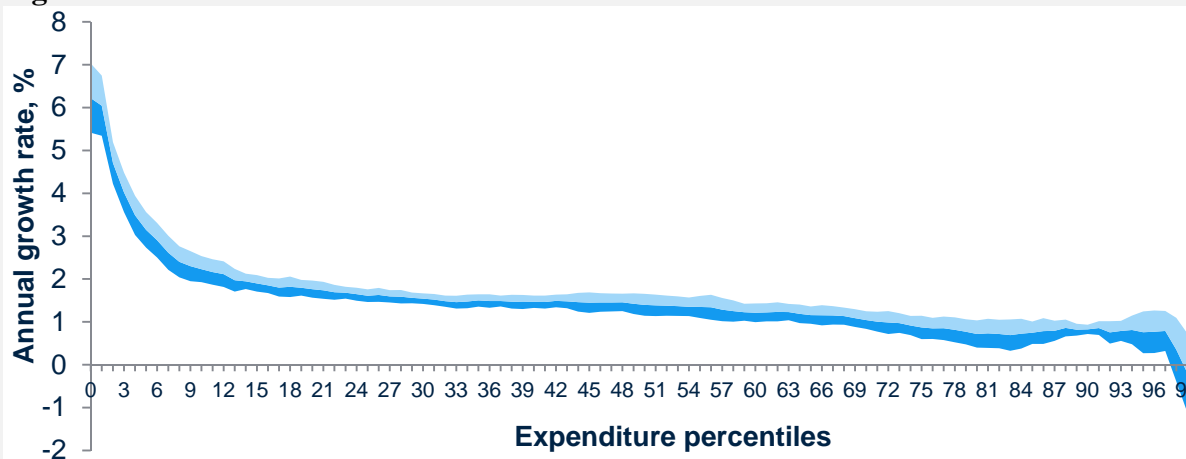


Source: State Statistical Committee and World Bank staff calculations, data from HBS Azerbaijan 2012.

### Shared Prosperity

40. **Performance on shared prosperity, as measured by the consumption growth of the bottom 40 percent, has been positive.** The consumption of the bottom 40 percent of the population in the income distribution grew by 2.09 percent annually between 2007 and 2012—twice as fast as the consumption of the top 60 percent, which experienced a growth in mean consumption of 0.90 percent per year. While the entire population experienced positive consumption growth, the lower end of the income distribution—in particular the bottom 20 percent—grew at a higher rate (Figure 9).

**Figure 9: Growth incidence curve 2007-2012**



Source: World Bank staff calculations, from Azerbaijan Poverty Note 2014.

41. **Between 2007 and 2012 mean consumption growth of the bottom 40 was higher than mean consumption growth of the total distribution which suggests that during the global financial crisis in 2008 and 2009 households in the bottom 40 did not fall behind.** A comparison between the household survey and the national accounts illustrates that the overall growth rate of consumption from household surveys is substantially lower than the growth rate of private consumption in the national accounts – this issue is not particular to Azerbaijan. In most countries, household surveys tend to underestimate total consumption, since non-response and the under-reporting impact the quality of available data. At the same time private consumption from the national accounts is determined as residual and therefore considered consumption of the entire distribution. To mitigate these data issues the concept of shared prosperity compares consumption growth of the bottom 40 to the mean consumption growth of the total population – under the assumption that non-response and under-reporting impact response behavior for all parts of the welfare distribution in a similar manner; therefore, the relative comparison remains valid whereas absolute values need to be interpreted with caution. A more detailed analysis of the household data raises concerns that non-response and under-reporting is more frequent at higher levels of consumption, which could underestimate mean consumption growth. Those are all data limitations to be dealt with in future rounds, but they do not, however, affect the analysis of the patterns.<sup>10</sup>

42. **A cross-country comparison of countries in the ECA region (Figure 12) reveals that Azerbaijan performs relatively well.** However, when benchmarked against other resource-rich comparator countries in the region for which data is available, such as Kazakhstan and Russia, Azerbaijan's performance falls behind. While GDP growth is clearly important for driving achievements in shared prosperity, it is important to note that the relationship between GDP growth and income growth of the bottom 40 percent varies widely across ECA countries - highlighting the role of the other factors involved (Figure 11).

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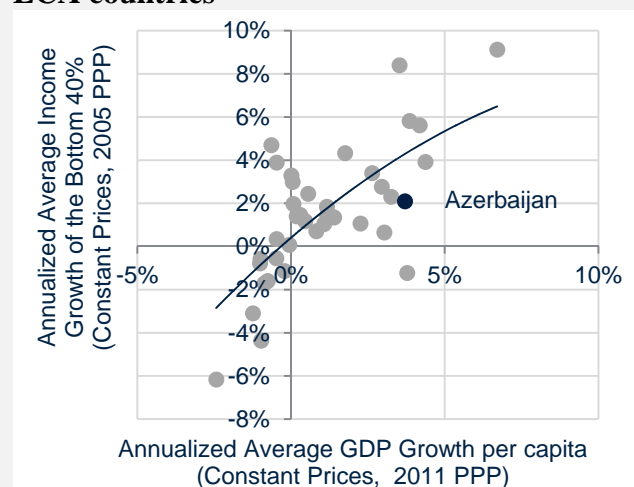
<sup>10</sup> One reason not to report inequality is precisely because of the inaccuracy of the estimate given the underreporting at the top.

**Figure 10: Growth in mean consumption and consumption of the bottom 40**



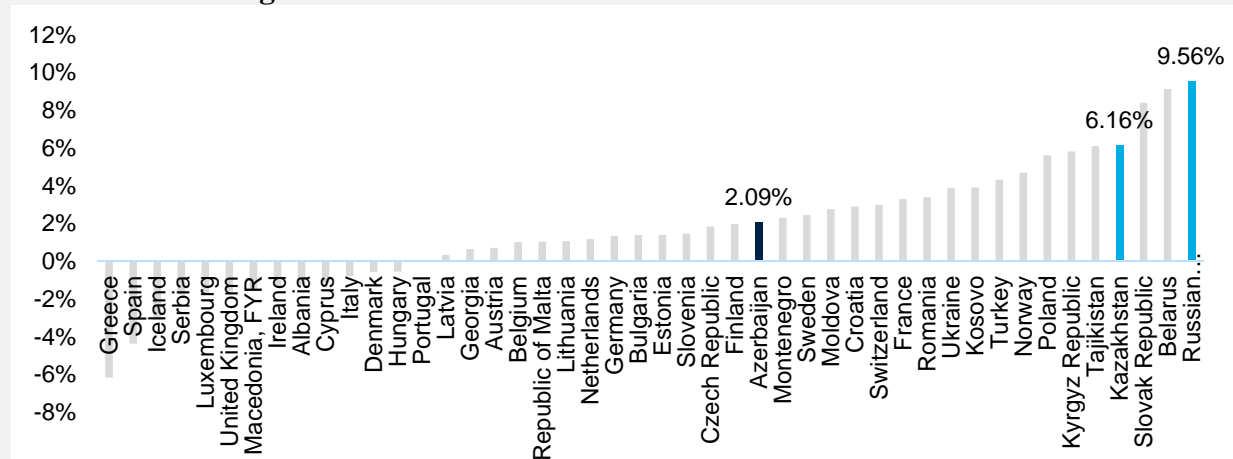
Source: World Bank staff calculations, from Azerbaijan Poverty Note 2014.

**Figure 11: GDP growth is key for the achievements, but the relation is not one-to-one and there is great heterogeneity across ECA countries**



Source: World Bank Staff calculations based on ECAPOV and EU-SILC data\*. Note: Growth and shared prosperity numbers are calculated for the ca. period 2006-2011. \*Data for Azerbaijan is based on national data and uses the period 2007-2012.

**Figure 12: Azerbaijan performs well on shared prosperity, but below other resource-rich countries in the region**



Source: World Bank Staff calculations based on ECAPOV and EU-SILC data\*. Note: Growth and shared prosperity numbers are calculated for the ca. period 2006-2011. \*Data for Azerbaijan is based on national data and uses the period 2007-2012.

### 1.3 The Top-Down/Bottom-Up Assets Framework

43. As growth is jointly determined by both macro and microeconomic drivers, the SCD uses an assets-based framework (Figure 13) to understand the constraints to progress on the twin goals and to identify key challenges in ensuring sustainable and inclusive growth. Assets

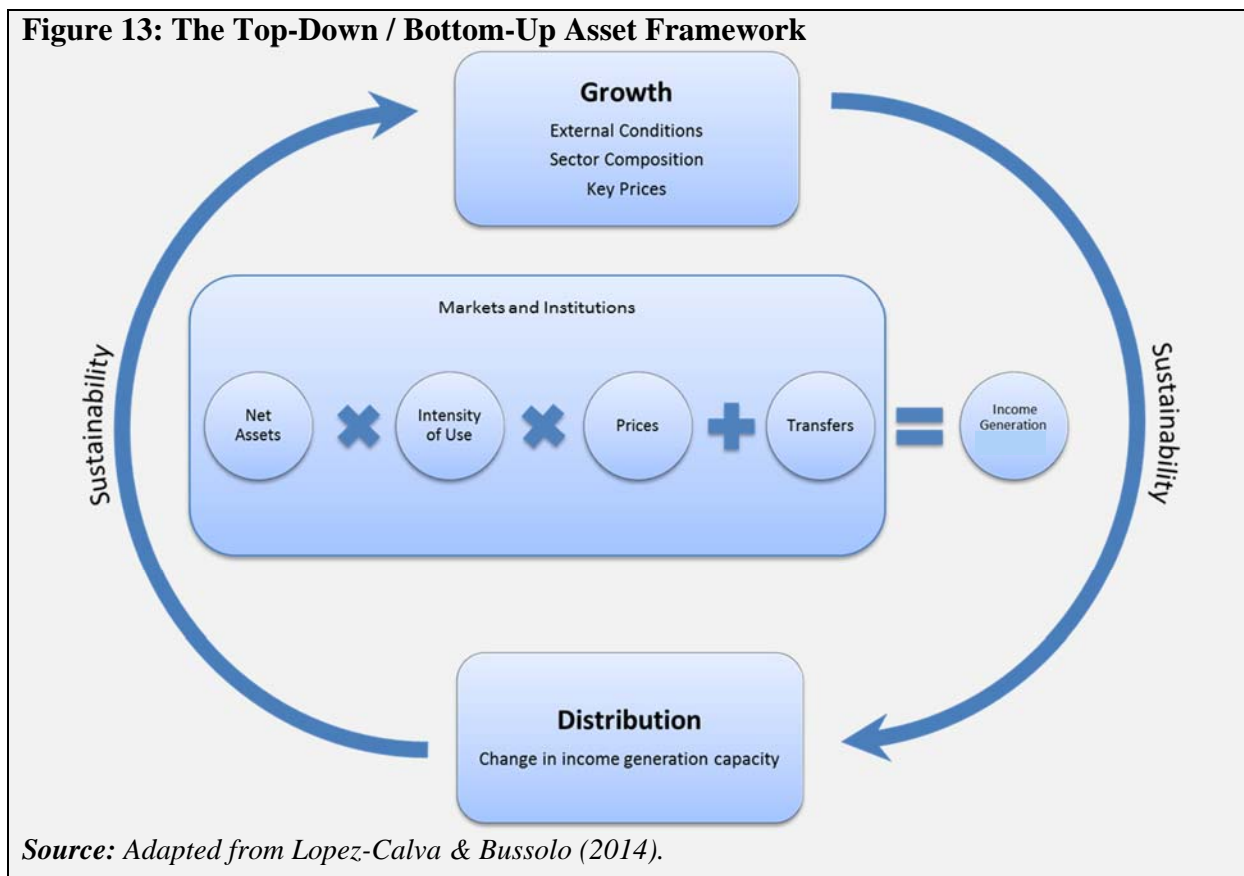
in this context refer to the human capital, financial capital, natural capital, physical capital, and social capital endowments of the economy and the population. Strengthening progress on the twin goals implies facilitating the accumulation of the asset holdings of the population and strengthening the intensity and productivity of the use of these assets, so that individuals—particularly those in the bottom 40—can benefit from *and* contribute more actively to the growth process. An assets approach builds on the idea that policies that focus on the income generation capacity of households or sub-groups of the populations (including different welfare, social, and regional groups) feed back into higher growth potential in the long run in a sustainable manner. Indeed, sustainability is a key element of the framework in every sense: fiscal, social, and environmental.

44. **The approach incorporates the macroeconomic, market and institutional factors which affect the accumulation, intensity of use and returns to assets over the economic cycle (the top-down story), as well as the long-term productive capacity of households to contribute to growth (the bottom-up story).** From the top-down perspective, the assets refer to the key elements of an economy’s portfolio of endowments. As noted in Gill et al (2013), the development of a diversified portfolio of assets—including built capital (human, financial, physical), natural resources, and institutional capital—is the basis of the economic efficiency associated with shared, stable and sustainable growth. From the bottom-up perspective, ensuring that the bottom 40 has a stake in the economy’s asset base and that this stake grows over time and generates returns that the bottom 40 can reliably claim is an important element of success on the twin goals. In addition to understanding the assets that the bottom 40 owns, the framework helps to identify how access to markets and economic opportunities as well as policies and institutions, influence the distribution of gains from growth.

45. **This integrated top-down/bottom-up analysis on constraints and challenges enables us to identify key priority issues that are cross-cutting and that can have the greatest impact on the twin goals.** Progress towards the goals will require addressing challenges and constraints related to both sustainable *growth* as well as *inclusive* growth. Solutions to removing the top-down and the bottom-up constraints can reinforce each other toward overcoming these challenges, moving the economy toward a new growth trajectory that can better enable Azerbaijan to achieve the twin goals. The asset framework constitutes a useful way to operationalize these elements from a policy perspective, by identifying the policies that can lift constraints to the key challenges.



**Figure 13: The Top-Down / Bottom-Up Asset Framework**



46. **However, access and availability of micro and macro data pose challenges to the application of this framework.** Azerbaijan is not a data-deficient country. However, like many other countries in Europe and Central Asia (ECA), Azerbaijan interprets statistical confidentiality/anonymity in its strictest form and does not make unit-level data available to users, relying instead on the publication of aggregate tables on macro and micro topics (Box 2). Restricted access to data, combined with the limited publication of metadata and methodological guidelines has raised concerns about the quality of many published macro and micro statistics and ultimately constrains the ability of the government and others to implement evidence-based policies. The latest Global Assessment of the system conducted by Eurostat, United Nations Economic Commission for Europe (UNECE), and the European Free Trade Association (EFTA) recognizes that one challenge facing the Statistics Committee is that of building trust: "In order to increase trust in official statistics and to promote prospective use of statistics in decision-making processes, activities leading to an improvement of national statistical literacy should be developed."<sup>11</sup>

<sup>11</sup> Global Assessment by Eurostat, UNECE and EFTA, p. 6.

47. **Therefore, the discussion on living standards, distributional patterns and other social indicators presented in this analysis draws primarily, on published or grouped data.** The core of the analysis is based to a large extent on publicly-available aggregate summary statistics published by the national Statistics Office in Azerbaijan.<sup>12</sup> Although generally of good quality, the Household Budget Survey (HBS) used for such summary statistics presents some concerns regarding high and growing underreporting and non-responses at the top of the distribution. This information is complemented with data from World Development Indicators (WDI), World Governance Indicators (WGI), Business Environment and Enterprise Performance Surveys (BEEPS), Doing Business, and non-official sources such as the Life in Transition Survey (LiTS) and the Caucasus Barometer surveys among others.

**Box 2: Measuring Poverty and Shared Prosperity: data sources, quality and accessibility**

Poverty analytics and the profiling of different groups in the welfare distribution require the use of household and individual-level data. In the case of Azerbaijan, the household budget survey (HBS), conducted annually between 2006 and 2012, as the official source for statistics published by the State Statistical Committee and the government, contains a wealth of information on household and individual characteristics, including consumption levels and composition. In addition, as the survey is representative at the national and regional levels, it also contains valuable information on regional differences in living standards and wellbeing of Internally Displaced Populations (IDPs) and refugees. However, access to the HBS is limited to the Statistical Committee and selected government actors due to strict data sharing requirements. As a result, preliminary evidence on poverty, shared prosperity and other micro-determinants of growth and distributional patterns presented in this diagnostic are based on publicly-available aggregate summary statistics published by the National Statistics Office in Azerbaijan.

In addition to the HBS survey, data collected and prepared by the Ministry of Labor (2008 and 2011) provides further information on those who contribute to social security systems. Nevertheless, the sampling design (over sampling of sub-groups in the population) and limited coverage of the survey constrain the use of this data to produce indicators on socioeconomic development in the country that are nationally representative. Alternative data sources, such as the population and housing census provided by the State Statistical Committee and the Life in Transition Survey—collected by the EBRD with support from the World Bank—may be used to draw a more precise picture of the situation in the country. Furthermore, the Caucasus Barometer and the Housing Affordability Survey for Baku generate insights on specific topics of interest. Yet, the existence of these additional data sources does not compensate the limited access to official consumption data from Azerbaijan, which significantly limits the possibilities to fully describe the socioeconomic context in the country.

Finally, there are concerns about growing underreporting and non-response in the HBS at the top of the distribution. Although this should have little or no impact on poverty calculations and the profiling of the poor, it is likely to introduce a bias in any analysis of the performance of the average household or top 60 percent of the income distribution—which are often used as the comparator groups for the bottom 40 percent—as well as on the profiling of the middle class.

<sup>12</sup> See Box 2 and Annex 5 for additional details.

48. **The remainder of the document is organized as follows.** **Section 2** will examine historical drivers of progress toward the twin goals—specifically unpacking the important role of overall growth, employment and wages, and fiscal transfers—alongside the potential fiscal, social, and environmental concerns which pose risks to the sustainability of this progress. Building on this analysis, **Section 3** and **Section 4** offer a detailed overview of the key challenges and underlying constraints facing Azerbaijan in order to continue on a path of sustainable and inclusive growth in the coming years. **Section 3** focuses on the top-down story and look specifically at the challenges Azerbaijan faces in order to ensure *growth*. These include (i) the strategic use of oil rents to support asset diversification in the economy; and (ii) unleashing productivity growth to foster long-term private sector growth and economic competitiveness and strengthen the intensity of use and returns to assets. **Section 4** focuses on the bottom-up story and looks specifically at the challenges that Azerbaijan faces in order to ensure *inclusive* growth. These include (iii) fostering the diverse accumulation of assets for all households in the country (in particular those in the bottom 40); and (iv) enhancing opportunities for households to use their assets more intensively. **Section 5** concludes the document by reflecting on the constraints identified in the previous sections and prioritizing those which will be most binding for Azerbaijan in making future sustainable progress on the twin goals in the coming years.

## 2 Drivers of historical progress and risks to sustainability

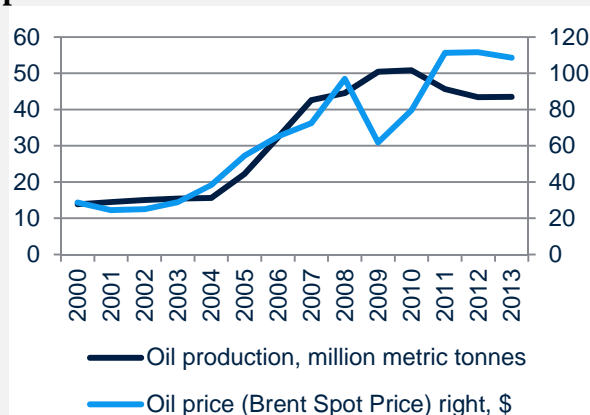
*The main drivers of poverty reduction thus far have been the positive growth environment engendered by rising oil production and prices – per capita income tripled in less than 10 years; strong labor market outcomes, including steady growth in wages across the board and some increase in employment; and a pro-active social assistance policy without which poverty rates would have been higher. However as downside risks emerge to oil prices and production, various structural challenges start to bite and economic growth becomes sluggish, it becomes clear that the dynamics of growth are not as conducive either to asset accumulation and or to an enhanced stake in the asset base of the bottom 40. This begs the key question: is growth sustainable?*

### 2.1 What has been driving progress toward the twin goals historically?

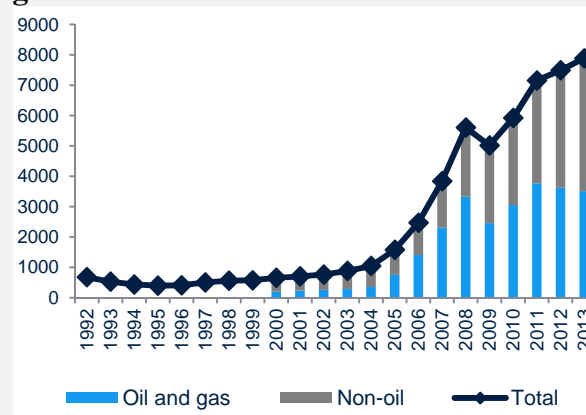
*Growth driven by public spending*

49. **Economic growth averaged 12.6 percent per year during 2002-13, and GDP per capita nearly tripled over the same period as Azerbaijan transitioned into middle-income country status.** Average household income increased by 19 percent over the same period. Large investments in the oil sector followed by growing production against a backdrop of rising oil prices (Figure 14) drove growth. Currently, this sector continues to dominate the economy. In 2013, the oil and gas sector directly accounted for 43 percent of GDP, 72 percent of consolidated budget revenues, and 93 percent of merchandise exports (Figure 15).

**Figure 14: Increases in oil production prices**

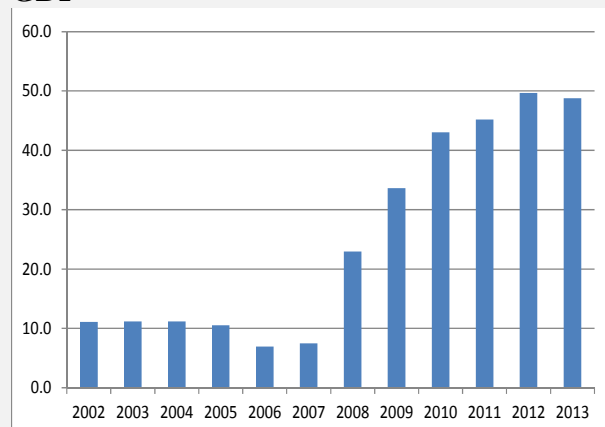


**Figure 15: Increases in per capita income growth**



50. **Overall, oil wealth has served Azerbaijan well, allowing significant accumulation of reserves.** The country relied on oil revenues to accumulate large foreign exchange reserves and reduce debt levels. The government has been running twin surpluses on the fiscal and current account, averaging 4.7 percent of GDP and 10.3 percent of GDP respectively over 2002-13. Azerbaijan successfully reduced public debt from 21.7 percent of GDP in 2002 to 14.1 percent in 2013. In addition, foreign exchange reserves increased to 68 percent of GDP by the end of 2013, nearly 70 percent of which are held by the State Oil Fund SOFAZ. Sustained savings in SOFAZ reflected the authorities' recognition of the importance of harnessing oil wealth for future generations and trying to contain real exchange rate appreciation (since the Fund's assets are held abroad).

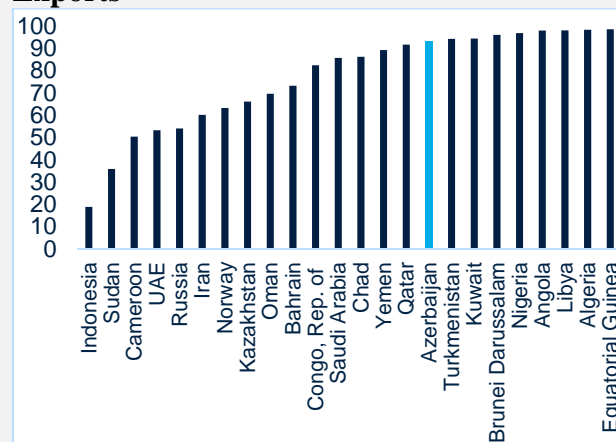
**Figure 16: Oil Fund reserves as percent of GDP**



Source: World Bank Staff Calculations

Note: In international benchmarking, latest available year is taken for each country

**Figure 17: Share of Oil in Total Goods Exports**



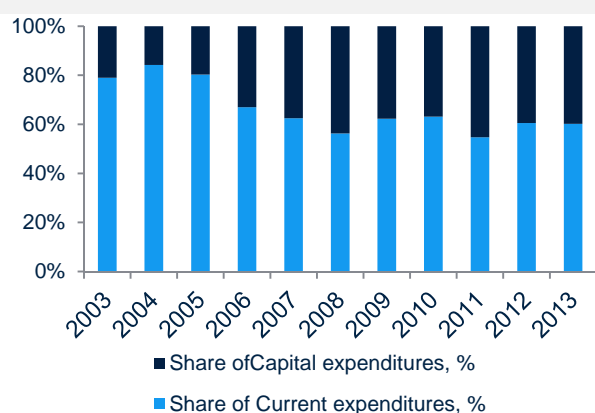
51. **Booming oil exports have supported a current account surplus.** Oil represented 94 percent of merchandise exports in 2013 and is fairly high as a share of exports relative to other hydrocarbon exporters in the region such as Kazakhstan and Russia. The current account surplus due to oil exports was still high in 2013 at nearly 16.6 percent of GDP. Receipts from oil have been financing significant growth in aggregate demand as evidenced by the high non-oil current account and fiscal deficits, which stood at 18 percent and 26 percent of non-oil GDP respectively in 2013.

52. **Revenues from oil have been financing, to a relatively large extent by international standards, the hefty increases in public spending and investment- which have been an important driver of aggregate demand and growth.**<sup>13</sup> Over the past few years, fiscal policy has been expansionary, with a quadrupling in nominal terms of consolidated government expenditures

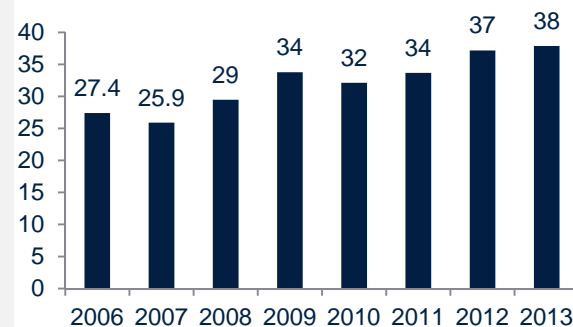
<sup>13</sup> As discussed below, this may prove hard to maintain in the long run. It has been estimated that the Oil Fund would decline from 37 to 30 billion USD between 2014 and 2015 in the absence of a significant adjustment of public spending.

between 2006 and 2012. Investment in infrastructure has grown substantially: indeed, the share of capital expenditures out of total public spending more than doubled since 2003 even as spending growth outpaced GDP growth. If we focus on the sub-period of the largest expansion in nominal terms, public capital spending doubled annually between 2005 and 2008. Public spending out of oil revenue has clearly emerged as an important contributor to aggregate demand and therefore to growth since the coming online of the Azeri-Guneshli-Chirag (ACG) oilfields. The non-oil deficit in Azerbaijan is relatively high compared to other oil exporters in the region, namely Kazakhstan and Russia.

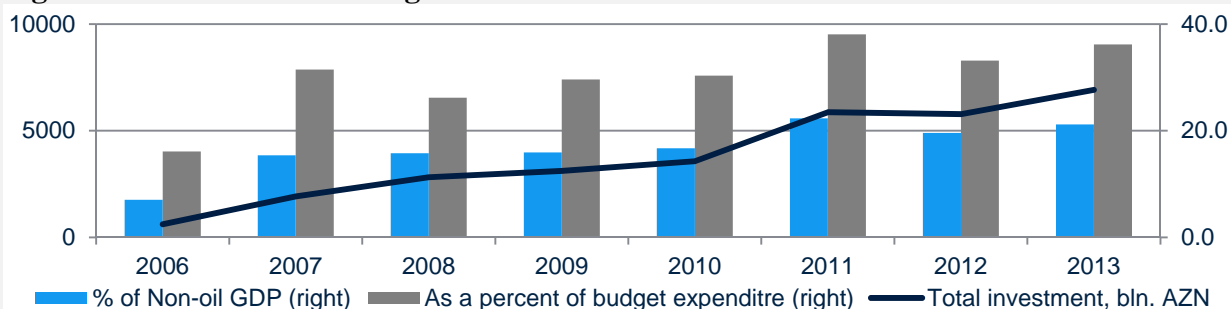
**Figure 18: Consolidated budget expenditures**



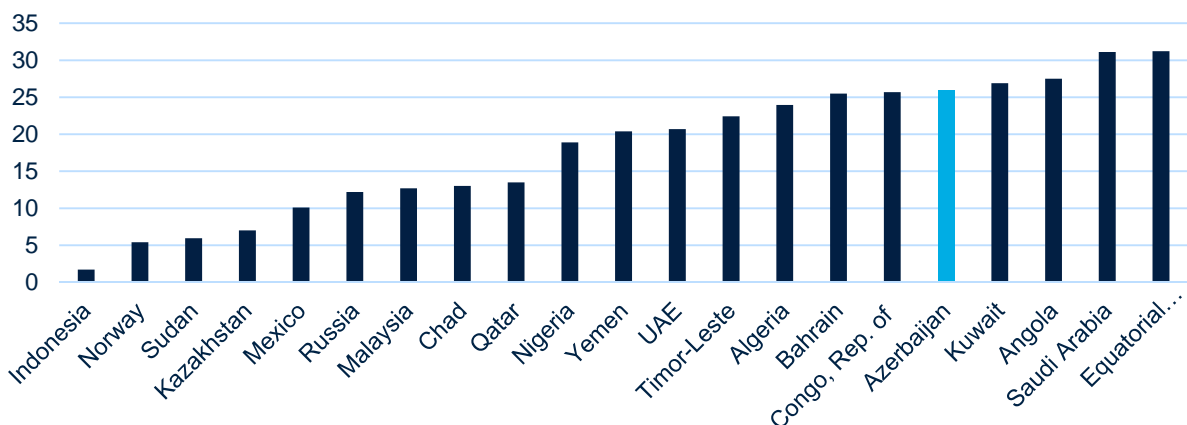
**Figure 19: Consolidated budget expenditures as a percentage of GDP**



**Figure 20: Public investment growth**



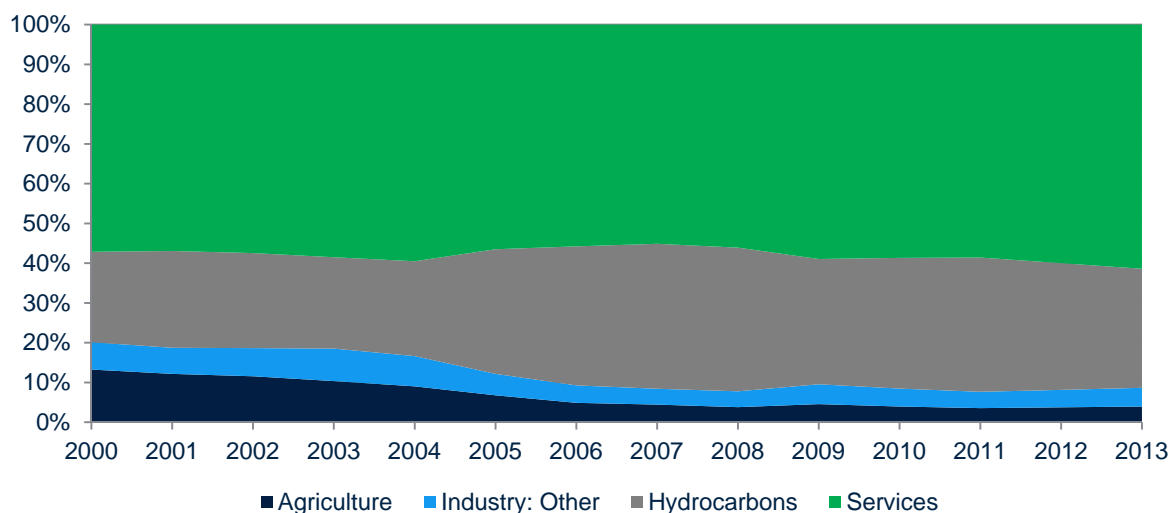
**Figure 21: Non-oil fiscal balance benchmarked (latest available year, percentage of GDP)**



Source: World Bank Staff Calculations.

53. **Moreover, public spending in turn has become the main conduit for the indirect impact of oil on the non-oil economy.** While the non-oil sector has emerged as the main contributor to growth since oil production peaked in 2010, non-oil growth has also been driven by public spending out of oil revenues. The massive increase in public investment, especially in infrastructure, since 2005 has supported strong growth in non-tradable services and construction. The construction sector for example saw an average growth rate of 20 percent during 2010-12. Service sectors including hotels and communication also performed well in recent years. Alternatively, growth in the agricultural sector, which employs nearly 38 percent of the population, has been relatively low, at an average of 3.8 percent a year during 2010-13.

**Figure 22: Sectoral composition of GDP**



54. **Oil therefore has a larger impact on the economy than its “direct” value-added would suggest.** The traditional method of calculating the role of a sector in the economy is based on the sector’s direct value-added as a share of GDP. However, this direct measure does not take into account the indirect contribution of a sector through its demand for goods and services from other sectors. To give an idea of the relative importance of the indirect effects, Azerbaijan’s oil and gas sector’s value-added multipliers were calculated, using input-output measures for mining and quarrying of which oil forms the greatest part.<sup>14</sup> Depending on the level of aggregation, the value added multipliers range between 1.087 and 1.109, suggesting that the total value added of the oil and gas sector is between 9 and 11 percent greater than direct value added. Given that public spending has increased significantly since then and that the construction sector has grown in dominance – construction plus services now dominate oil – the multipliers are likely to be higher in 2013 than they were in 2006.

**Table 1: Value Added Multiplier of the Oil and Gas Sector (2006 Input-Output Table)**

Direct value added coefficient	Direct plus indirect value added coefficient	Value added multiplier
100 Sector Table		
.916	.996	1.087
25 Sector Table		
.903	.996	1.103

*Source: Azerbaijan Public Expenditure Review, World Bank 2013.*

#### *Labor market income as a driver of poverty reduction*

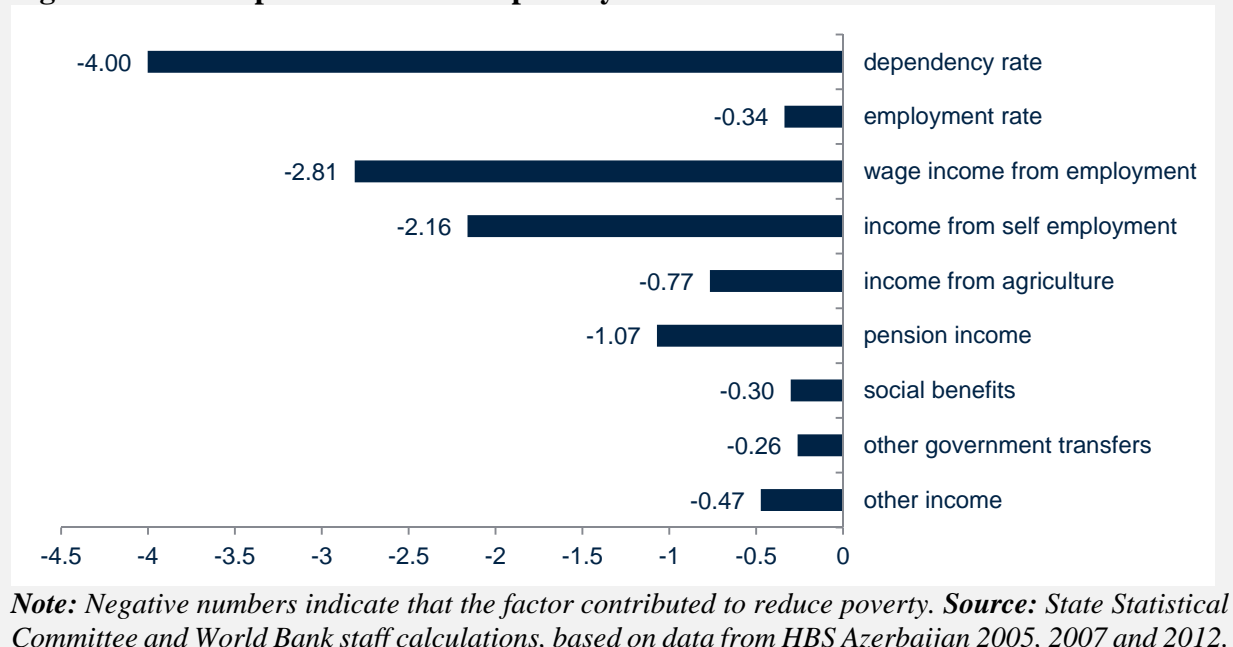
55. **A diagnostic on income growth between 2007 and 2012 illustrate that labor market income has been central in reducing poverty (Figure 23).** The income growth decomposition links the structure of the income generation process of households to poverty reduction between 2007 and 2012, when income poverty decreased by 12.18 percentage points.<sup>15</sup> The positive contribution of higher wages in formal employment (-2.81 percentage points) and self-employment (-2.16 percentage points) highlights the relevance of labor markets in lifting people out of monetary poverty.

<sup>14</sup> Value added multipliers are defined as the ratio of total (direct plus indirect) effects to the direct effect (and are sometimes known as “type I multipliers”).

<sup>15</sup> The income growth decomposition uses income per adult equivalent as variable of interest; the national poverty line for consumption is scaled by the marginal propensity to consume and then used as a threshold in 2007 and 2012. Income poverty declined from 18.33 percent in 2007 to 6.66 percent in 2012.



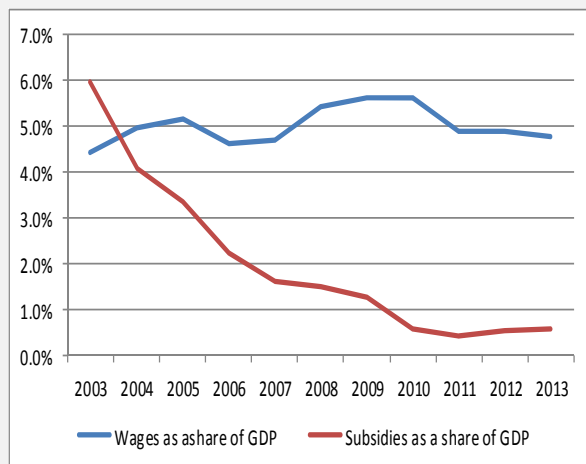
**Figure 23: Decomposition of income poverty reduction**



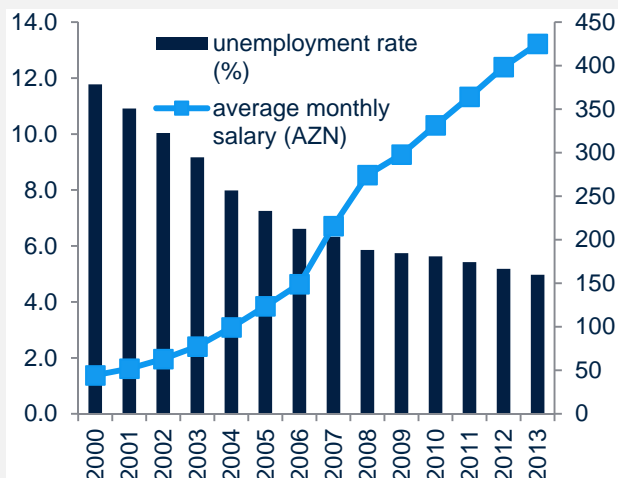
56. **Rapid wage growth – mainly driven by mandated increases in the minimum wage – has been a significant contributor to poverty reduction.** The overall positive growth environment allowed the government to raise the minimum wage, from 1.1 manats in 2000 to 105 manats in 2013. In fact, real wages increased by over 11 percent annually between 2000 and 13, while nominal wages increased over 9 fold over this period. Albeit from a low base, the largest increase has been in agriculture, though the gains have been across the board. Public expenditures on wages and subsidies do not currently pose a fiscal risk and have been relatively well contained over the years, growing at a rate slightly higher than that of GDP to reach 4.8 percent of GDP in 2013 compared to 4.4 percent of GDP in 2003 (Figure 24). In nominal terms, the consolidated state budget spent AZN 2750 million on wages and salaries in 2013, an 8.7 times increase relative to 2003.

57. **Overall unemployment rates have declined in Azerbaijan from 11.8 percent in 2000 to 5.0 percent in 2013 (Figure 25), although the share in total employment of each sector has not changed significantly.** A small decline in agriculture and a corresponding increase in the number employed in construction is the only noteworthy shift. However the data may be affected by the high degree of informality in the economy, as only 30 percent of wage earners in Azerbaijan report having a formal contract.

**Figure 24: Public sector wages and subsidies**



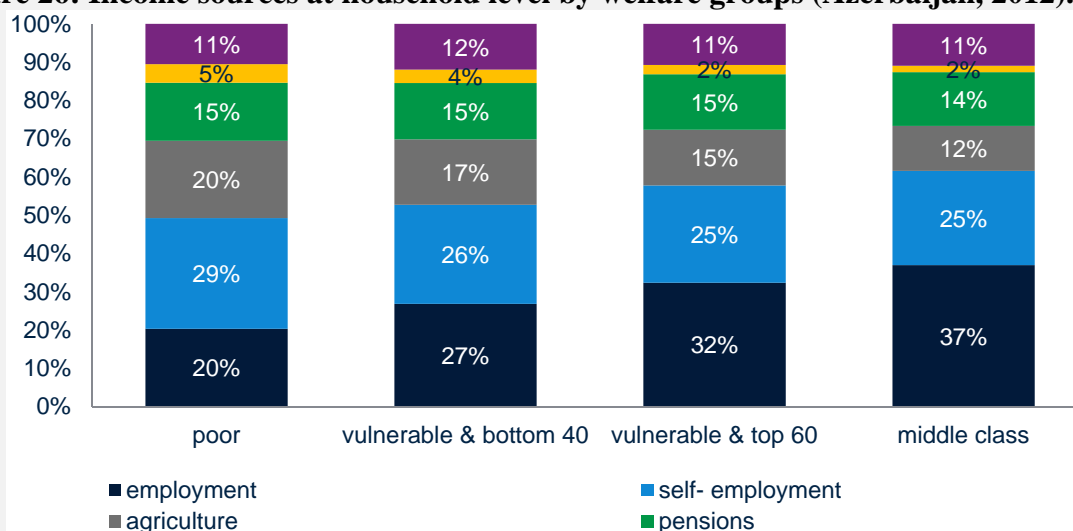
**Figure 25: Unemployment rate and the average monthly salary, 2000-2013**



### *Fiscal Transfers have helped*

58. In addition to labor income, households in the bottom 40 rely on transfers (similarly to other households higher up in the income distribution). Public transfers, in the form of pensions and other social transfers make up 19 percent of the income of the bottom 40, and about 16 percent for the top 60. Nearly two-thirds of the population in Azerbaijan receive at least one kind of public transfer, and benefits, especially pensions, have been increasing steadily (imposing a non-negligible burden on public finances).

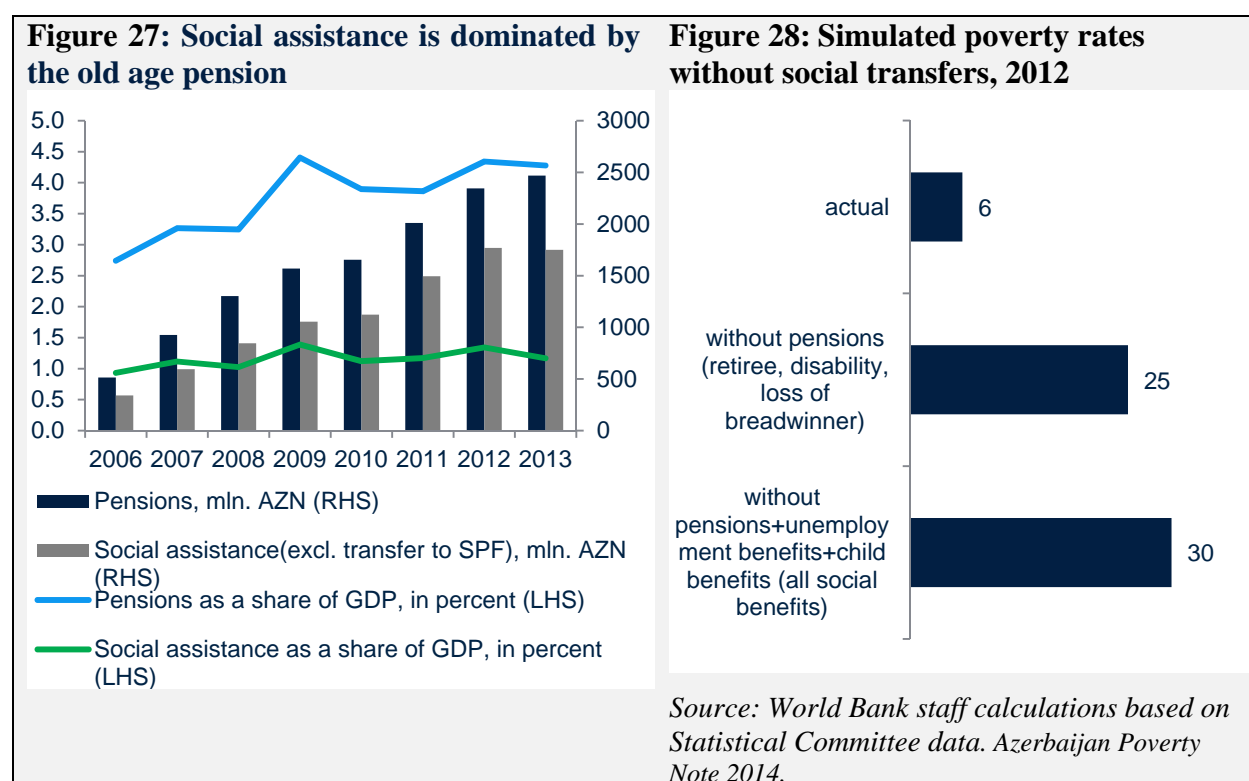
**Figure 26: Income sources at household level by welfare groups (Azerbaijan, 2012).**



*Source: State Statistical Committee and World Bank staff calculations, data from HBS Azerbaijan 2012.*

59. **Rapid economic growth has been accompanied by increased social spending.** Total expenditures on social transfers accounted for 4.8 percent of GDP in 2008. This non-market income played a key role for individuals, particularly those in the bottom 40. Pensions, representing 75 percent of public spending on social protection, have played an important part in reducing poverty, as their amount increased to 95 percent of the minimum subsistence level (Onder, 2013). While generous payments from social assistance and pension payments may provide disincentives to work in the (formal) labor market, previous research suggests that social transfers do not have a large negative impact on the supply of labor.

60. **The income decomposition in the previous section (Figure 23) demonstrates that social transfers such as pension benefits (-1.07 percentage points) and an increasing dependency rate (-4.00 percentage points) were key contributors to poverty reduction.** It has been estimated that the current poverty rate, in fact, would be considerably higher in the absence of transfers—at 25 percent without pensions, and at 30 percent without any social benefits in 2012 (vis-à-vis the observed 6 percent for that year) (Figure 28).



## 2.2 How sustainable is this progress fiscally, socially, and environmentally?

*Despite significant progress, the current growth model raises concerns about the fiscal, social, and environmental sustainability of the development process for the future. Fiscally, aggregate*

*growth trends hide potential risks such as dependence on a small number of industries and limited private sector growth - which will be of ever greater importance in the face of declining oil production and prices. Socially, there are noteworthy regional disparities across the country, particularly between urban and rural areas and between Baku and the rest of the country. There is also a growing proportion of vulnerable in the bottom 40 and certain demographic groups – notably IDPs – are especially at risk. Moreover, with a growing youth population, the labor market may face additional pressures in the near future. It not clear that the existing dynamics of the economy fully support the aspirations of the bottom 40 and emergent middle class. Environmentally, the continued degradation of natural resources on which the bottom 40 are heavily reliant, and the poor quality of environmental infrastructure services (water, sanitation, and solid waste management) pose a challenge. Also better governance of the natural resource sectors needed in order for prices to reflect social costs and in order to introduce an efficient system of compensations for environmental externalities.*

#### ***Fiscal sustainability***

##### ***Economic slowdown and increasing fiscal pressures***

**61. Economic growth in Azerbaijan peaked in 2010 along with oil production<sup>16</sup>, and both have since been tapering off.** This has compounded concerns regarding falling oil prices at a time of peaking oil dependence. The shock to oil prices – projected to average \$53 per barrel in 2015 relative to \$98 in 2014 – has affected several countries in the region, including Azerbaijan, where growth projections have been revised downwards for 2015 by 3 percentage points from 4.4 percent to 1.4 percent. There will also be an impact of the contraction of the Russian economy particularly on small farmers – with especially adverse implications for inclusion – since nearly two-thirds of non-oil exports, which are primarily agricultural goods, go to Russia. The devaluation of the manat by 33.6 percent on February 21 2014 will help create more competitive conditions though it is still early to assess the impacts and significant structural reforms would be essential to strengthen non-oil exports substantially.

**62. The current planned budget suggests a large general government fiscal deficit that would have to be financed by the Oil Fund given that current expenditure increases will more than offset a proposed cut in public capital spending** (See Annex 1). Sustained spending and falling oil revenues have already led to deteriorating fiscal trends. The government ran a consolidated fiscal surplus estimated at 2.7 percent of GDP in 2014. However according to the current planned state budget and approved oil fund budget a significant fiscal deficit of 10.6

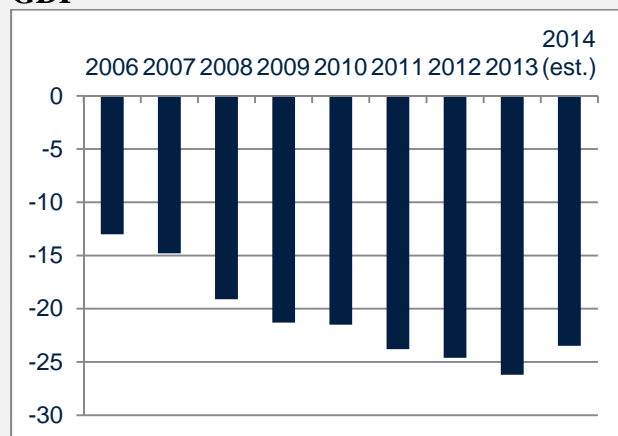
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<sup>16</sup> Oil wells also require significant maintenance expenditure. Based on the current production sharing agreement (PSA) with the international oil companies, the outlook for the oil sector remains somewhat challenging. Even if a new PSA comes into force, the investment needed and the cost of extraction will need to be weighed against new, lower oil prices.

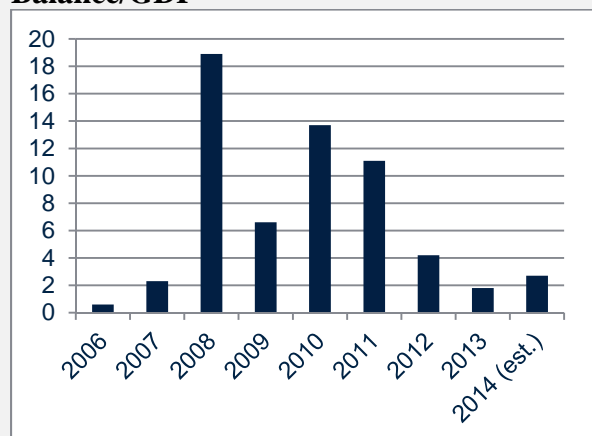
percent of GDP was envisaged in 2015, the first fiscal deficit since 2004. This reflects an assumption of a cut of 20 percent in public investment; more than offset by an increase in current expenditure by 21 percent. The gap would have entailed a drawing down of the Oil Fund by \$5.2 billion (or 14 percent), i.e. 8.3 percent of projected 2015 GDP (See Annex 1) before the devaluation (at the new exchange rate this transfer falls to \$3.9 billion). There is therefore an urgent need for consolidation and for developing new revenue sources. Downside risks to oil prices and production underscore the inherent volatility in commodity dependence and the importance of not undermining the role of SOFAZ.

63. **Fiscal trends look even more alarming when the non-oil deficit is measured in relation to non-oil GDP.** This ratio averaged 47 percent a year between 2009 and 2013 and has been growing steadily as shown below. This is mainly because of the fact that the relatively robust performance of the non-oil sector in recent years has not translated into higher non-oil tax revenues. Non-oil taxes to non-oil GDP fell from 17.6 percent in 2009 to 15.7 percent in 2013 a period over which non-oil GDP growth averaged 8.1 percent, significantly higher than oil GDP growth, which averaged 0.4 percent over the same period. At the same time expenditures increased steadily, to 38 percent of GDP by 2013.

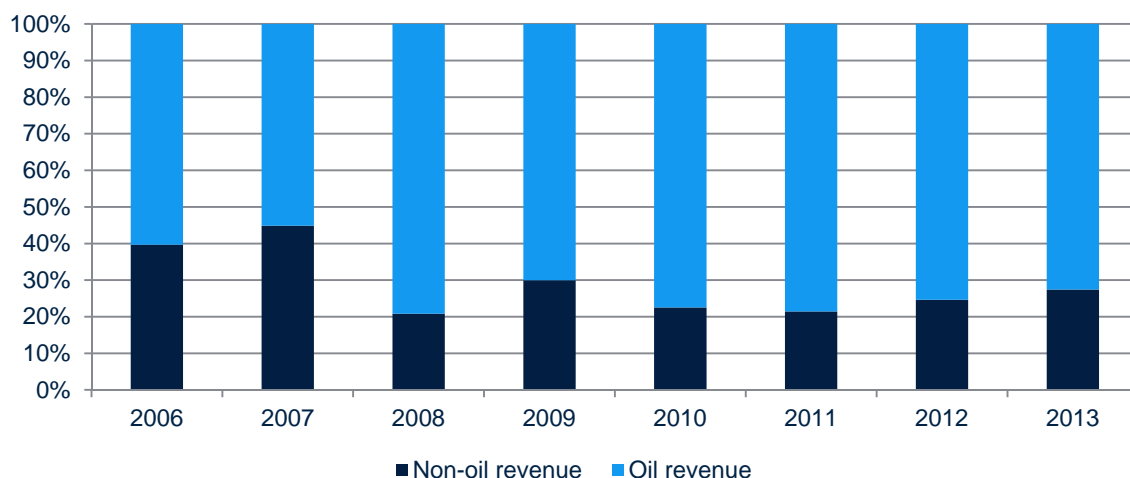
**Figure 29: Non-oil Fiscal Balance/Non-oil GDP**



**Figure 30: Consolidated Fiscal Balance/GDP**



**Figure 31: Non-oil and oil revenues out of the consolidated budget**

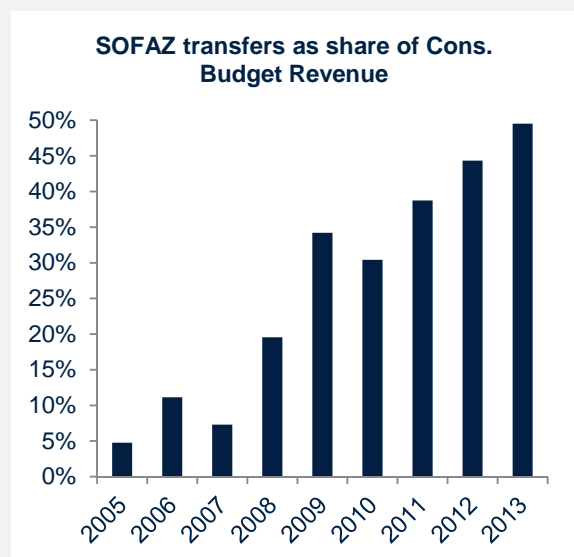


*Source: MOF and AzStat.*

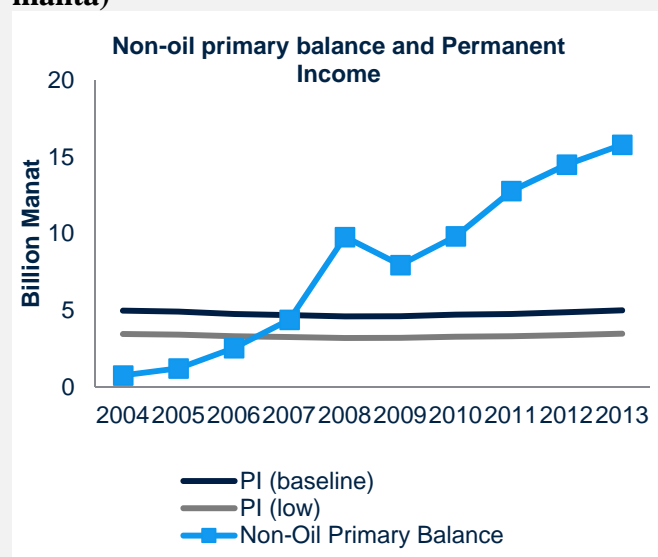
64. **The assets of the Oil Fund provide only a limited buffer, thanks to growing transfers.** The following numbers give an idea of the magnitudes. In 2013, total government expenditure was approximately AZN 22 billion and transfers from the Oil Fund to the budget accounted for around AZN 11 billion (total revenues of the Oil Fund were AZN 13.6 billion). The assets of the Oil Fund currently stand at AZN 29 billion and oil production is expected to decline significantly over the coming years. In addition, a big part of tax revenues also comes from the oil sector. While gas production grows, it is unlikely to fully offset the effect of declining oil production in the longer term.

65. **This is especially cause for concern as the government has been spending in excess of its permanent income (PI) from oil since 2008.** Managing the level of spending out of oil revenues in a credible, objective and transparent manner is important for Azerbaijan, especially if oil and gas will remain important sources of public revenues, given the need to maintain savings as a buffer against shocks, ensure effective resource use geared towards social objectives, and share the management of these natural endowments with future generations. The PI approach provides a benchmark against which the fiscal position of Azerbaijan, measured by the non-oil primary balance, could be evaluated and is based on the non-oil primary deficit being equal to the permanent income out of hydrocarbon revenues. To evaluate the vulnerability to shocks, two oil-price scenarios were considered: a ‘baseline’ oil price scenario consistent with current World Bank projections and an adverse ‘low’ scenario, under which oil prices would revert back to their 2001-2010 average. The results suggest that from 2008 onwards Azerbaijan exceeded the permanent income level of spending out of hydrocarbon revenues (Figure 33).

**Figure 32: Growing reliance on oil fund transfers**

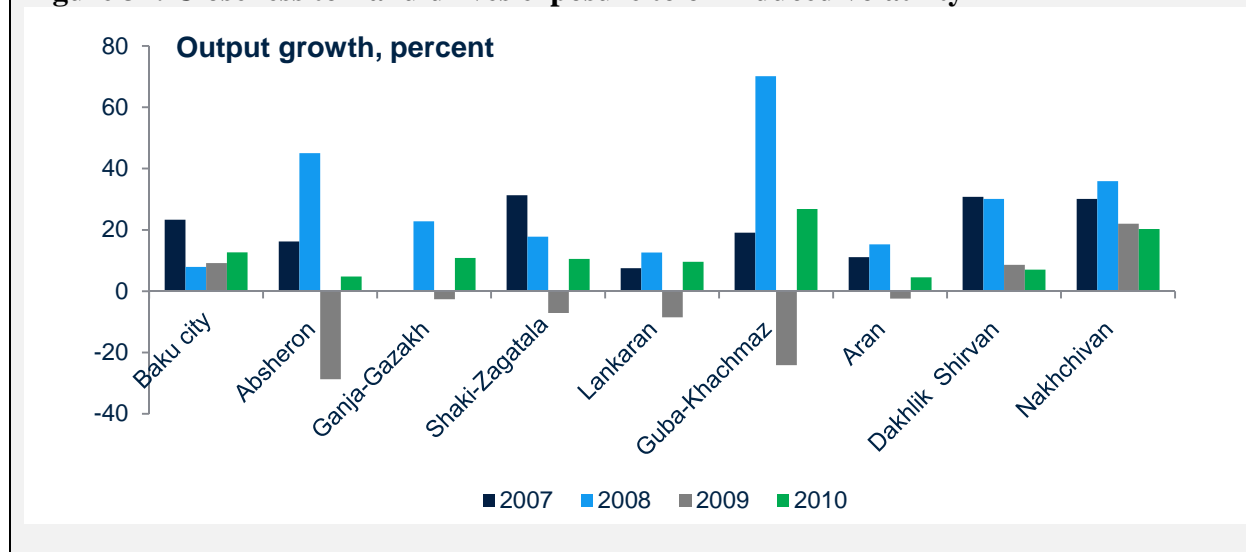


**Figure 33: Expenditures in recent years have exceeded the permanent income level (billions of manta)**



66. **Spending oil revenues in excess of permanent income can potentially be justified under certain conditions, however budgetary exposure to downside risks to oil prices and production introduces volatility that is likely to disproportionately affect the poor; at the same time fiscal policy remains the main instrument of the Government.** The growing budgetary exposure to oil has introduced volatility, given that fiscal expansion is the economy's mainstay, exemplified by Azerbaijan's experience when prices fell in 2008-09. The economic shock in 2009 revealed how connected different regions are to Baku and is a telling preface to events starting to gather momentum today. The global financial crisis hit Azerbaijan starting from late 2008 and continued throughout 2009. The main channel of the transmission of the shock was a sharp decline in oil prices, which reduced the resource flow to the budget and drove down activity in the non-oil sector. Regions close to Baku were affected more severely than others, with Absheron and Guba-Khachmaz declining substantially. Absheron was affected directly since it is Baku's closest neighbor and depends largely on growth in aggregate demand in Baku. Guba-Khachmaz has a border with Russia and was affected mainly because of the sharp depreciation of the Russian ruble at that time coupled with falling demand in Russia for its agricultural exports. All regions which experienced sharp declines in output in 2009 managed to recover as oil prices picked up again and the fiscal stimulus took hold. Not entirely dissimilar conditions loom now. And this does tie the Government's hands and explain partly why the consolidated budget allowed for its first deficit in a decade. Even a small consolidation in public investment from AZN 8696 mln in 2013 to a budgeted AZN 8400 mln in 2014 (3.5 percent decline) has led to a sharp fall in the growth of construction from 30 percent to 7 percent in the first 9 months of 2014, with strong implications for non-oil growth – which fell from 10.3 percent to 6 percent in the first 9 months.

**Figure 34: Closeness to Baku drives exposure to oil induced volatility**



#### *Sectoral composition of growth and job creation*

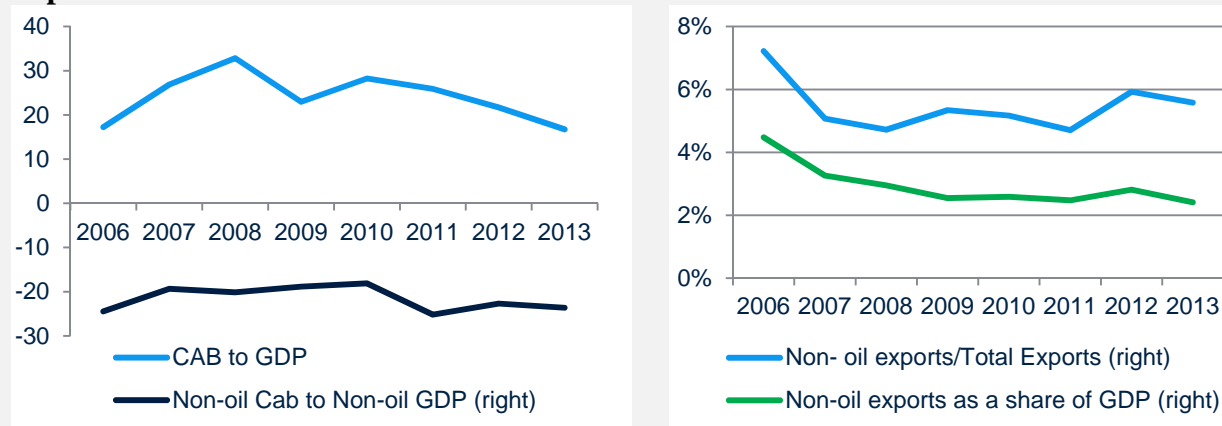
67. **The sectoral composition of GDP and its growth suggests that, outside of the extractive industries, productivity growth and resource accumulation has been mainly in the non-tradable sectors, particularly in construction.** Non-oil exports remain below 7 percent of total merchandise exports reflecting the dominance of non-tradables in the non-oil sector. A part of the problem is that high public spending out of oil revenues has led to growth mainly in non-tradables – construction and services – which has contributed to real exchange rate appreciation with adverse implications for non-oil competitiveness. Between early 2004 and late 2008—the peak of the oil boom—the Real Effective Exchange Rate (REER) appreciated by about 78 percent. Following a sharp drop in inflation after the global financial crisis, the REER has held steady until the recent sharp depreciation of the ruble. The ruble has depreciated by 30 percent since the beginning of 2014, a main driver of appreciation in Azerbaijan’s NEER by 6.7 percent in the first 9 months of 2014.

68. **While some of these investments no doubt enhance the productive potential of the economy, the fact remains that non-oil exports remain a small fraction of the total, suggesting that economic competitiveness remains a challenge.** For a small open economy such as Azerbaijan, strengthening economic competitiveness will be important if production is to be scaled up and the needed jobs generated for the middle class and the bottom 40. The need for productivity growth in non-oil tradables is underscored by the difficult prospects for oil production and prices. A case in point is that currently nearly two-thirds of non-oil exports go to Russia and are mainly agricultural. The high share of agriculture in these exports may hurt vulnerable producers with obvious implications for inclusion and rural-urban disparities. This highlights the importance of building economic resilience in the face of downside risks to oil production and prices, not just

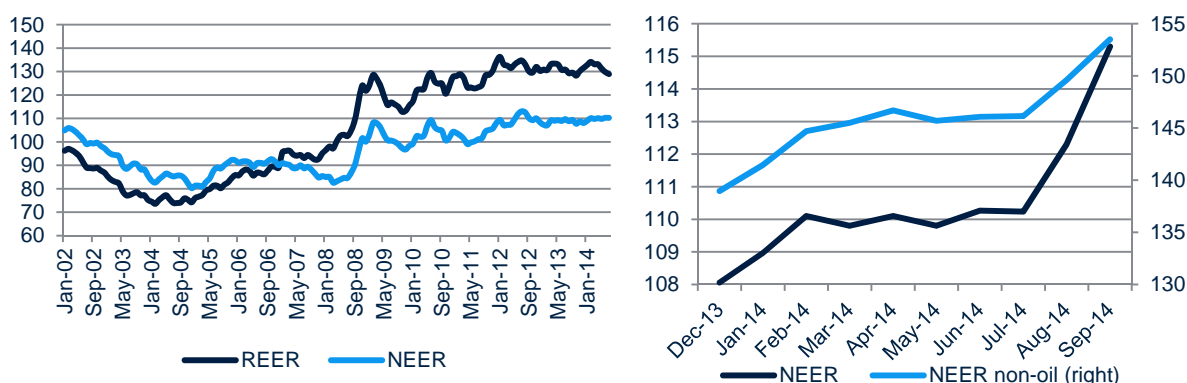


because of the current exposure to the situation in Russia but also in the interests of longer run sustainability. Higher productivity growth in non-oil tradables – including agriculture – will support the economic competitiveness needed to ensure income generation opportunities for the bottom 40 independent of oil prospects and will ensure.

**Figure 35: A growing non-oil current account balance as non-oil competitiveness fails to improve**



**Figure 36: Weak non-oil competitiveness is partly because of real exchange rates**



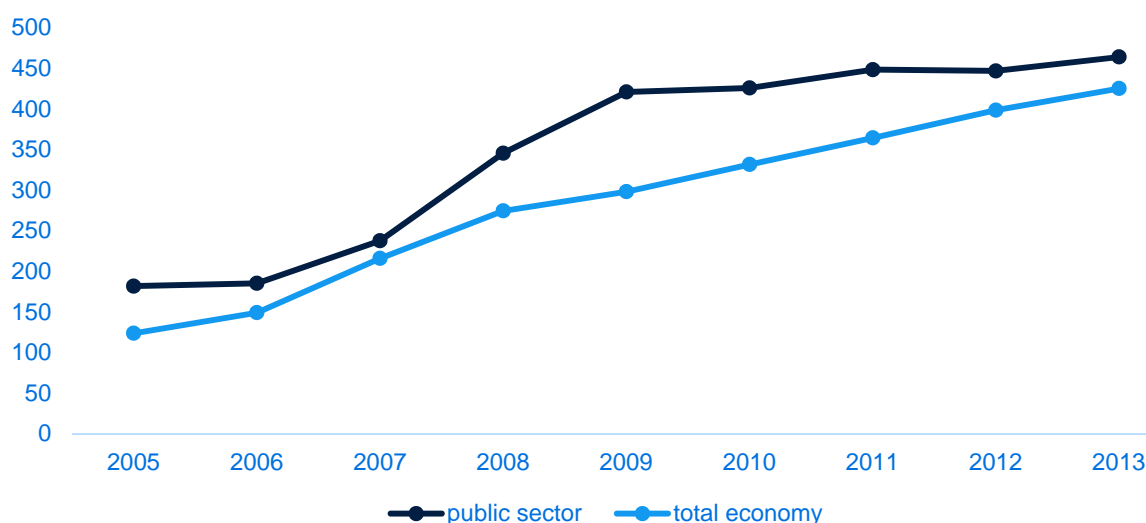
69. **Labor markets play an important role in transforming human capital into earnings from employment and self-employment.** From the firm side demand for additional workers is largely driven by private sector growth and a well- functioning business environment. On the supply of labor the quality of education and training and well- aligned incentives largely determine the availability of workers. In addition, labor market institutions and the legal framework play an important role in determining labor market outcomes.

70. **Labor markets in Azerbaijan show inefficiencies which dampen the employment growth especially in the private sector.** From a demand side, low private sector growth due to deficits in governance and limited access to finance reduce the demand for additional workers. In response to the current regulatory framework and governance structure firms keep their workforce

small to escape regulation. Moreover, bad connectivity and in particular limited access to markets reduce job creation in rural areas outside the capital city.

71. **Fast wage growth in the public sector - in combination with low productivity growth in the private sector - introduce distortions into the labor market which in turn reduce the demand for additional workers.** For the time period from 2007 to 2009, the wage growth in the public sector has been higher than for the economy as a whole. The trend for the total economy is most likely biased upwards as calculations only include employees and abstract from self-employees who are mainly concentrated in lower productivity jobs such as agriculture. High informality also distorts information on employment and wages.

**Figure 37: Average monthly nominal wages and salaries by statistical Classification of Economic Activities: wage growth in the public sector and the total economy.**



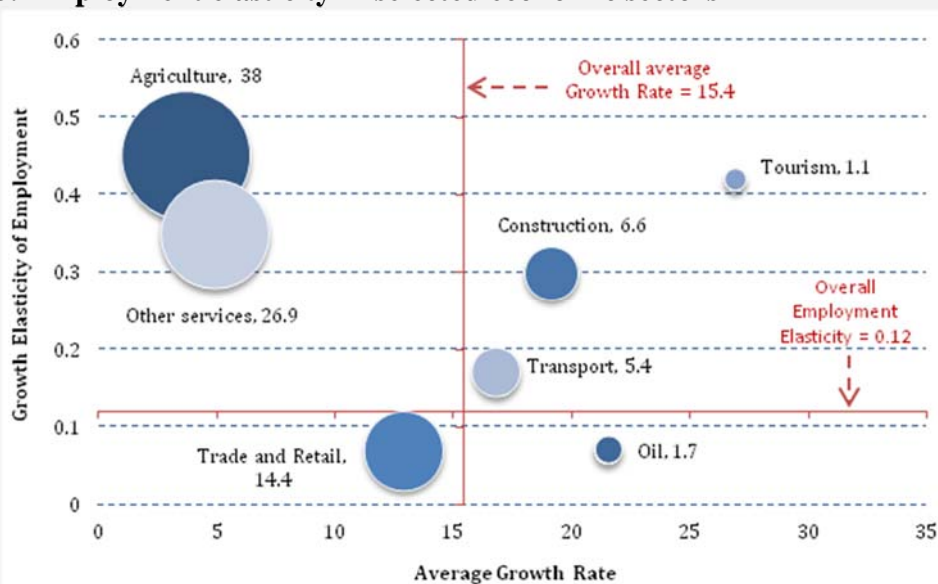
Source: SSC: Labor resources and employment.

72. **Average wages in Azerbaijan differ systematically across industries and raise concerns about frictions between industries and a lack in competition.** For the mining sector (1516 manat), but also financial and insurance activities (1126 manat) monthly wages are far above the national average for employees (425 manat). Both industries are relative small and only employ 2.5 and 1.9 per cent of employees in Azerbaijan. Differences in wages across industries are also correlated to large regional disparities in economic welfare. For instance, information and communication and construction services are highly concentrated in the capital area (Baku and Absheron) whereas agriculture, forestry and fishing plays a much more important role for rural areas. The breakdown of the total work force by industry and the corresponding employment status (employed versus self- employed) draws a slightly different picture of the labor market in Azerbaijan. In total around 37 per cent of the work force is working in agriculture, forestry and fishing – with only 2.6 per cent of workers employed. To the bottom of the distribution are mainly

industries which have a large share of employees but are not that important when it comes to the breakdown of the work force. In consequence the figures on wage growth which build only on information for employees needs to be interpreted with caution.

73. **Moreover, the sectors which have contributed the most to economic growth so far have not created a significant number of jobs.** The agricultural sector remains the biggest employer, absorbing nearly 38 percent of the workforce while contributing only 5.4 percent of GDP. Services absorb half of the population, while contributing 30.9 percent of GDP in 2013, and within services the public sector dominates. Notwithstanding the dominance of mining and construction in output, these capital-intensive sectors account for less than 10 percent of the workforce. With a growing population entering the labor market, Azerbaijan urgently needs new sources of quality jobs in the private sector, and these will clearly not come from mining.<sup>17</sup>

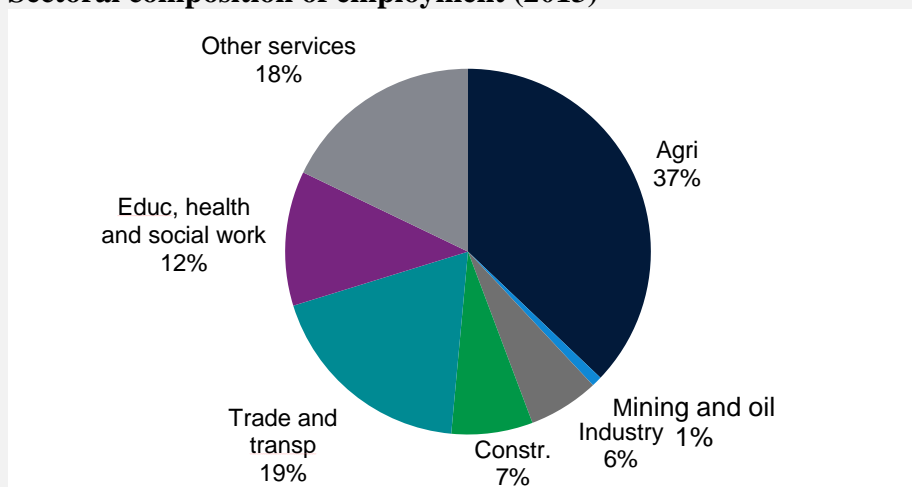
**Figure 38: Employment elasticity in selected economic sectors**



Source: World Bank staff calculations. Note: Bubble size indicates the employment share in the sector.

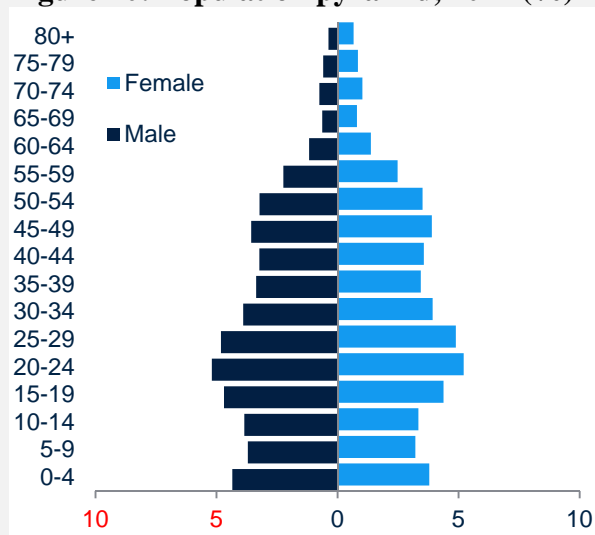
<sup>17</sup> World Bank, 2011, *Azerbaijan Country Partnership Strategy FY2011-14*.

**Figure 39: Sectoral composition of employment (2013)**

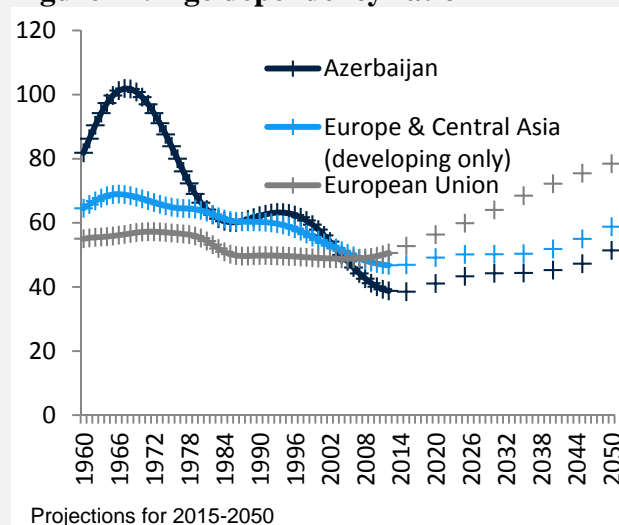


74. **An important concern in this context is how Azerbaijan’s ‘youth bulge’ may put additional pressure on the labor market.** The country has a large youth population and a large influx of the young into the labor market will continue over the next three decades. As of early 2014, the population under 25 years of age constituted 40 percent of the total, and nearly 60 percent of the total population is under 35. More than 70 percent of the population is within the working-age, ages 15 to 64. This high share is estimated to remain as high until 2025. By 2025, the working-age population will have increased by a net number over 350,000. The dependency ratio has reached a historic low, about 39 percent, in recent years and will only pick up gradually in the future. This sustained low dependency ratio up to year 2050 predicts a large influx into the labor market for the next decades. By comparison, dependency ratios in ECA region and the EU were much higher at 47 and 51 percent, respectively (Figure 41).

**Figure 40: Population pyramid, 2012 (%)**



**Figure 41: Age dependency ratio**



### *Social sustainability*

75. **In spite of the progress on reducing poverty and boosting shared prosperity, there are underlying nuances to the story as discussed in Section 1.2 above.** Gains have been geographically and socially uneven, which though not unusual for transition economies, suggests strains on both growth and social sustainability going forward. There are noteworthy regional disparities across the country, particularly between urban and rural areas and between Baku and the rest of the country. There is also a growing proportion of vulnerable in the bottom 40 and certain demographic groups – notably IDPs – are especially at risk. It is not clear that the existing dynamics of the economy fully support the aspirations of the emergent middle class and of the bottom 40, for relevant education and affordable and quality health care, for better jobs and more opportunities outside of subsistence agriculture, for strengthened connectivity and access to reliable and cost effective services including water, sanitation, and energy, and for greater voice.

### *Environmental sustainability*

76. **Environmental sustainability is at risk if the depletion of resources—measured by changes in indicators of net national wealth—continues at the rate it has shown in the last decade and if the resources generated by natural resources are not invested with a long-term perspective.** In particular, landscape degradation, desertification, limited waste water treatment leading to significant pollution of river waters and of the Caspian, and poor quality of drinking water are major concerns. It would be important to further strengthen environmental aspects of public service provision, given the importance of sustainable land use for the bottom 40 and the overall risks imposed on health, especially of the demographically and geographically vulnerable, of environmental damage and chemical pollution.

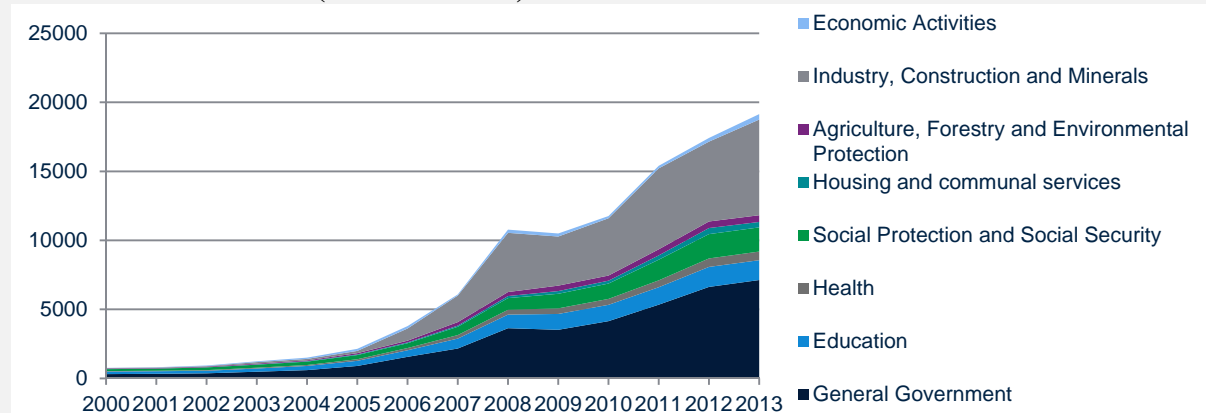
### 3 The top-down story: Challenges and constraints for ensuring sustainable growth

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*From the top-down perspective, overall growth is unbalanced and slowing down alongside troubling fiscal imbalances and limited employment creation. In order to maintain growth in the coming years, Azerbaijan faces two key challenges: (i) the strategic use of oil rents to promote asset diversification – especially the accumulation of built capital – including human and physical capital – and institutional capital and (ii) unleashing productivity growth to foster long-term private sector growth and economic competitiveness and strengthen the intensity of use and returns to assets.*

77. **In Azerbaijan, public spending has been the main instrument through which the Government has shared oil wealth with the population but this is sustainable only if it led to “genuine” savings, which does not appear to be the case.** Oil revenues have been shared with the population through rapid increases in public spending. While high public spending has led to asset accumulation, mainly in the form of built capital and some improvement in basic public services, there are pending challenges to converting oil wealth into a diversified asset base—especially those needed to manage oil rents, provide a facilitating business environment for the private sector, and ensure the provision of high quality public services. Genuine savings (see Gill et al, 2013) – asset accumulation net of natural resources used up – are a measure of a country’s success in building a portfolio of endowments consistent with a competitive economy that can participate in global markets, achieve upper income status, and provide opportunities to an increasingly aspirational people. Azerbaijan has yet to diversify its economy’s asset base however: while natural resources constitute only between 8-13 percent of overall wealth in Australia, New Zealand, Norway and Canada – the most advanced resource-rich countries – these are still 76 percent of Azerbaijan’s total endowment (Gill et al 2013). This ratio is especially of concern in the face of downside risks to oil production and prices.

**Figure 42: Growing public expenditures of the state budget, with increasing share of investment 2000-2013 (million manat)**



*Source: Azerbaijan State Statistical Committee. Note: Further disaggregated data could not be obtained that would allow a more accurate assessment of the composition of public investment; General Government includes “Others” which is primarily defense expenditures.*

78. **International evidence suggests that economic efficiency is what matters for shared and sustainable growth and that this is best served through the accumulation of diversified assets.** Rather than targeting diversification of growth by picking specific sectors, development is best helped by policies that “raise the overall ability of a country to increase productivity and quality and to move to more sophisticated tasks” (Lederman and Maloney 2012). The flagship report on diversified development in Europe and Central Asia makes the important point, especially relevant to Azerbaijan, that the priorities of change are best identified through reference to the successful experiences of commodity producers. A look at Norway, Canada, Australia, the Emirates, Chile suggests that countries with diversified assets – that is the natural, built and institutional capital referred to earlier in this report – have economies that are more productive, inclusive and stable.

79. **Could the private sector step up to center stage in Azerbaijan if public spending could not be sustained? Yes, if the conditions are created that could unleash productivity growth.** There are many reasons why it should. The private sector creates 9 jobs out of 10 world-wide; and more and better jobs for an aspirational bottom 40 and middle class is a priority for Azerbaijan. Ensuring better standards of living will not be possible for this small relatively closed economy in the absence of the productivity growth associated with improved economic and private sector competitiveness and greater trade openness so firms can scale up, hire, innovate, compete and thrive. A rebalancing of the roles of the public and private sectors is therefore in order. This does not necessarily mean a small role for the state: as noted in Lederman and Maloney (2012) market failures abound and as emphasized in Gill et al (2013) resource-based development is intensive in institutions that are typically shaped by public policy and regulation.

80. **Two broad challenges must therefore be overcome if Azerbaijan is to find renewed growth dynamism and a pathway to shared prosperity.** (i) While oil production has plateaued, natural resource rents are likely to remain an important contributor to public resources in the foreseeable future. Deteriorating fiscal trends must be reversed, highlighting the need for strategic use of oil rents for asset diversification, both in the aggregate through the necessary institutional and regulatory reform and at the level of the bottom 40 through better focus on programs and results; (ii) To escape the middle income trap and achieve the development outcomes consistent with upper income status while boosting asset ownership and use by the bottom 40, unleashing productivity growth – including in agriculture – for enhanced economic competitiveness will be critical to create income generation and trade opportunities.

### **3.1 Challenge 1: The Strategic Use of Oil Rents for Asset Diversification**

81. **Growth in public spending suggests a strong bias in favor of construction though nominal increases have been sharp across the board.** A look at the composition of the consolidated state budget and how it has changed between 2006 and 2013, suggests a growing share in expenditures for “industry, construction, and minerals” and general government administration and a declining share for housing, transport and communications, agriculture, health, education, social protection, municipal infrastructure such as water and sanitation and waste management (including industrial waste and clean-up of contaminated lands). At the same time, the level of spending in nominal terms has of course been significant across the board, as the size of the budget increased overall from 3.8 to 19.1 billion Manat (1 Manat is approximately 1 Euro). While public spending is not the criteria for determining if service provision is adequate it is not clear, given our current knowledge of outcomes, that the budget is aligned with development needs. We have already noted significant pockets of persistent vulnerability and poverty and regional disparities.

82. **Has oil wealth been successfully converted into built and human capital and institutions: the diversified asset base necessary for stable, sustainable and inclusive growth?** Fiscal expenditures have grown much faster than oil revenues and will need to be realigned to account for prospects on both output and prices. As the Government steers fiscal policy towards a sustainable medium-term path, the challenge is to take measures to improve the efficiency and outcome-orientation of government spending. A projected consolidated budget deficit for 2014 marks a likely change in the direction of fiscal policy towards expenditure consolidation and realignment. This will call for policies that focus spending on diversifying assets away from natural resources to institutions, human and financial capital, and infrastructure, and create the space to do so through improved efficiency of expenditures and further strengthening of the Oil Fund. Supporting economic efficiency and improved global integration will generate the gains in terms of growth and jobs needed to support non-oil revenues, and reduce the exposure of the budget to oil prices and production, reducing costly volatility and ensuring sustainability.



### Box 3: Managing oil rents

#### Improve investment efficiency:

- Improve project evaluation by systematically avoiding bad projects early on, avoiding the destruction of good projects, assessing the risks, and slowing down the decision making process. This would introduce gradualism as all projects go through the public investment management cycle.
- Invest in the capacity to invest. This will entail strengthening the public investment management and execution capacity both at the center and in the regions and strengthening the transparency and accountability of public procurement, including by implementing the recommendations of the national anti-corruption strategy.
- Review and revise governance of SOFAZ to further strengthen its capacity to implement a revised fiscal rule and resist political pressure that may jeopardize fiscal sustainability in the longer run.

#### Strengthen fiscal and budgetary management and focus on results:

- Specific improvements here could be focused on budget classification, internal and external audits and medium term expenditure framework planning.
- There is also a need to improve oversight and management of state owned enterprises to ensure their financial viability.
- It is also a good practice to route all public expenditures through the budget and avoid off-budget expenditures through the Oil Fund.
- Programmatic budget structure with well-defined outcome indicators would support improved planning, accountability, transparency, and public knowledge of fiscal processes.
- Focus on diversification of endowments to benefit the bottom 40 regardless of location. This will call for an increase in public expenditures on education and health, along with adequate safeguards to ensure efficiency would be highly beneficial. Public spending realignment to focus on regional development is critical.
- Institutional reforms at a more decentralized level. The Government has mainly focused on narrowing disparities in terms of infrastructure and provision of public goods, but the institutional component also needs to be addressed. Bold reforms are needed in the area of local public management including shifting more functionality and responsibility to the municipalities. Municipalities lack resources and authority to be engaged in the provision of public goods. Revenue sharing mechanisms would help. In addition business environment reforms in the regions become more important given the “natural” attractiveness of the Baku for private investors given the concentration of the oil industry, market size, and construction sector.
- Implementation of a credible and transparent fiscal rule would support governance of the state oil fund and impose discipline in terms of the type of expenditures that the oil revenues could finance.

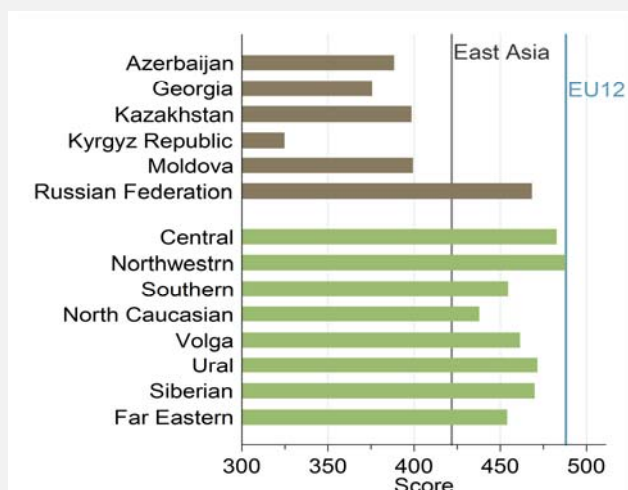
Source: Azerbaijan Public Expenditure Review (2013). World Bank.

### *Human Capital*

83. **Human capital has been identified as the pending investment for resource-rich Eurasia, and Azerbaijan does not seem to be an exception.** Apart from Russia, it would in fact appear that the most urgent gap to fill is human capital, regardless of whether the country is resource rich or resource poor. Two out of three 15 year olds in Azerbaijan and Kazakhstan turned out to be functionally illiterate according to the latest available results for these countries in the

OECD's PISA test in spite of the oil wealth that both countries have been endowed with- results similar to those in resource-poor Georgia, Moldova and Kyrgyz Republic (Gill et al 2013).

**Figure 43: Education outcomes need to be strengthened urgently throughout the region except in Russia<sup>18</sup>**



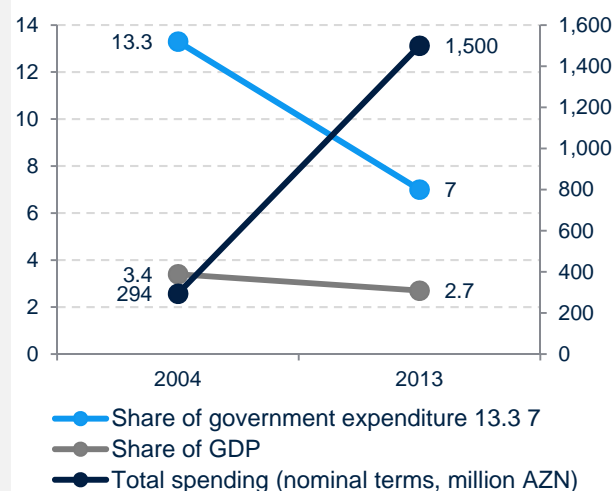
Source: Ajwad et al based on PISA 2013 dataset as reproduced in *Diversified Development*, World Bank 2013. Note: The score is an average of math, science and reading. Median scores are reported for the European Union-12 and East Asia.

## Education

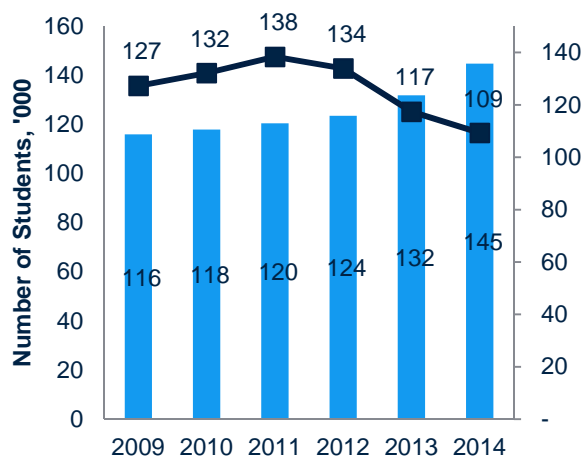
84. **While natural resource rents have allowed for public spending increases, expenditures on education remain low.** In 2013, Azerbaijan's GDP was 58.2 billion AZN (USD 73.7 billion), and the government's consolidated budget was 37.9 percent of GDP, of which only 7.0 percent was spent on education. Over the last decade, public spending on education has dramatically increased in nominal terms from AZN 294 million in 2004 to AZN 1.5 billion in 2013, but it has not grown as fast as GDP. In 2004, public spending on education was 13.3 percent of government expenditure and 3.4 percent of GDP. By 2013, it dropped to 7.5 percent and 2.7 percent, respectively. In particular, higher education spending declined in absolute terms since 2011—from AZN 138 million (USD 175 million) in 2011 to AZN 109 million (USD 140 million) in 2014 when the number of students steadily increased (Figure 45). As a result, per student spending dropped from AZN 1,148 in 2011 to AZN 755 in 2014.

<sup>18</sup> The Programme for International Student Assessment (PISA) is organized by the Organization for Economic Co-operation and Development (OECD) and measures education's application to real-life problems and lifelong learning (rather than knowledge) of 15-year-old students in different countries.

**Figure 44: Public expenditure on education 2004-2013**



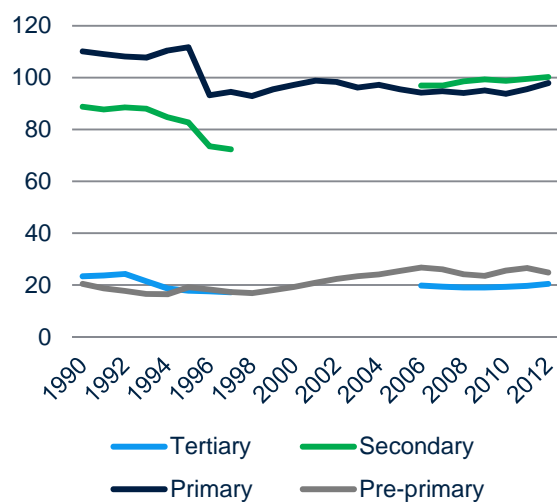
**Figure 45: Higher education spending in millions of AZN and number of students**



Source: 2014 World Bank Group Azerbaijan Partnership Program Snapshot.

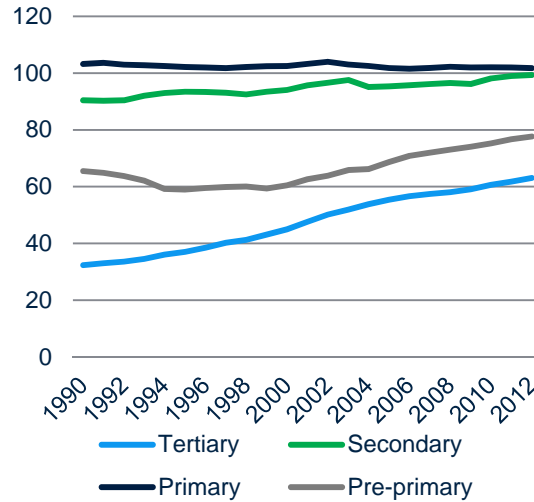
85. **Azerbaijan has achieved universal access to basic education, thus strengthening the foundations of its human capital base.** Gross enrollment rates for primary and secondary education in Azerbaijan in 2012 were 98 and 100, respectively. However, while primary and secondary enrollment rates are high and on par with ECA averages, pre-primary and tertiary enrollment rates lag behind other countries. Azerbaijan has the second lowest enrolment rate in tertiary education in the ECA region, second only to Uzbekistan. The gross enrolment rate for tertiary education in 2012 was 20.4 percent, significantly below the ECA average of 55.6 percent.

**Figure 46: Azerbaijan school enrollment (% gross) 1990-2012**



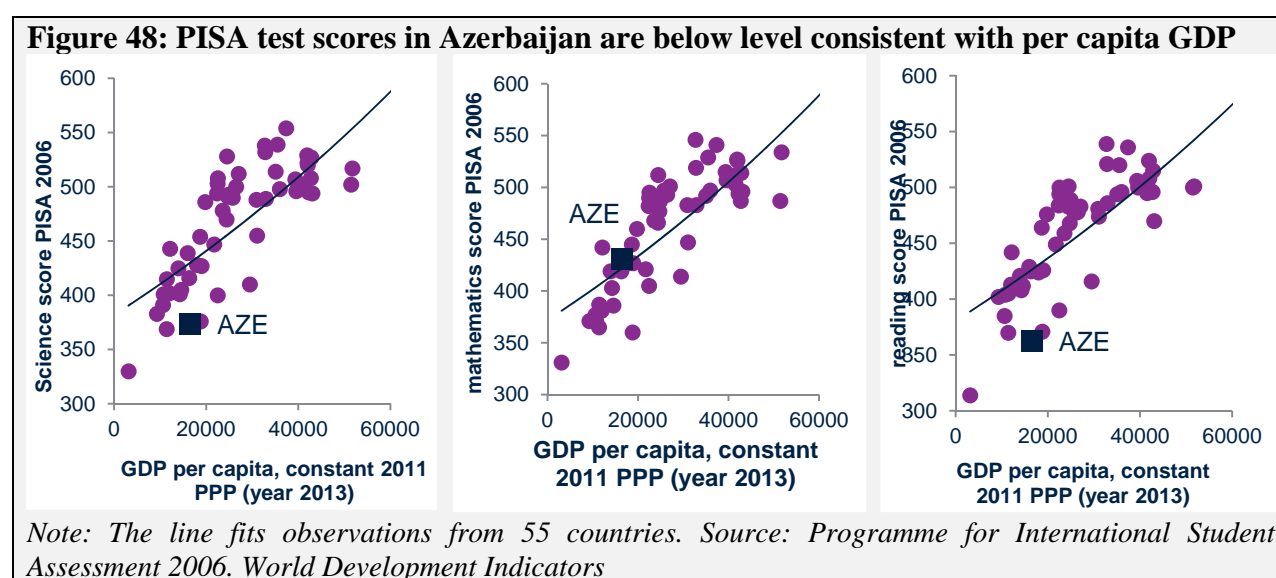
Source: World Development Indicators.

**Figure 47: ECA school enrollment average (% gross) 1990-2012**



Source: World Development Indicators.

86. **Although access to basic education (grades 1st-9th) is near universal, student performance has not improved.** In the 2009 Program for International Student Assessment (PISA) test for 15-year olds, Azerbaijan ranked 64th out of 65 countries in reading, 63rd in science, and 45th in mathematics. The PISA scores on reading and science show that Azerbaijan lags behind countries with similar levels of GDP per capita<sup>19</sup> and are only internationally competitive in the area of mathematics. It is important, however, to account for the change in the alphabet in Azerbaijan in the 1991, which potentially explains why the country performs relatively poorly in the area of reading. Alternatively, students' skills to solve analytical problems and science-related issues show gaps compared to other countries. Azerbaijan did not participate in the 2012 PISA but did register for the Progress in International Reading Literacy Study (PIRLS) 2016, which may help evaluate more recent reforms.



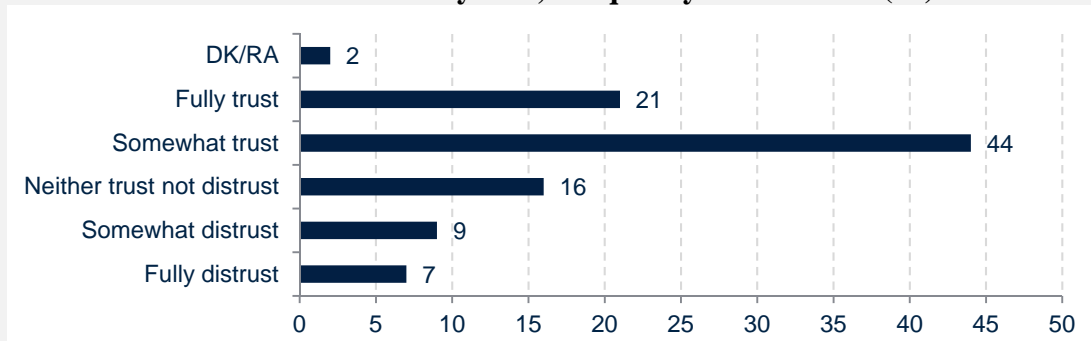
87. **Low teacher quality is a key determinant of the quality of education in the system.** Salaries are low at all levels, failing to attract and retain high quality teachers. For instance, primary teachers earn only 80 percent of per capita GDP after 15 years of service. Low hiring requirements have led to the continued decline of the student-teacher ratio. In primary education, this ratio declined from around 19:1 in 2000 to 12:1 by 2012.<sup>20</sup> The government has already started piloting programs for teacher assessment. Looking ahead, holistic reforms should be considered including pre-service teacher training; employment and deployment of teachers; as well as professional teacher support and performance assessments

<sup>19</sup> See PISA 2012 Results: What Students Know and Can Do (Volume I, Revised edition, February 2014): Student Performance in Mathematics, Reading and Science; DOI:10.1787/9789264208780-5-en

<sup>20</sup> See United Nations Educational, Scientific, and Cultural Organization (UNESCO) Institute for Statistics (2012). Primary school pupil-teacher ratio is the number of pupils enrolled in primary school divided by the number of primary school teachers (regardless of their teaching assignment).

88. **The education system is centralized in practice and there is little capacity at the local level to make decisions in terms of content and educational practices, as well as budget planning and execution.** Data from the 2013 Caucasus Barometer suggest that only 65 percent of the population fully trust or somewhat trust the educational system. Governance of the education system could be re-defined to make the service provision more responsive to local needs.

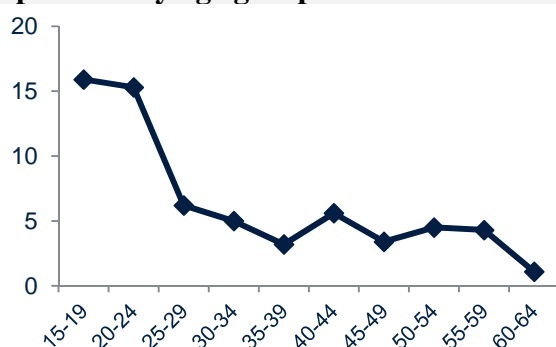
**Figure 49: Trust in the Educational System, Frequency Distribution (%)**



Source: 2013 Caucasus Barometer Azerbaijan.

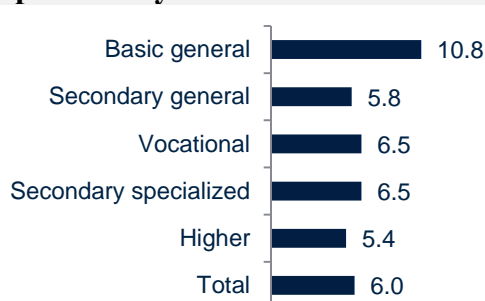
89. **Information from the Enterprise Survey 2013 signals significant gaps related to the quality of post-secondary education and highlights the need to further improve the quality of vocational training and tertiary education in the country.** In contrast to the regional average for Europe and Central Asia, Azerbaijan shows a high proportion of unskilled workers out of all production workers (63.0 per cent for Azerbaijan, and 22.0 per cent for ECA) and a small share of workers who are offered a formal training (13.5 per cent and 55.8 per cent respectively). Inadequate qualification is a major constraint to the supply side of the labor market. Findings from the PISA study published by the OECD and results from the STEPS study conducted by the World Bank suggest that labor market entrants often lack adequate skills to be employed in the private sector. Unemployment rates are particularly high among individuals below 30 years and with regard to education data from the Labor Force Survey 2013 show how a strong relationship between low educational attainment and worse labor market performance.

**Figure 50: Unemployment rates of population by age groups**



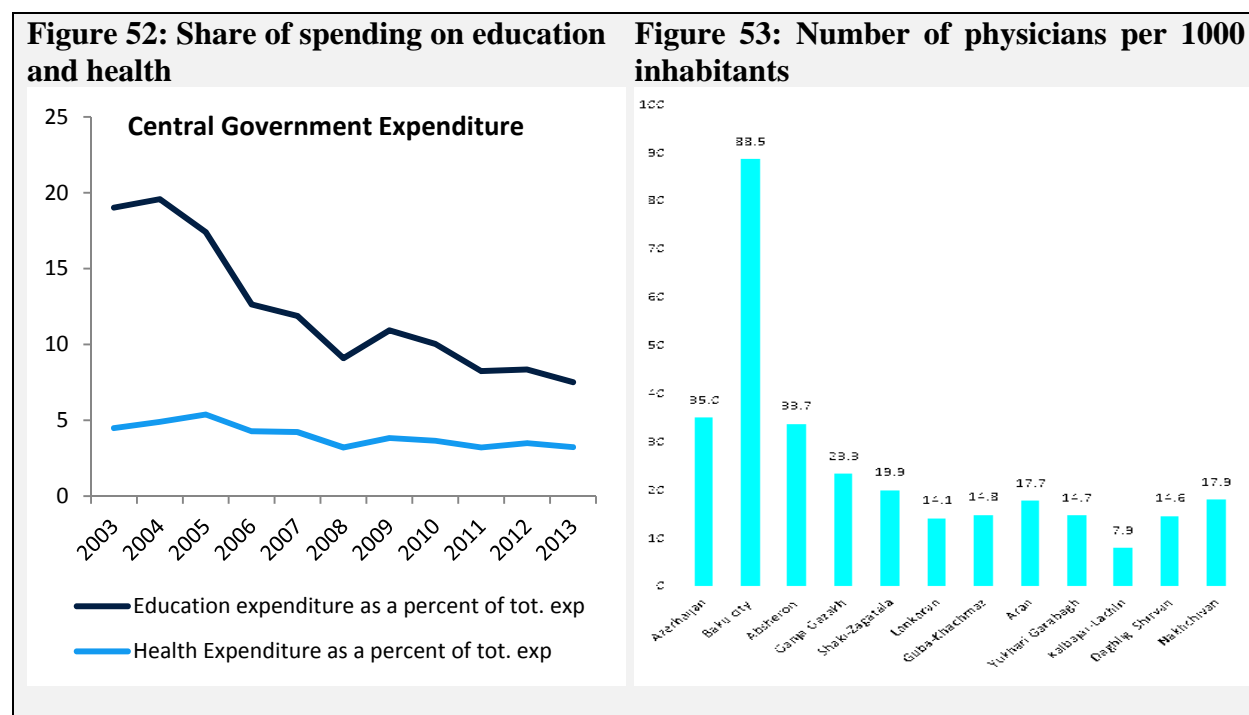
Source: Labor Force Survey Azerbaijan 2013. World Bank staff calculations.

**Figure 51: Unemployment rates of population by education level**



## Health

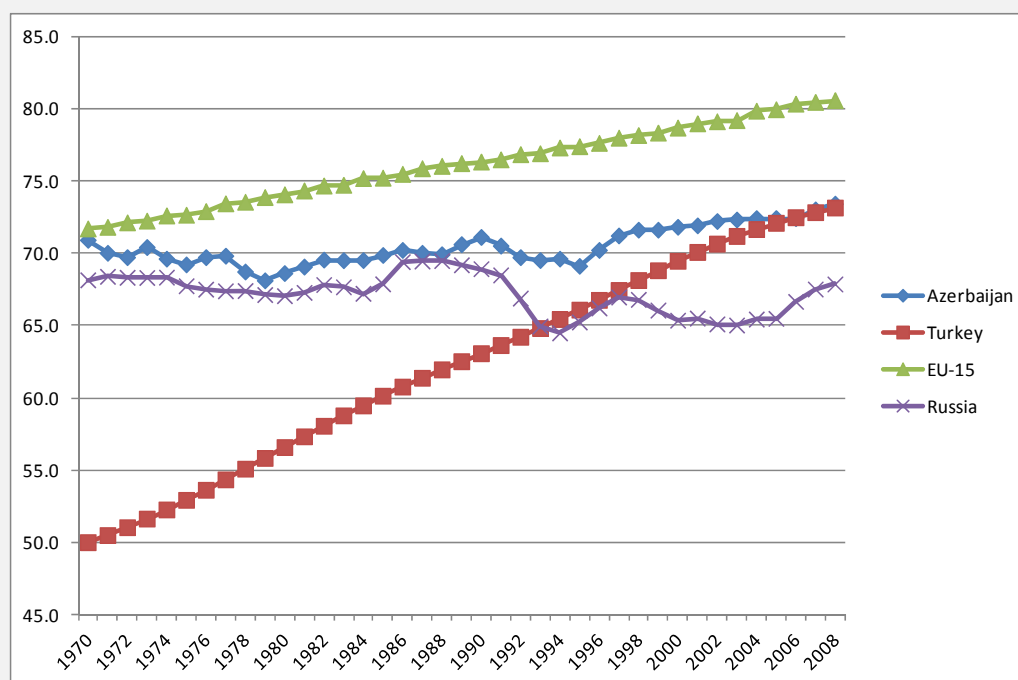
90. **Government expenditures on health, similar to education, are relatively low.** Government health spending, at around 1 percent of GDP, is one of the lowest in the ECA region. This has resulted into high out-of-pocket spending by the population which amounts to nearly 70 percent of household health expenditures and 10 percent of total household spending, suggesting a significant burden on the poor.



91. **Overall, Azerbaijan has made significant progress in improving health outcomes in recent years; infant, child and maternity mortality have decreased consistently over time.** Over the period 2006-2012, the infant mortality rate decreased from 11.9 to 10.8 per 1,000 live births; and the under-5 mortality rate decreased by 13 percent, from 16.2 to 13.9 over the period. Official statistics also show a positive trend for maternal mortality. The maternal mortality rate decreased by about 56 percent, from 34.2 per 100,000 live births in 2006 to 14.9 in 2012. Nevertheless, life expectancy in Azerbaijan did not improve in the way one would expect for middle income countries. As illustrated in Figure 54, Turkey, for instance, has made significantly more progress. In Azerbaijan, limited awareness of good health behavior resulting in the excessive use of tobacco and alcohol, an unhealthy diet, physical inactivity and high prevalence of risk factors such as hypertension, diabetes and high levels of cholesterol reduce life expectancy

significantly (life expectancy at birth was 67.6 for men and 73.9 for women in Azerbaijan according to United Nations Population Division data for 2013).<sup>21</sup>

**Figure 54: Life Expectancy in Azerbaijan and Selected countries, 1970-2008**



92. **Azerbaijan is in the middle of a demographic and epidemiological transition.** The country experiences a favorable demographic situation with relatively high fertility and a proportionately large working-age population.<sup>22</sup> On the other hand, as a result of a decreasing population growth rate, a slowdown in the growth of fertility rates, and a shift in the burden of disease from communicable to non-communicable disease (NCD)<sup>23</sup>, the demand and supply for health services have shifted and reveal substantial deficits in the health care system in Azerbaijan.

93. **Limited public investment is reflected in heavy reliance on secondary health care units instead of primary care, focusing on treatment vs. prevention.** Nearly half of the population seeks assistance from a hospital doctor as the first point of care, as primary care services

<sup>21</sup> A national Survey conducted in 2011 revealed that almost all respondents had one of these risk factors and half had a combination of 3-5 factors. The survey demonstrated high prevalence of smoking among men (49.5 percent). Fruit and vegetable consumption and physical activity are low, and 62 percent of respondents were overweight.

<sup>22</sup> It should be noted that, for older age groups, the sex ratio favors women.

<sup>23</sup> According to the State Statistical Committee of Azerbaijan, chronic NCDs, such as circulatory diseases, cancer and chronic respiratory diseases, account for 77 percent of all mortality cases in Azerbaijan in 2012.

are, although available, often not considered of good quality.<sup>24</sup> This allocation of resources is inefficient, as international studies have shown that gains in life expectancy are not made at the hospital level, but rather by improving primary care and investing in public health.<sup>25</sup>

94. **Quality of health services constrained by lack of quality standards for health professionals and absence of incentives.** The low level of health workers salaries<sup>26</sup> and subsequent high demand for informal payments jeopardize the effectiveness of the health system as a whole. Performance payment mechanisms can motivate health professionals and introduce incentives to increase quality of health services. This might also offer possibilities to mitigate disparities in the distribution of quality health professionals across regions, as health workers are not interested in working in the poorer and remote areas.

95. **Low quality of health services and inefficient allocation of facilities, especially for health care units in rural areas, reduces the demand for health services and partly explains the underutilization of existing services.** Inefficiency of overall structure and quality of care in primary and secondary health care units (necessity for structural changes, update in equipment, and improvement of skills and knowledge of PHC providers) lead to underutilization of primary health care in particular for the rural population, but also for city population. The problem is not that the facilities do not exist, but rather that they are outdated and require a new approach and overall new structure for the primary health care, including new financial mechanisms of payment and incentives.

96. **Health policymaking, quality assurance, M&E, and IT constitute key areas of opportunity.** The absence of a national healthcare information system introduces large inefficiencies and generates additional costs. Further gains in terms of quality of health services could be generated by developing financial incentives mechanisms.

### *Physical Capital*

97. **Higher than PI based spending can be rationalized if it is on productive investments in infrastructure and/or human capital.** This would imply that these investments generate returns for the current and future generations in excess of the returns on wealth accumulated in the Oil Fund. In Azerbaijan, capital expenditures almost tripled between 2007 and 2011 and grew at an average annual rate of 39 percent during this period. However, as noted in the preceding section,

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<sup>24</sup> In a first step, optimization had been realized in 65 regions with a reduction from 444 to 214 secondary facilities and an increase from 543 to 782 primary facilities (information relates to the year 2010).

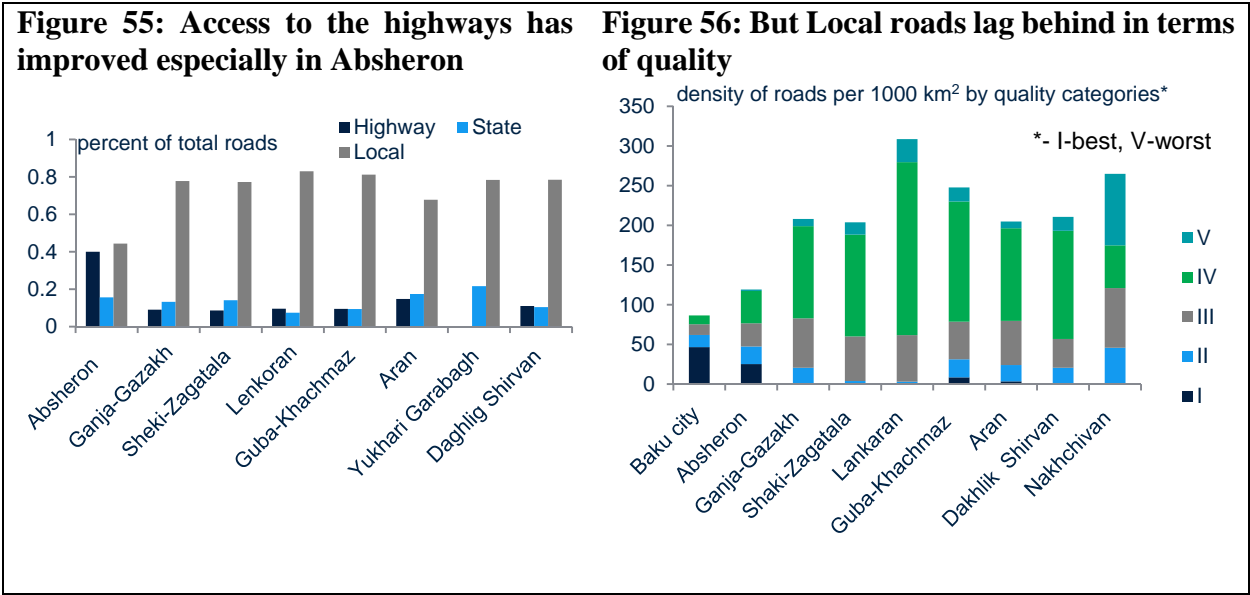
<sup>25</sup> The expanded coverage of key screening and early diagnosis interventions (for hypertension, cholesterol, diabetes) and particularly treatment of NCDs could reduce future costs for more invasive treatment. Only 10% of people suffering from high blood pressure have it under control. And only 10% of adults received a cholesterol test in the last 12 months. Equally low figures are reported for screening for breast-cancer and flu vaccine received.

<sup>26</sup> Salaries of health workers in general are low with most doctors earning a monthly salary between AZN 160 and 220, about twice the minimum wage (93.5 AZN in 2011). In most advanced health systems, doctors earn at least 3 times the average wage.



there is limited evidence that additional oil revenues have been effectively invested in human capital. The same applies to physical capital, though Azerbaijan has made more progress here. It should also be noted that the returns on public investment spending would need to be weighed against the resulting exchange rate appreciation, which adversely affects competitiveness and non-oil exports.

98. **The ongoing effort to improve the capacity and condition of major transit corridors is important for the realization of some of Azerbaijan’s competitive advantages, though regional disparities persist.** Transportation costs are high in Azerbaijan, which negatively affect the access of domestic road users to markets and services, taking a toll on competitiveness. The modernization of key highways and railways infrastructure can help the country compete for more cargo transit in the region and capitalize on its strategic geographic position. The development of main transport corridors, along with relevant logistical services, can help local producers deliver their products to local and international markets in a faster and cheaper way. Reduced transportation costs are also expected to spur private investments. The construction of rural and regional roads, multi-modal corridors, railways, and inland waterways has great potential for alleviating poverty, boosting macro and micro economic activity and reducing income inequality, as discussed in detail in the bottom-up section, below.



99. **Baku accounts for 76 percent of Azerbaijan’s total output and provides 72 percent of the total government revenues.** The city is growing rapidly and will accommodate an estimated population of more than 3 million people and 1.2 million employments by 2030. The city is becoming a regional metropolitan center with increasing difficulties in meeting urban mobility needs. The development of an integrated urban transport system for Baku will require (i) the adoption of a holistic and multi-modal approach for urban transport; (ii) the development of

integrated urban transport infrastructure, and (iii) the establishment of an adequate institutional set up.

**100. Critical infrastructure gaps remain in spite of high public investment and significant improvements over the past decade.** Azerbaijan's capital stock per capita is on the lower side in the ECA region and significantly below international levels. The country started at a very low level of capital stock per capita in 2000. Over the past decade, it has gradually built it up but it still lags behind regionally and internationally. Average gross fixed capital formation in Azerbaijan was one of the lowest during 2007-2011 in the ECA region and was dominated by the public sector. The total rail network in Azerbaijan, at 2079 kilometers in 2011, was also lower than most of the neighboring countries. In addition, Azerbaijan's per capita power consumption is less than one-third the ECA average while transmission and distribution losses are more than double the ECA average.

**101. Rehabilitation of irrigation and drainage infrastructure, especially the infrastructure managed by farmers, is critical to maintaining and increasing agricultural productivity.** Agriculture absorbs nearly 40 percent of the work force and contributes less than 10 percent of GDP. Strengthening agricultural productivity would support rural incomes and create new business opportunities encouraging the population migration and urbanization that is associated with development in many countries, including Turkey and Poland. Since almost all agricultural lands are in (semi-) arid zones, irrigation is the crucial input for reliable crop production for 85 percent of the agricultural output in the country. An irrigation command area of about 1.4 million ha is was built during the Soviet times, but it is estimated that as a result of deferred maintenance about 50 percent of the infrastructure is not in condition to provide adequate water supply to end users, and 630,000 ha was estimated to have poor drainage and subsequent soil salinization. Especially the 1.1 million ha of on-farm systems managed by farmer-managed Water Users Associations are in dire need of rehabilitation and improved maintenance, whereas under several World Bank projects only 140,000 ha are being rehabilitated. Results from World Bank-financed projects show that rehabilitation of these systems leads to yield improvements in the order of 20-25%.

**Box 4: Investments in on-farm irrigation systems are critical for maintaining and improving agricultural productivity**

Results in 15 rayons where the World Bank-financed Irrigation and Drainage System Improvement and Modernization Project (IDSMIP, 2005-2010) and the Water Users Association Development Support Project (WUAP, 2011-2016) are implemented, show that there are significant benefits resulting from investment in rehabilitation of on-farm irrigation systems and capacity building of Water Users Associations (WUAs):

- Agricultural productivity benefits include: (1) increase in yields due to improved irrigation water distribution to farmers in average by 23% for all crops; (2) increase in the area irrigated and a subsequent reduction of uncultivated land from approximately 10,500 ha in 2006 to 2,300 ha in 2009-2010; and (3) change in cropping patterns to more lucrative cash crops like vegetables and orchards.
- Higher Irrigation Service Fees (ISFs) and better collection rates: The projects have significantly improved WUAs' recovery of management, operation and maintenance (MOM) costs for the irrigation and drainage infrastructure. In the north region, WUA ISFs increased from AZN 0.5 /1,00m<sup>3</sup> to AZN 6.0 /1,000 m<sup>3</sup> with close to 100 percent collection rates as the project enhanced farmers' capacity to pay for irrigation services.
- WUAs have more revenues, better financial and irrigation management, and depend less on the Raion Irrigation Departments. Budgets of the rehabilitated WUAs increased by more than 4 times reaching on average AZN 12,000 per year, compared to AZN 7,400 for non-rehabilitated WUAs in project raions. The rehabilitated WUAs had carried out 91 percent of the O&M works agreed in their plans. In contrast, one third of the non-rehabilitated WUAs have not done any O&M work at all, heavily depending on Raion Irrigation Departments to carry out such work.
- Increase in the total amount of water supplied, better planning of water delivery, and reduced water losses. While the amount of water supplied to non-rehabilitated WUAs remained relatively constant over 2006-09, the beneficiary WUAs witnessed an increase by over 40 percent.

*Source: IDSMIP and WUAP surveys and IDSMIP Implementation Completion Report (2011).*

102. **Agriculture and agri-business is an important potential means of stimulating rural incomes and consumption and thereby of boosting shared prosperity but several challenges need to be addressed first.** The current lack of improved seed varieties and more productive livestock breeds, combined with outdated processing technologies, limits product quality and, in turn, restricts the competitiveness of agri-business. The supply chain needs strengthening, especially in terms of management of on-farm production, handling, distribution, warehousing, distribution centers, and processing. Financial access is limited including for export and for SMEs as is investment in critical land management practices, developing a legal and regulatory system for ensuring food safety, veterinary services, and sanitary and phyto-sanitary control. Private sector involvement in agricultural input and machinery leasing markets also needs to be enhanced as do agricultural research and extensions services.

103. **Telecommunications connectivity needs to be strengthened.** Supporting telecom, both in terms of legislative provisions and competition to increase service provision and reduce costs is another challenge to address. ICT infrastructure/services are critical for several reasons: innovative use can support governance as is already the case with Azerbaijan's one-stop-shop; can support the ability of businesses and citizens to connect with global knowledge, including education; plays an important role increasingly in logistics and supply chain management; and it crucial to many kinds of high value added ICT-enabled services with export potential. ICT is also important for general operational efficiency – both in the public and private sectors. The demand for strengthened public service can be best supported by enhanced use of technology and improved e-services as well.

104. **The provision of adequate and affordable housing is one of the greatest challenges facing the Azeri government.** Bureaucratic burdens and legal constraints undermine the coherent development of housing, encouraging urban sprawl and the construction of informal settlements. At the same time, the existing multi-family housing stock is deteriorating rapidly as a result of hasty privatization in the absence of sufficient housing management and maintenance. A 2010 Azerbaijan Housing Profile study carried out by the UNECE determined that there is a lack of reliable data and statistics in the sector. Government estimates regarding housing stock -- its supply and demand are based on old Soviet measurement systems, i.e. square meter area instead of dwelling units stratified by size, occupancy or quality -- is misleading and does not give a meaningful assessment of the situation that can inform policy in a meaningful manner. The lack of housing data also hampers the establishment of a land administration system with proper registration, standardized valuation mechanisms and a wider taxation base.

105. **About 30 percent of the population in Azerbaijan live in informal settlements, many of which are concentrated in Baku and the Absheron peninsula** which makes up most of Greater Baku metropolitan area. Urban sprawl, a consequence of growing informality, is a serious problem facing Greater Baku. The lack of proper legislation and lax enforcement on one hand, and the artificial demand created by oil-driven growth coupled with the primacy of Baku as the unrivalled economic center of the country on the other, is fueling rural-urban migration. This is happening without the necessary housing or infrastructure to accommodate the burgeoning population.

106. **Due to a growing demand for affordable housing in urban areas, there is flourishing and recognized “informal” housing market between developers and buyers that is not regulated.** The problem of illegal construction in Azerbaijan is distinct from other countries in the region: in most cases, it is the direct outcome of bureaucratic red tape in acquiring permits and titles, forcing developers to construct and sell houses without titles. Due to this largely informal nature of the primary housing stock (new units), it is not uncommon for many units to not be connected to utilities, which makes them unsuitable for habitation. This partially explains the large

number of vacant units in Baku<sup>27</sup>: although specific data on this is not available, the fact that a large number of these units have no lights on in the evenings suggests that they are not occupied despite being ‘completed’.

**107. The provision of reliable piped water supply and sanitation services is another constraint, especially in rural areas, with important implications for public health.** Azerbaijan inherited a relatively extensive water supply system from the Former Soviet Union (FSU). About 95 percent of the population in Baku and about 83 percent of those living in secondary cities and small towns are connected to piped water. However the quality of infrastructure and services has deteriorated severely since independence, due to a lack of investment and deferred maintenance. In many secondary and small towns, water treatment facilities are largely dysfunctional or lacking completely, leaving the population in these towns without access to safe water. In addition, almost everywhere in the country, the piped water supply is unreliable and often available fewer than 12 hours per day. Centralized piped water supply systems are rare in rural areas, where less than 33 percent of the population has access to a piped water supply.

**108. The rehabilitation of infrastructure, particularly roads and railways, must be accompanied by significant efforts to ensure the sustainability of investments.** This will require the provision of adequate financing for maintenance and the modernization of the asset management system. While the reconstruction of the main highway network is expected to be completed over the next 5 years, a maintenance system for the key road network is still not functional. As a result, even some of the recently rehabilitated major road assets are deteriorating. If maintenance is neglected, Azerbaijan would start losing the benefits of ongoing investments, while the current asset value of the main road network will decline by about 10 percent by 2020. Ongoing reforms in the railway sector need to be completed to improve competitiveness, financial sustainability, operational and cost efficiency. To improve efficiency and sustainability in the sector, the Government needs to establish an institutional framework for the preservation of investment and provide incentives for the gradual engagement of the private sector in the management and maintenance of transport assets.

**109. Quality gaps also suggest a need to strengthen the quality of the institutional environment to support the impact of public investment spending on long-run growth** (World Bank 2013). The importance of improvement in institutions in Azerbaijan is underscored by estimates that every manat invested in Azerbaijani public infrastructure would yield an additional 23 percent of output if institutions were the same as in the OECD<sup>28</sup>. The potential for enhancing

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<sup>27</sup> There is also major speculative activity in real estate in Azerbaijan, but data on this is not available.

<sup>28</sup> This has been estimated using an aggregate Cobb-Douglas and translog production function involving measures of public, private and human capital using a fixed effects regression (Annex 3). The regression model predicts that if Azerbaijan’s institutional quality were equal to the OECD average, the marginal product of investments in public infrastructure would be 23 percent higher.

the quality of public sector investment through institutional improvements is evident in other studies as well. Based on the public investment management index (PIMI) of Dabla-Norris et al. (2012), which evaluates the institutional environment underpinning public investment management across four stages (appraisal, selection, implementation and evaluation), Azerbaijan ranks 43 out of 71 developing countries.

**110. Limited private participation in infrastructure is a challenge, addressing which will call for significant institution-building but will support both fiscal sustainability and service provision.** The main emphasis of public spending on infrastructure has been on roads, which absorbed nearly half of the \$9 billion of infrastructure spending during 2005-09. Road maintenance, however, has not kept pace. One of the reasons for the low level of physical capital could be the relatively small contributions from the private sector due to the poor business climate. The government has made a valiant attempt to step in with significant capital expenditures which averaged 40 percent of the consolidated government budget during 2007-11. There is potential for public-private partnership in infrastructure in general, as well in operations and maintenance of facilities, including on water and sanitation. While the business climate overall – and especially the perception of property rights – is a driver here, it would be important to think in terms of the institutions and regulatory frameworks necessary to support such partnerships. These are important both from the perspective of service provision and asset management, and also from the point of view of fiscal sustainability and increasing the role of the private sector in the economy.

#### *Financial Capital*

**111. Financial development is critical to both private sector growth and inclusion.** In terms of financial capital, Azerbaijan has been growing rapidly in the past decade, supported by the record high economic growth since 2004, with the composition reflecting underlying growth patterns. Rapid growth of the financial sector in the recent years was supported by high growth of consumer lending and the construction boom, fueled by the rapid poverty reduction and high public sector spending. The structure of bank lending has veered towards consumer lending and shrinking lending to the real economy.

**112. Despite significant development and continued rapid growth, the financial sector remains largely underdeveloped and inefficient as compared to upper middle income countries.** The share of private credit to non-oil GDP, as reported by the Central Bank of Azerbaijan, stands at above 70 percent, but is heavily concentrated towards larger firms. Banking sector assets to GDP stood at 35 percent in 2013, with deposit to GDP at only 22 percent in 2013 – the smallest in the Caucasus countries in relative terms, but the largest in absolute terms. Domestic credit to private sector as a share of GDP (oil plus non-oil) increased between 2004 and 2013 from 9.3 percent to roughly 25.5 percent, but still remains much lower than in the rest of the South Caucasus and upper-middle income countries (UMIC) like Kazakhstan (36.8 percent),

Belarus (24.1 percent), Ukraine (74 percent) and Bulgaria (71.6 percent).<sup>29</sup> This is partially explained by the large share of oil-generated growth and its dominance in the export and GDP structure.

**113. Part of the challenge is financial sector efficiency: strengthening competition will be critical in this context.** Large state ownership, concentration, and lack of a conducive environment for new banks interact with an underdeveloped legal framework and weak credit infrastructure to compound the challenges faced by the sector. The International Bank of Azerbaijan (IAB) accounts for around one-third of banking assets. Taking into account state-affiliated owners, public influence can be estimated at around three-quarters of the total. Foreign banks account for only 10 percent of the total assets; while this reduces external vulnerability, it slows down financial sector modernization and innovation. Low competition is one of the factors explaining high operating costs, poor quality loans and large interest spreads.

#### *Natural Capital*

**114. Environmental sustainability is at risk in Azerbaijan if the depletion of resources continues at the rate of the last decade and this would primarily impact the bottom 40.** Environmental issues have not been in the focus of the government policy for a long period of time in Azerbaijan. The Greater Baku Area enjoys relatively improved provision of services in terms of water treatment and solid waste management; however, rural areas, and secondary and tertiary towns where the majority of the poor live remain critically underserved and, thus, are characterized by low level of environmental performance. This is exacerbated by unsustainable agricultural and natural resource management practices such as overgrazing and illegal forest cutting. Agricultural land, subsoil minerals, timber and other forest resources, are economically and socially significant for economic developing of the country, and make up a relatively large share of population income. Governance is intricately linked to natural resources. In particular the most vulnerable and poorest part of the population that remains reliant on social safety nets or on lower wage employment, especially in subsistence agriculture, would benefit the most from the sustainable use of natural resources. Domestic and industrial wastewater delivered by the rivers flowing into the Caspian Sea and discharged directly from coastal cities, towns and industrial facilities is an important source of pollution. This creates critical risks for the large population in Azerbaijan's coastal zone and depletes the natural riches of the Caspian.

**115. Land degradation and desertification probably is the most negative economic consequences of the environmental disaster.** Due to over exploitation, excessive cattle grazing, forest destruction and the use of poor irrigation methods, land degradation and desertification have become among the most important problems for Azerbaijan. This situation is caused by both economic and social factors: low population awareness; war; drought; and global climate change. Currently, more than 40 percent of land in Azerbaijan is the subject to degradation. The main

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<sup>29</sup> Source: World Development Indicators, World Bank

causes of this process are water erosion (82%), irrigation erosion (7.6%) and wind erosion (10.4%). More often these processes occurred in the densely populated areas of the Kura-Araz lowland, Absheron Peninsula and in the Nakhchivan Autonomous Republic. This fact strongly influences the reduction of arable land and shortens incomes of the poor households working in agriculture, which is the main type of activity in these regions.

**116. Solid waste management is poor throughout the country.** Azerbaijan's fast economic growth, the household consumption of products and services has been increasing, resulting in larger quantities of produced domestic waste. According to the State Statistics Committee the generation of the solid waste across the country increased 34 percent since 2000. However, monitoring of the International Organizations, including UNDP reveals even higher figures. Although, the system of municipal waste management works well in Baku, the most of the existing landfills do not meet international sanitary standards. The rural areas are only partly covered by waste services, while reuse and recycling of waste is done on a limited scale. Unsafe landfills and uncertain separation of hazardous from nonhazardous waste are the key problems, and is an open source of diseases and destructive for the landscape. In some cases such areas are located not far from habitation of poor people, which in turn bears high health risks for people living in the area.

**117. Azerbaijan and particularly Absheron Peninsula has limited and poor quality water resources and is heavily dependent on distantly located sources, with Baku again getting preference in terms of treatment facilities.** Furthermore, the quality of most sources does not meet high standards and require high-technological treatment process. The water of lower quality is distributed in suburbs of large cities, mostly populated by poor. The national operator Azersu, responsible for water treatment, distribution, and wastewater management across the country, has constructed a few water treatment facilities but most of the country still utilizes untreated water. In general, despite enormous capital investments disbursed in the framework of the State Investment Program projects have been implemented in only a few rayons. Public water systems face a number of challenges including aging infrastructure, increasing regulatory requirements, water quantity and quality concerns and inadequate resources, though during recent years, Azersu rehabilitated significant portion of outdated infrastructure in the Baku city and decreased the quality of technical losses.

### *Social Capital*

**118. The presence of a strong civil society also plays an important role in increasing the accumulation and use of social capital, although the space for this appears to have been recently curtailed in Azerbaijan.** Civil society and the social capital it engenders can be a crucial provider of informal social insurance and can facilitate economic development.<sup>30</sup> Civil society in Azerbaijan has been steadily developing, however, still has ambivalent relationships with government and citizens. Nevertheless, the recent stance of the government towards civil society

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<sup>30</sup> Social capital and Civil Society, Social Development Topics, The World Bank.



appears to be limiting the activities of civil society in Azerbaijan, although on paper it seems to strive to transparency and accountability. Public trust in NGOs is low. The LiTS showed a decline of public trust in NGOs from 2006-2010, hovering under 30 percent in 2010, below the western European average.<sup>31</sup> Trust in NGOs has remained at that level: the 2013 Caucasus Barometer Survey showed that only 30 percent of the population fully trusts these organizations.<sup>32</sup>

**119. The government has been supportive of the development of civil society, providing financial support for projects and activities; however, new regulations have negatively impacted activities.** In 2007, the Azerbaijan government established the Council on State Support to NGOs to provide financial support to NGOs and facilitate cooperation with civil society. Funding has grown from EUR 3.8 million in 2012 to EUR 8.2 million in 2013. The environment for civil society appears to have become more restrictive due to a number of new amendments to the laws on NGOs which came into force in 2014 (Box 5). The new regulations limit the activity of both local and foreign NGOs, and impose increased penalties for failure to register grants, noncompliance with, or inaccurate financial reporting. The regulations also limit cash donations, and increase the monitoring of foreign funding of bank accounts of all NGOs by the Central Bank of Azerbaijan. The regulations impact the day-to-day activities of NGOs: due to the registration requirements for foreign grants and Central Bank monitoring, banks have been imposing new restrictions and fees on NGOs, limiting their access to their own funds and to banking services. Commercial banks, not wanting to be fined for non-compliance (penalties can range from 5000-8000 AZN<sup>33</sup>), have increased account maintenance fees for bank accounts for NGOs from 1 AZN to 100 or even 300 AZN a month. The EU released a statement in February 2014, expressing concerns with regard to the impact of this legislation on civil society.<sup>34</sup> Also in 2014, Freedom House lowered Azerbaijan's rating on civil society from 6.25 to 6.50 (out of 7) in 2014<sup>35</sup>.

**120. Social capital may be enhanced through greater public participation by citizens and NGOs alike.** Electoral turnout for elections is high, but public participation in policy debate and decision-making is weak. There are limited feedback roles for the public to comment on legislation. For example, during the public consultations on the anti-corruption legislation, public participation was limited, and not inclusive of all relevant stakeholders, such as civil society organizations (CSOs) working on anti-corruption issues. However, the Law on Public Participation adopted by Parliament in November of 2013, which aims to create legal assurances for citizen

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<sup>31</sup> European Bank for Reconstruction and Development. 2010. "Life in Transition: After the Crisis". p.63.

<sup>32</sup> Caucasus Barometer, 2014.

<sup>33</sup> International Center for Not-for-Profit Law, NGO Law Monitor: Azerbaijan. August 5, 2014.

<sup>34</sup> European Commission Joint Staff Working Document: Implementation of the European Neighborhood Policy in Azerbaijan Progress in 2013 and recommendations for action. March 27, 2014.

<sup>35</sup> Freedom House Nations in Transit 2014 Azerbaijan Country Report.

participation in public administration and decision-making.<sup>36</sup> The law calls for the creation of public councils comprised of CSOs, which would be responsible for initiating public consultations and facilitating debate on policy issues with government. The law also calls for all draft legal acts to be made public before adoption and to be considerate of public recommendations.<sup>37</sup> Despite the enabling legislation, public councils have yet to be created by most central and local authorities. Civil society representatives stated that there are significant weaknesses in the new law, for example, terms are not clearly defined, nor is the process for public hearings. The perception is that the government is not ready to institutionalize interaction with the public, preferring ad hoc committees and consultations.

**Box 5: Amendments to laws on NGOs: Limiting the activities of domestic and foreign civil society organizations?**

In 2007, the Azerbaijan government established the Council on State Support to NGOs to provide financial support to these organizations and facilitate cooperation with civil society. The Council is composed of 11 members who are each appointed by the President and work on a voluntary basis. Eight of these 11 members are first nominated by NGOs, and the other three represent government bodies: the Ministry of Justice, the Ministry of Finance, and the Office of the President.<sup>38</sup> The Council distributes grants to local NGOs for projects. Financial support significantly increased: funds allocated to the Council increased from EUR 3.8 million in 2012 to EUR 8.2 million in 2013.<sup>39</sup> This increased allocation may be an effort, however, to curtail the flow of foreign funds going to NGOs. CSOs are advised to go to the Council to get domestic funds, which requires NGOs to register with the Ministry of Justice. This requirement facilitates government monitoring and knowledge of NGO activities. However, the perception among CSOs is that the Council gives preference to organizations run by members of Parliament and those with which it has ties.<sup>40</sup>

The environment for civil society appears to have become more restrictive due to a number of new amendments to the laws on NGOs which came into force in 2014. The new regulations limit the activity of both local and foreign NGOs, and impose increased penalties for failure to register grants, noncompliance with or inaccurate financial reporting. The regulations also limit cash donations, and increase the monitoring of foreign funding of bank accounts of all NGOs by the Central Bank of Azerbaijan. While on paper the actions of the government toward civil society seem to foster transparency and accountability of the NGO sector, in practice they appear to be limiting the activities of domestic and foreign NGOs.

<sup>36</sup> The law, which came into force in July 2014, was designed to “allow citizens to exercise social control over executive bodies and local authorities, and ensure a fruitful relationship with them, thus serving to provide transparency and publicity in the work of these entities”. Azernews. “Bill on Public Participation Discussed in Azerbaijan”. April 3, 2013.

<sup>37</sup> European Commission Joint Staff Working Document: Implementation of the European Neighbourhood Policy in Azerbaijan Progress in 2013 and recommendations for action. March 27, 2014.

<sup>38</sup> Guluzade, M and N. Bourjaily. “Azerbaijani NGO Support Council: Overview of Three Years of Activity”. International Journal for Not-for-Profit Law. Vol. 14. Issue 1-2, April 2012.

<sup>39</sup> Freedom House Nations in Transit 2014 Azerbaijan Country Report.

<sup>40</sup> USAID 2012 CSO Sustainability Index for Central and Eastern Europe and Eurasia, 16<sup>th</sup> Edition, June 2013.

The regulations impact the day-to-day activities of NGOs in many ways. Due to the registration requirements for foreign grants and Central Bank monitoring, banks have been imposing new restrictions and fees on NGOs, limiting their access to their own funds and to banking services. NGOs must now register grants with the Ministry of Justice, receive the notification of registration, and then take the notification to the bank in order to access the funds. Commercial banks, not wanting to be fined for non-compliance (penalties can range from 5000-8000 AZN<sup>41</sup>), have begun requesting retroactive notifications on grants activated before the regulations took effect.<sup>42</sup> The additional compliance measures increase the burden on banks, and many are taking informal measures to get NGOs to take their banking business elsewhere. For example, commercial banks have increased account maintenance fees for bank accounts for NGOs from 1 AZN to 100 or even 300 AZN a month.

High profile organizations such as Transparency International and OXFAM appear to have been targeted by the government, while some lower profile organizations have had to suspend activities. OXFAM is under investigation for tax evasion. Transparency International was not able to access its grant funds from USAID. Other NGOs' bank accounts have been frozen by the General Prosecutor's office.<sup>43</sup> Human Rights Watch noted, in 2014, that these activities affected CSOs involved in the Extractive Industries Transparency Initiative (EITI) who were forced to suspend their activities. In response, these CSOs have called for Azerbaijan's suspension from the EITI.<sup>44</sup>

### *Institutional Capital*

**121. Natural resource rich economies face specific institutional challenges.** Managing resource rents and the associated political economy and governance challenges, channeling windfalls into accessible and high quality service delivery suggests that natural resource rich economies need to build institutional capital early in their development. Gill et al (2013) suggest that lessons from resource-rich countries that have been successful at developing a diversified asset portfolio are relevant therefore for Azerbaijan. The experience of Canada, Australia, Norway, the UAE, and Chile all highlight the importance of “intangible capitalism” – especially strengthening public service delivery, transparency and accountability, and improving the business environment to facilitate private investment, competition, ownership and growth.

**122. Overall institutional capital in Azerbaijan can improve as measured by international governance indicators.** According to the 2013 Economist Intelligence Unit Democracy Index, Azerbaijan's overall score corresponds to an overall rank of 140 of 167 countries. In the previous year, Azerbaijan ranked 139th of 167, with a slightly higher overall score.<sup>45</sup> Similarly, Freedom

<sup>41</sup> International Center for Not-for-Profit Law, NGO Law Monitor: Azerbaijan. August 5, 2014.

<sup>42</sup> Informant Interview, August 2014

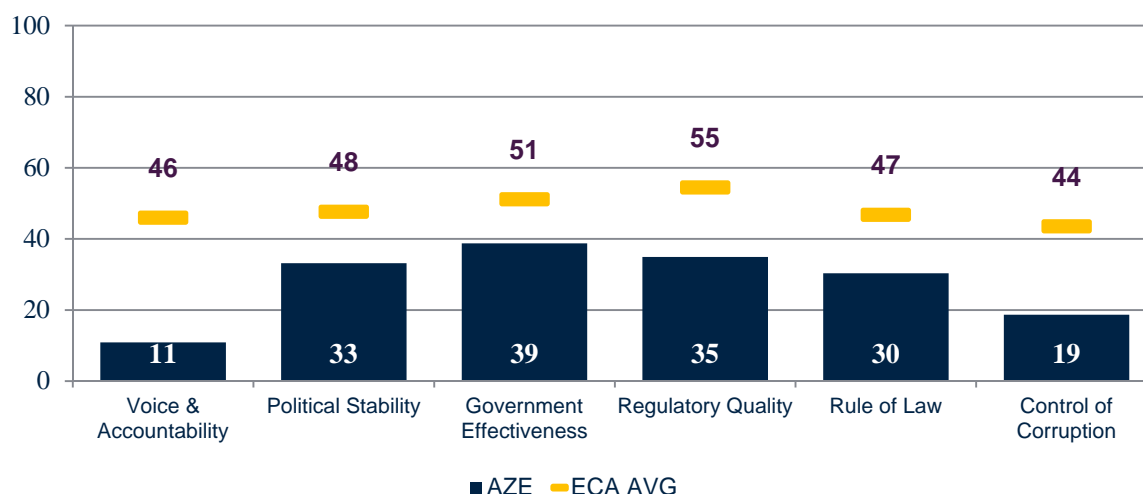
<sup>43</sup> APA. “Seven More NGO Bank Accounts Frozen” August 5, 2014. Available from: <http://en.apa.az/news/214809>

<sup>44</sup> Human Rights Watch. “Azerbaijan: Transparency Group Should Suspend Membership”. August 14, 2014.

<sup>45</sup> Economist Intelligence Unit, 2014. “Democracy Index 2013: Democracy in Limbo”.

House Nations in Transit’s overall democracy score for Azerbaijan has worsened steadily from 5.86 in 2005 to 6.68 in 2014 with the lowest scores seen in electoral process, independent media, national democratic governance, and corruption.<sup>46</sup> The World Governance Indicators (WGI) show that Azerbaijan falls below the ECA average on all indicators, with the largest gaps in voice and accountability, and control of corruption (where Azerbaijan falls in the lowest quintile) (Figure 55).

**Figure 57: World Governance Indicators for Azerbaijan, 2013**



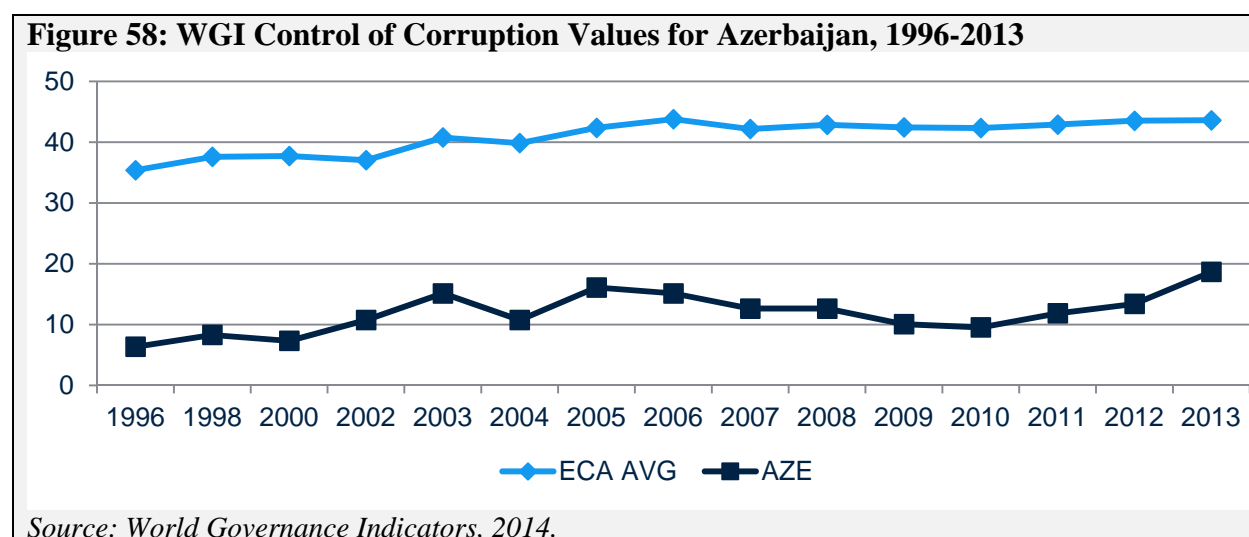
Source: World Governance Indicators, 2014.

**123. Institutional governance in Azerbaijan faces human and technical capacity constraints, policy coordination issues, and lack of accountability.** Weaknesses in governance and capacity seem widespread across ministries, the judiciary, and industrial sectors. The “rules of the game” for coordination are unclear. This leads to higher levels of corruption, limits innovation and entrepreneurship, hindering Azerbaijan’s potential. The issues are not solely within the institutional structures, but also in agency and ministry capacity to implement and enforce laws and regulations. Policy coordination in sectors such as land, food safety, water, and agriculture is hampered by the involvement of multiple ministries with overlapping competencies. One confounding factor is the influence of informal networks: there is a nexus between business and administrative officials, which provides incentives for weak implementation and enforcement.

**124. Gaps in institutional capital have fostered an environment vulnerable to corruption.** Azerbaijan ranks consistently worse in global corruption indicators than peer countries. The country ranks in the lowest quintile on the WGI Control of Corruption indicator. It also ranks in the lowest third of global corruption indices, such as Transparency International, where, in the

<sup>46</sup> Ratings are based on a scale of 1 to 7, with 1 representing the highest level of democratic progress and 7 the lowest. The Democracy Score is an average of ratings for the categories tracked in a given year.

2013 Corruption Perceptions Index, it ranked 127 of 177 countries (the average ranking for ECA countries was 89).



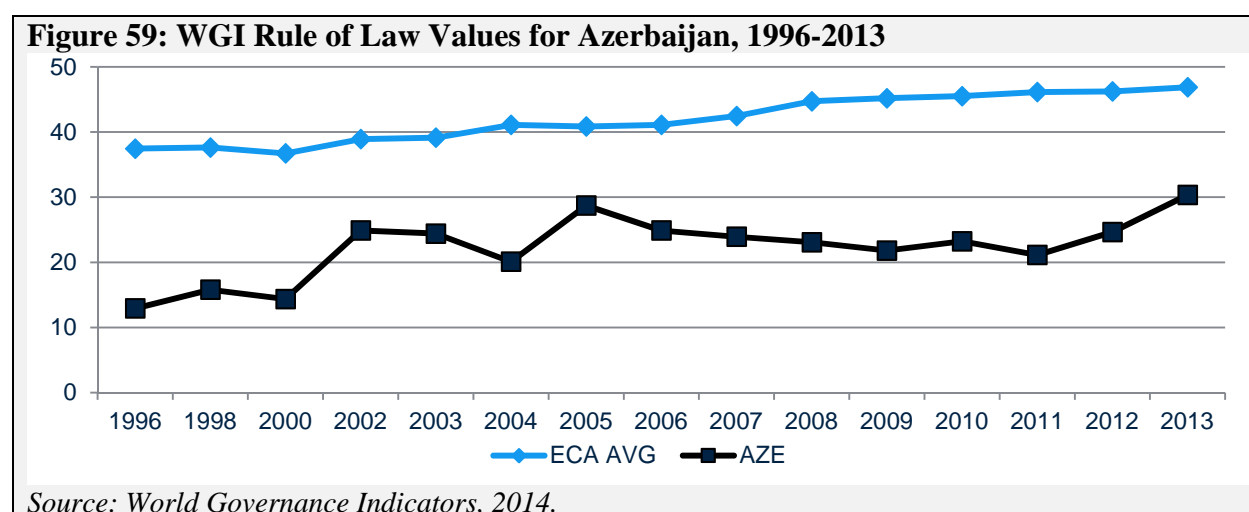
125. **Azerbaijan has a number of key institutions charged with anti-corruption activities, including the Commission on Combating Corruption (CCC), the Anti-Corruption Department of the Prosecutor General’s Office, and the Ministry for Internal Affairs.**<sup>47</sup> Since 2011, Azerbaijan amplified its efforts against corruption, which are beginning to show results. Initiatives launched by presidential decrees to promote enforcement of the National Anti-corruption Plan, include establishment of the ASAN service delivery center, the promotion of the Open Government Partnership, and the smart transport system, which monitors police behavior. The 2013 WGI on Control of Corruption discussed showed improvement in the 2012 ranking, moving from the 13<sup>th</sup> percentile to the 19<sup>th</sup> (Figure 56). Similarly, Azerbaijan improved on the Transparency International Corruption Perception Index, progressing from 143rd in 2011 to 127th in 2013<sup>48</sup> The 2013 Global Corruption Barometer (GCB) shows progress on perceptions of corruption, although a key indicator –on the payment of bribes to access services—is missing due to concerns with the reliability of data. To better track the progress of these government initiatives, it has been recommended that the country implement a M&E system to track the progress of anti-corruption programs. The Istanbul Anti-Corruption Action Plan by the OECD recommended that Azerbaijan put forth more efforts to survey citizens’ corruption perceptions on a regular basis and publicly disseminate the results.<sup>49</sup>

<sup>47</sup> The Anti-Corruption Department was established in response to the Presidential Decree dated 3rd March 2004 on Implementation of the Anti-Corruption Act 2005.

<sup>48</sup> Transparency International, 2014. Comparison across years is for illustrative purposes only as each year the Index may include or exclude certain countries. In 2011, 183 countries were included in the Index vs. only 177 in 2013.

<sup>49</sup> OECD Anti-Corruption Network for Eastern Europe and Central Asia Istanbul Anti-Corruption Action Plan. 2013. Third Round Monitoring Report: Azerbaijan.

126. **One primary aspect of institutional capital fundamental for economic growth and development is the existence of a capable rule of law.** Rule of law in Azerbaijan is weak, and the politicization of the judiciary reduces the effectiveness of checks and balances. Prosecution and judicial decisions are often influenced by political considerations in Azerbaijan.<sup>50</sup> While the country ranks in the top 40 on the World Economic Forum Global Competitiveness Index, on the sub-indicator for judicial independence it ranks 99th of 144.<sup>51</sup> Efforts supported by projects from the World Bank, the EU and the Council of Europe have facilitated the creation and upgrading of courts, the training and evaluation of judges, piloting new information systems, increasing efficiency, improving legal aid and boosting citizens' trust in the judiciary. These efforts have resulted in some improvements on rule of law indicators such as on the WGI. In 2013, Azerbaijan ranked in the 30th percentile on this indicator, up from the 21st percentile in 2011. However, it remains below the ECA average of 47 (Figure 57), and gaps in access to and quality of judicial services remain.



127. **Voice and accountability appear to have worsened in Azerbaijan in recent years relative to peers.** Azerbaijan is weakest on the WGI Voice and Accountability indicator, where it scored in the 11th percentile in 2013, falling from the 14th percentile in 2012. Of ECA countries, Azerbaijan is only ahead of Tajikistan, Belarus, Uzbekistan and Turkmenistan. In a similar line, on the Reporters without Borders Press Freedom Index, Azerbaijan slipped three positions in 2013, falling to 160th of 180 countries.<sup>52</sup>

128. **Governance constraints are also present in terms of accountability and transparency.** Particularly, this is viewed in relation to the low quality of spending, linked to weak accountability of public delivery, lack of voice of certain groups and the importance of connections, as well as the existence of small- and large-scale corruption in public investments and service provision.

<sup>50</sup> Bertelsmann Transformation Index 2014 Azerbaijan Country Report. Page 9.

<sup>51</sup> World Economic Forum Global Competitiveness Report 2014-2015. Page 119.

<sup>52</sup> Reporters Without Borders Press Freedom Index.

129. **Lack of transparency is a widespread issue across government, from the judiciary—as discussed above—to other processes, such as public spending.** On the 2012 Open Budget Index (OBI), Azerbaijan scored 42 out of 100, corresponding to a “some transparency” value. This shows worsening from a score of 37 in 2008<sup>53</sup>, although the Minister of Finance has contested the assessment, arguing that the 2012 score does not reflect the results of recent reforms.<sup>54</sup> Azerbaijan has made significant efforts to improve public financial management (PFM) and public investment management (PIM). The improved budget classifications have increased the amount and quality of budget information available. However, opportunities remain to improve PFM for accountability and transparency, including enhancing participation.

130. **Access to information is the key mechanism for fostering transparency in institutions providing for greater accountability to the citizen and other stakeholders.** Azerbaijan’s Constitution ensures that “everyone is free to look for, acquire, transfer, prepare, and distribute information”.<sup>55</sup> In 2005, Azerbaijan enacted the ‘Law on the Right to Obtain Information’, which elaborates on the right to information and responsibilities of agents and citizens in facilitating information access.<sup>56</sup> Still, access to information has been reported as a major governance constraint by experts and stakeholders. Although some data is available on the Statistical Committee website, there are issues with quality and reliability.

131. **Azerbaijan’s commitment to transparency includes joining the Extractive Industries Transparency Initiative (EITI) and the Open Government Partnership (OGP); although interest appears to be declining.** Both of these memberships imply significant reporting requirements and cooperation with civil society for consultation and coordination. Reports on EITI implementation show limited scope in financial transparency, and thus large scale diversion of funds continues to occur, particularly at stages of the value chain not covered by EITI requirements.<sup>57</sup>

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<sup>53</sup>International Budget Partnership 2012 Azerbaijan Country Info.

<sup>54</sup> Of the eight key budget documents reviewed in the 2012 OBI Survey, Azerbaijan was missing a pre-budget statement that provides information linking government policies and budgets and a citizen’s budget. Azerbaijan has since published a citizen’s budget.

<sup>55</sup> Article 50, the Constitution of the Republic of Azerbaijan.

<sup>56</sup> Law of the Republic of Azerbaijan on Right to Obtain Information.

<sup>57</sup>European Parliament Briefing June 24, 2014. The Extractive Industries Transparency Initiative: State of Play.

#### **Box 6: Membership to the Open Government Partnership (OGP)**

In 2012, the Government of Azerbaijan endorsed its commitment to the OGP. The Open Government Partnership offers a platform for countries to become more transparent, accountable and responsive to their citizenry. Member countries must endorse the Open Government Declaration, which commits them to increase availability of information on government activities, support civic participation, implement highest standards of professional integrity throughout the administrations, and to increase access to new technologies for openness and accountability.

Azerbaijan adopted its first National OGP Action Plan for 2012-2015, endorsed by presidential decree in September of 2012. The OGP Action Plan is linked to Azerbaijan's broader Anti-Corruption strategy, an approach that has worked well in other OGP countries paying large dividends for public service delivery (e.g. Indonesia).

Modest progress has been made in the implementation of the commitments to date. The Plan included 37 commitments focusing on: access to information, improving the Central Legislative Electronic Database, fostering public participation, improving e-services, and increasing transparency in Tax Control and State Financial Control Institutions, and in extractive industries. While these commitments have the potential to enable sustainable and measurable governance impacts, modest progress has been made in implementation. The 2014 Independent Reporting Mechanism indicated that only 6 of 37 commitments were completed. Challenges facing implementation of the OGP commitments include limited awareness of OGP within government, weak coordination with civil society, and absence of strategic milestones for achievement of OGP commitments.

Azerbaijan appears to be having difficulty in meeting some of the requirements for OGP participation. Azerbaijan was late in submitting its self-assessment in 2014. In April 2014, the OGP sent a letter warning the government that it was acting contrary to the expectations of the OGP Articles of Governance, and that if non-compliant for two consecutive action plan cycles, the country's membership would be formally reviewed. Other concerns voiced by civil society refer to limited public consultation and civic participation in the development of the Action Plan. The Independent Review Mechanism Report for 2014 indicated the government only sought input from a small segment of civil society for this action plan and did not include private sector stakeholders. The CSOs that participated in consultations were provided with limited information on the government's plans and timelines, as confirmed by civil society sources.

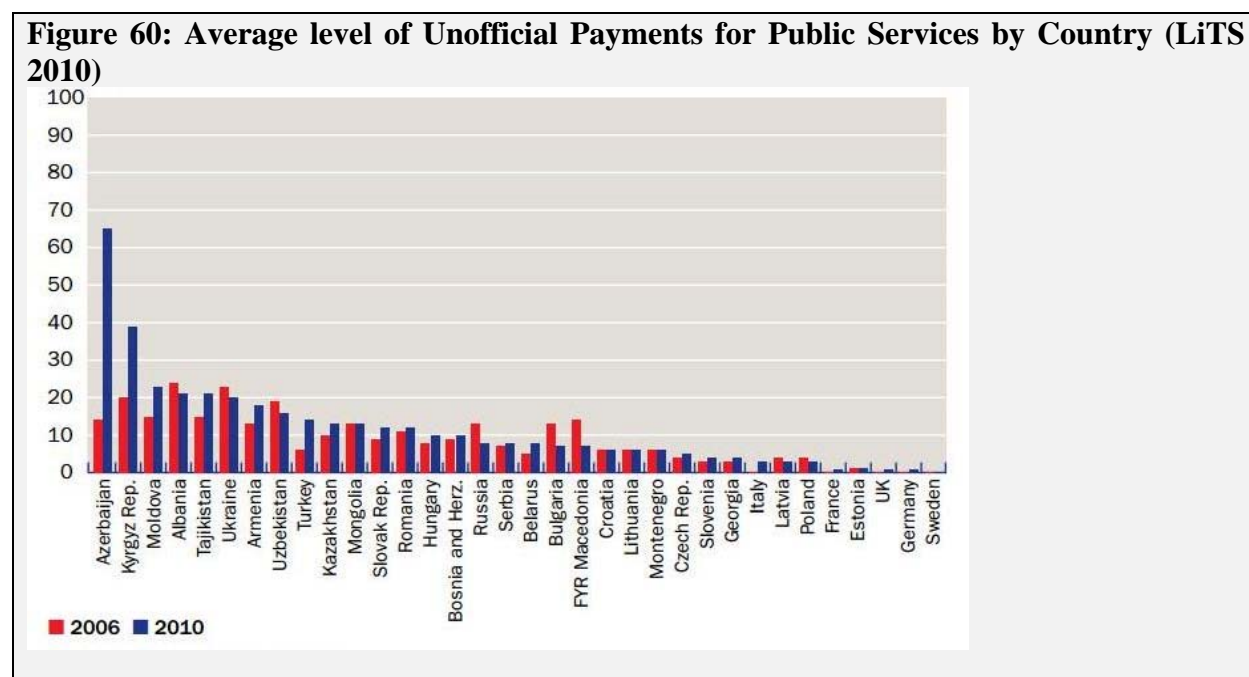
Without participation from citizens, civil society, academia and other stakeholders, and developing a demand for and use of available data and information, there is the risk of not achieving the intended objective of improving government performance and service delivery for citizens. By revising and creating additional commitments under its Action Plan to raise awareness, identify local government focal points to create a reform network for OGP, and reaching out to civil society, Azerbaijan could leverage its OGP commitments to improve service delivery, transparency, and accountability at both the central and local levels.

*Sources: <http://www.opengovpartnership.org/about/open-government-declaration>; Open Government Partnership. Official Communication from the Open Government Partnership Support Unit. April 30, 2014.*

**132. Public service delivery, including petty corruption to access services, appears as a challenging area for Azerbaijan vis-à-vis comparable countries, though it has improved in**



**recent years.** The 2010 Life in Transition Survey (LiTS) shows that Azerbaijan is the only country (out of the 34 surveyed) where citizen satisfaction with service delivery for most public services declined from 2006 onward.<sup>58</sup> On the other hand, petty corruption, in the form of informal payments, has been on the rise since 2006. The LiTS showed that in 2010, Azerbaijan had the highest percentage of respondents stating that unofficial payments or gifts are necessary to access public services, over 60 percent—a dramatic increase from 14 percent in 2006 (Figure 46). These increases were spread evenly across services, with the highest rates seen in public health, road police, and vocational education. The 2010-11 Global Corruption Barometer showed that 42 percent of respondents stated paying a bribe to access services.<sup>59</sup>



133. **Azerbaijan has taken steps to adopt good practices in bureaucratic service delivery—such as The Azerbaijani Service and Assessment Network (ASAN Service)—with positive results.** Presidential decrees have mandated national-level efforts, including ICT development, electronic access to services, mobile service delivery units, improvement of courts’ functioning and the establishment of special agencies to overcome service delivery inefficiencies. One such agency is the State Agency for Public Services and Social Innovations which manages ASAN Service centers, “one-stop shops” for citizens to access a number of public and private services, designed to reduce contact points and provide efficient services to citizens without the risk of corruption. Anecdotal evidence from citizens, private sector representatives, civil society and donors show that the ASAN initiative has changed the way citizens in Baku and the regions access services, with positive perceptions.

<sup>58</sup> European Bank for Reconstruction and Development. 2010. “Life in Transition: After the Crisis”. p.35. The survey looks at almost 39,000 households in 34 countries in Central and Eastern Europe and Central Asia.

<sup>59</sup> Transparency International Global Corruption Index, 2010.

### **Box 7: ASAN Easy services: Expanding Reach of Public Services**

In 2013, a new mechanism for service delivery, the Azerbaijani Service and Assessment Network (ASAN) Easy Service Center was introduced in Azerbaijan, based on the ‘one-stop shop’ principle. Established by Presidential decree in 2012, these centers were designed with three objectives: to improve relations between government and citizens; to apply IT innovations to remove subjectivity; and to reduce corruption and “negative momentum” of government/citizen relations.

The ASAN centers provide an example of how competition in service provision can benefit citizens. The services provided under the umbrella of ASAN are provided by representatives of relevant managing authorities (ministries and agencies), and citizens can access services through either the ASAN or by going to the ministry directly. The cost to the citizen is the same, although, for certain services, citizens can pay an additional fee to expedite their transaction for some processes (such as passports). The costs are posted on the ASAN website for all transactions and fees are paid through the bank to remove the potential for informal payments. ASAN retains 30 percent of all fees for services, which is used for merit and performance bonuses for staff, while the remainder goes to the relevant ministry.

There are eight ASAN service centers, four in Baku and four in the regional cities of Sumgait, Ganja, Sabirabad and Barda, in addition to the mobile bus services that travel to the more remote areas. Since January 2013, the ASAN Service centers have served nearly 5 million citizens, averaging 2500 applications per day per center.

The citizens appear to be very satisfied with the quality and variety of services rendered. ASAN offers a myriad of feedback mechanisms for citizens to provide inputs on access and quality of services received at the centers and mobile units. These include a video-chat booth in the ASAN centers, a point of service survey via touchscreen when leaving the ASAN center, a call center, and web-based mechanisms on their home page.

Informal interviews with citizens have highlighted a few concerns including limited information available from the ASAN staff about other ASAN services (the physical centers have volunteers who provide general assistance) and shortcomings in the feedback system and complaint handling.

Citizen feedback on the mobile unit in Shamakhi focused on the issue of capacity: demand for services is higher than supply as the buses visit each district only once per year. Those interviewed stated they do not have time to wait so they prefer to use the traditional services and apply to the local branch of the ministry instead. But of those accessing services, many stated that the mobile unit saves them time and effort, as they would otherwise drive 82 kilometers to Sumgayit or 120 kilometers to Baku to complete their processes. Common complaints were that the mobile unit staff very often refused to provide certain services and directed them to other service providers.

The ASAN representatives interviewed outlined additional needs to increase the scope and efficiency of ASAN services, including additional buses to expand access to services, additional training needs, support for the call center and additional software to track and analyze data. The World Bank is developing a project to support the ASAN service centers and expand their reach to assist Azerbaijan in providing more efficient and inclusive service delivery.

*Sources: World Bank Staff*

134. **However, Azerbaijan continues to face a number of constraints that impact service delivery including weak institutional capacity and coordination, limited budget transparency, and limited citizen voice.** Weak institutional coordination leads to gaps in implementation and monitoring. Downward accountability to the citizen is missing due to limited voice, and a weak and fragmented civil society. Budget transparency limits accountability, as it is unclear how decisions are made on spending, what the efficiency ratio of spending is or internal rates of return. Another issue for service delivery is that there is no culture or capacity for measuring service delivery, efficiency, and satisfaction which is key to closing the feedback loop between the citizen and government. As a result, the government is unable to discern if there are gaps in service access, or disparities in quality of services, and if services are being provided inclusively.

135. **While there is interest in reforming certain areas of governance, changes have been driven mostly from the top-down.** In Azerbaijan, the culture of administrative autonomy, accountability or empowerment in the public administration is scarce. In some sectors, there is a reticence to implement reforms at the middle and lower levels due to lack of incentives. In addition, lower-level bureaucrats are not empowered to make decisions and solve problems. Experts note that a systemic view of government—where ministries, agencies, management and frontline staff work together to coordinate and implement policy in an effective and efficient way—is lacking. Moreover, as discussed above, frontline staff is not held accountable by the citizen, as there is no regular practice of collecting citizen feedback. The citizen has limited power if voice and participation is constrained, impacting the development of social and institutional capital. We will return to this in greater detail in the next section, when we discuss the constraints on addressing the “bottom up” challenges.

136. **Moreover, public spending is not aligned with development needs in a clear manner because of limited empowerment of local government.** Per capita spending levels of local executive authorities on average doubled compared 2013 to 2006. Lankaran, which was poorest among regions in terms of output per capita also has the lowest per capita spending, raising concerns about the identification and execution of public projects. Except Absheron all regions rely largely on transfers from the Central Government to sustain spending levels. Absheron made significant progress towards collecting local revenue and in 2013 transfers from the state budget accounted for only 4 percent of spending compared to over 60 percent in 2007. A part of the problem is that institutional arrangements for empowering municipalities are not in place in terms of revenue sharing. Municipal elections have been held regularly since 2000; however municipalities lack resources for assuming leadership of regional development because of the absence of mechanisms for revenue collection and coordination between municipalities and executive authority of the rayons. The Central government finances both the executive authorities of the rayons directly through transfers and also provides funds through the line ministries. The executive authorities also raise revenue locally. However, a more effective system of public

spending in the regions is needed, empowering municipalities and their engagement in the provision of public goods and services at the local level. Currently, tax collection mechanisms are not well developed at the local level and municipalities end up with only marginal collections.

## SUB-SECTION REVIEW AND KEY EMERGING PRIORITIES

### Challenge I: Strategic use of oil rents for asset diversification

*Looking forward to the medium-run, annual GDP growth is likely to remain well below 3 percent, with oil GDP shrinking and the non-oil sector unable to accelerate without significantly strengthened competitiveness in the face of slower public expenditures. Deteriorating fiscal trends suggest that the high and pro-cyclical public spending that drove growth in the past is not sustainable. Rather, the experience of other resource-rich developers suggests that managing oil revenues to support the accumulation of a diverse portfolio of assets, namely built capital – both human and physical – and institutional capital is the only means to ensuring stable, sustainable, and shared growth. Azerbaijan has made progress on institutional asset accumulation – for example through efforts to accumulate reserves in SOFAZ, the state oil fund, to modernize the judicial system and to provide a one-stop-shop for several kinds of public services – but there is a significant pending agenda to be addressed. In particular, addressing the infrastructure deficit efficiently while strengthening focus on human capital accumulation will be essential if conditions are to be created for greater geographic and demographic inclusion. Ultimately this asset diversification is also the best way to ensure at the macro level that oil wealth is shared with future generations.*

*Asset diversification will only be possible with strategic use of oil rents through effective fiscal management. The deterioration in fiscal trends implies two immediate priorities: (i) creating fiscal space through efficient public spending, particularly investment, which is performance-oriented and prioritized based on transparent monitoring, information sharing, and impact evaluation; and (ii) strengthening governance by building credible and accountable institutions with the capacity to enforce fiscal rules and a medium term fiscal framework while planning for sustainability. This will allow effective fiscal management directed at macroeconomic stabilization and economic efficiency, and will ensure the channeling of public expenditures towards the provision of accessible and quality infrastructure and social services. Currently the State Oil Fund is mainly a stabilization fund and source of transfers to the state budget, which satisfies part of the requirements of fiscal responsibility but is not sufficient to ensure that oil wealth is genuinely shared with future generations or put to best use. For this it needs to be complemented by institutions that will ensure sound governance and strategic and transparent fiscal planning, prioritization and execution.*

#### Key Emerging Priorities

- **Enhanced governance of the State Oil Fund.** Review and revise governance of SOFAZ to further strengthen its capacity to implement a revised fiscal rule and resist political pressure that may jeopardize fiscal sustainability in the longer run.
- **Focus on diversification of endowments, in particular human capital.** This will call for an increase in public expenditures on education and health, along with adequate safeguards to ensure efficiency. Education policy should focus on quality improvement at secondary level and strengthened access and

coverage at tertiary level. Health policy should focus on risk pooling and reforms to support autonomy, standards and quality.

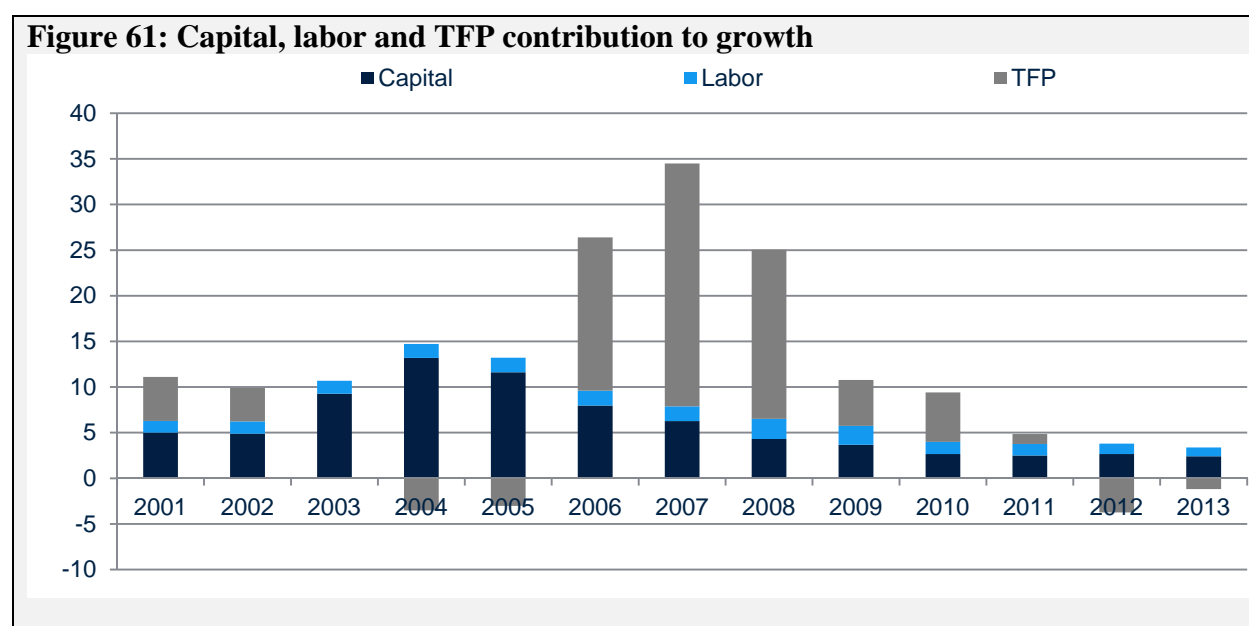
- **Institutional reforms at a more decentralized level.** Bold reforms are needed in the area of local public management including shifting more functionality and responsibility to the municipalities. Municipalities lack resources and authority to be engaged in the provision of public goods.
- **Continued investment in key public services** such as irrigation and roads infrastructure, housing, water and sanitation, and social services. Public spending realignment to focus on regional development is critical.
- **Enhanced governance to promote environmental sustainability.** In particular, reform policies should focus on addressing landscape degradation, desertification, waste water treatment, and poor quality of drinking water in rural areas as well as secondary and tertiary towns.
- **Enhanced accountability and governance of public service delivery programs.** This would call for completing the roll-out, review, and evaluation of ASAN. Moreover, this would require instruments such as monitoring and information systems and impact evaluations that would allow for more efficient allocation of resources and the delivery of high quality services.
- **Capacity building and autonomy of the judiciary.** A level playing field is essential for building a business environment capable of promoting private investment and fostering competition. It is the basis for the enforcement of property rights and a lower concentration of ownership in financial, manufacturing and key service sectors. Without a boarder application of rule of law, all other reforms may have a limited impact.

### 3.2 Challenge 2: Unleashing productivity growth for greater economic competitiveness

137. **Oil has served Azerbaijan well but to get to the next stage – i.e. escape the middle income trap and achieve the development outcomes consistent with upper income status, there needs to be a re-balancing of drivers to include private sector led employment growth.** Non-oil sector growth has been positive but below its potential due to a combination of institutional and economic factors that hinder firm and productivity growth, and ultimately formal employment creation. Unleashing this growth across sectors– including in agriculture – will be critical for sustained progressed. Firms and farms need to be able to emerge, grow, innovate, and compete globally to create more and better jobs for all. All of this however, is of course dependent of the accumulation of the assets described above.

138. **In this context it is especially worrying that productivity growth – essential for determining growth prospects and job creation in the long term – has slowed down**

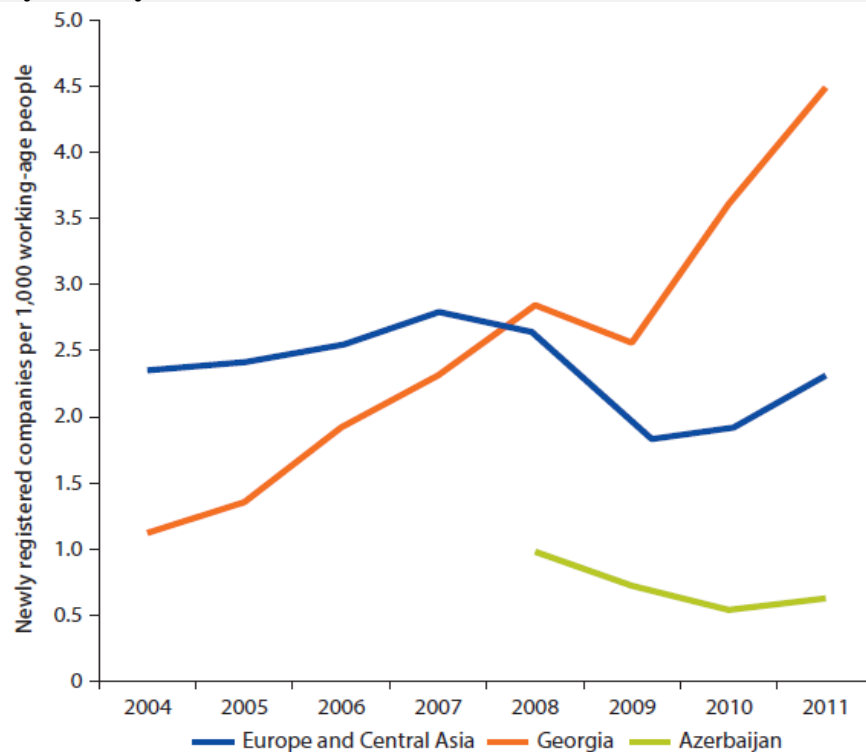
**substantially in recent years.** There was a burst of oil related FDI inflows during the initial years of oil production which raised both capital and total factor productivity (TFP) levels (Figure 23). Declining productivity in recent years is likely because of limited investments in human capital, and in research and development, and limited inflows of foreign capital because of various reasons. In addition, the agricultural sector, which employs a sizeable share of the population and is Azerbaijan’s traditional comparative advantage, has seen limited improvements in productivity levels mainly because of inadequate access to agricultural services (extension, animal health) and improved technologies, poorly functioning irrigation and drainage systems, undeveloped value chains, weak rural connectivity and limited access to finance. Another challenge is soil erosion and land degradation, which affects resources on which the bottom 40 are heavily reliant and which could lead to excessive exploitation of pastures and forests. Water pollution is a challenge to productivity growth in the fisheries sector and is a significant health hazard with high adverse potential impact on affected populations’ productivity.



139. **Low productivity growth is partially because intra-industry dynamics or “churning”—the entry of new firms, the growth of productive firms, and shrinkage/exit of unproductive firms—is not working to its potential in Azerbaijan.** For instance, it does not seem to be the case that labor reallocation across sectors is in line with productivity growth. Ideally, employment should shift towards sectors experiencing faster productivity growth. During 2005-09 for example, the sectors with the largest relative improvement in productivity were mining (oil), health services, and financial services. Of these, only the financial sector’s labor share increased during the period covered. Most of the increase in labor share occurred in the sectors that exhibited productivity stagnation (trade services) or losses (manufacturing and construction) relative to the average (Onder, 2013). A recent World Bank study of entrepreneurship in Azerbaijan shows that a low rate of firm entry is another major concern (Kuriakose, ed., 2013). Azerbaijan’s “entry

density”, the number of newly registered companies per 1,000 working-age (ages 15–64) persons, is less than half of the ECA average, and does not seem to be increasing.<sup>60</sup>

**Figure 62: Entry Density of New Firms**



Source: World Bank Entrepreneurship database 2012a. Note: Entry density for ECA is calculated with population-weighted averages for working age (ages 15-64) population, using data from World Bank (2013). Averages are based on countries with full data coverage for 2004-11.

<sup>60</sup> Source: World Entrepreneurship Database, the World Bank Group. The database does not account for informal firms and measures only private, formal companies with limited liability.

## **Box 8: Unleashing Productivity Growth**

### **Facilitating business environment**

- While Azerbaijan has instituted significant business climate reforms in recent years, there is evidence that some parts of the regulatory and tax regime continue to hurt incentives for entry and expansion in the private sector. The government's tax policies on SMEs reduce incentives to hire more workers, and instead create an incentive to remain small and informal. Transitioning from a special regime intended for MSMEs to the "regular" tax regime is costly. Not surprisingly, firms reportedly split their operations into smaller segments to be able to continue hiding under the STR. High direct taxation of labor, in combination with weak enforcement, also fosters informal employment. The regulatory reforms undertaken in recent years have succeeded in streamlining of business registration. However, the regulation of licensing and permits still requires reforms, given the absence of a uniform system for issuing licenses, permits, and approvals.
- Efforts to improve the business climate should also address the issue of limited competition. The government, together with international donors such as the USAID, has been working to draft a unified competition code conforming to international best practices, and to build an independent antimonopoly agency.
- Access to finance of the bottom 40 could be improved through a comprehensive reform effort. High collateral requirements are one bottleneck. Owner's personal assets and other moveable (cars) and immovable property are usually the most commonly required collateral types. Many banks prefer real estate for collateral, and in the absence of efficient secured transactions framework for movable assets, with a viable registry real time on line registry of security interests for movable assets, don't use movable assets (such as accounts receivable, inventory). Building MSMEs capacity to keep financial records and plan for future cash needs, prepare financial statements and business plans would also be critical. or borrowing. Strengthened equity and debt financing and the development of longer term financial instruments would help. Expanding development of new financial products and credit infrastructure, including leases, letters of credit and guarantees would also support financial access. Future development of the mortgage market in the environment of lower fiscal space will require more commercial based lending and refinancing, with competitive interest rates and attractive capital markets instruments for external and domestic investors (to mobilize private savings and attract investors). Underdeveloped or non-existing credit infrastructure significantly inflates lending risks and results in higher cost of lending. Reforms launched by the Government in the area of credit reporting and credit information sharing as well as secured transactions reform are still pending.

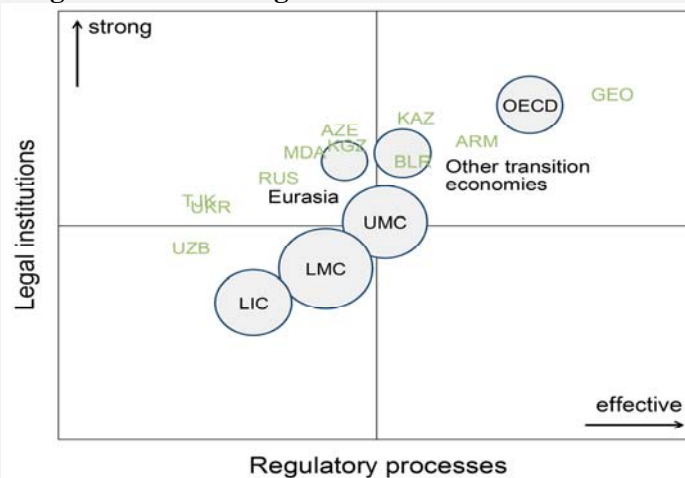
### **Trade policy and logistics**

- Reforms to promote a competitive enterprise sector must be accompanied by efforts to improve access to international markets that address the regulatory and logistical barriers that exporting and importing firms still face. Azeri exporters and importers face higher transaction costs due to weaknesses in Azerbaijan's trade facilitation infrastructure. Azerbaijan's Logistics Performance Indicator (LPI) is below that of most other CIS economies, and lower than the average for the Europe and Central Asia region. This is mainly due to the higher costs of local logistics: transportation, terminal handling, and warehousing; timeliness of shipments in reaching destinations; and direct freight costs. Further, Azeri exporters also are at a disadvantage relative to firms in WTO member countries as their access to foreign markets is not regulated by the multilateral trade agreements that form the basis of the WTO.
- Customs reforms are urgently needed. Large discrepancies between the data on exports to Azerbaijan, as reported by partners, and those on imports registered at Customs indicate substantive unreported imports, implying that some Azeri imports receives differential treatment, due to either smuggling or collusion between importers and border authorities. Some importers also appear to get additional differential treatment—VAT and duty exemption status. Thus, more transparency and uniformity in customs regulation is needed.



140. **Most developed economies regulate firm behavior to ensure ease of entry and exit.** However, in less developed economies, government actions play a large role in restricting entry and competition. Barriers to competition may stem from various sources. One is government regulations: cumbersome procedures deter smaller market entrants into the formal sector. An examination of 49 Latin American, OECD, and FSU countries found that economic regulations increased the size of the informal sector. If labor market regulations make it difficult to lay off workers, or restitution laws impede land transactions, firm exit and hence entry may be deterred. A second source may be rigidity in capital markets or the monopolization of the banking sector as these could potentially limit access to finance resulting in lower competition. A third source is restrictions on international trade. The share of imports in GDP, for example, is found to be inversely correlated with price-cost mark-ups. International competition promotes productivity growth to a greater extent than local competition and pushes competitiveness-enhancing institutional reforms to the forefront of developing country agendas. Finally, “abuse of dominance” is possible, which in OECD economies may stem from controls on research and development, but in smaller economies can arise from state-capture - i.e., key government policies or institutions tend to follow private rather than the common interest.

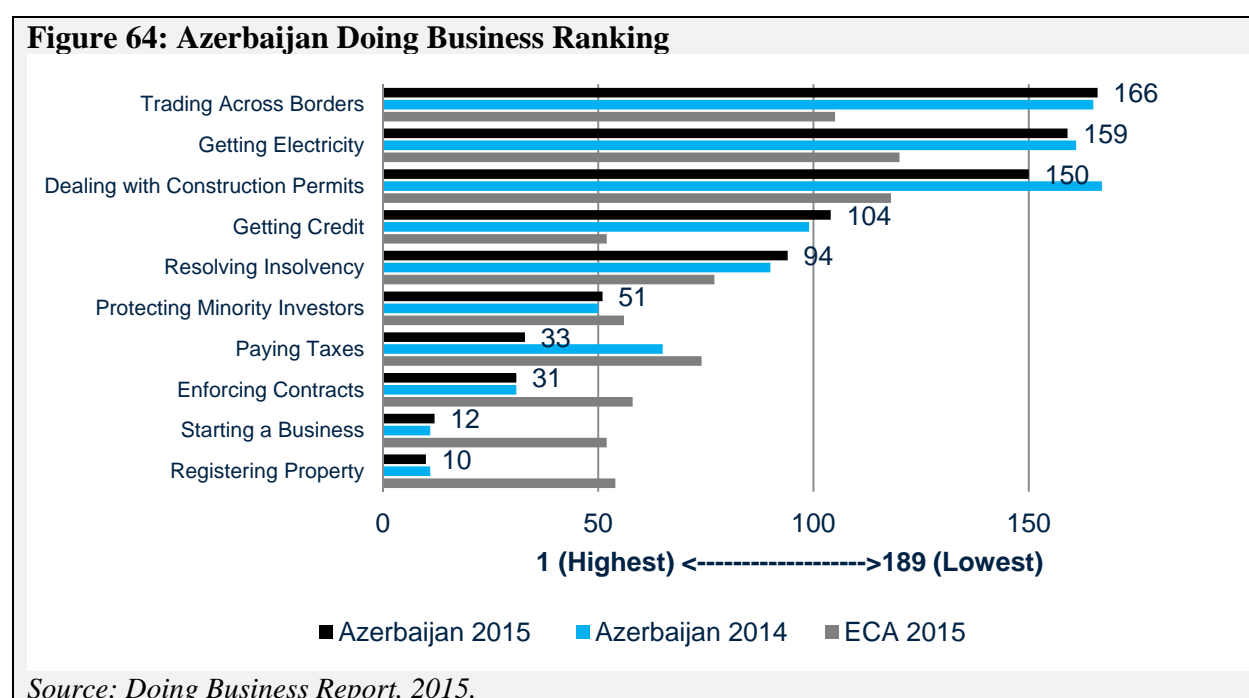
**Figure 63: Azerbaijan lags on Effective Regulation**



Source: Gill et al (2013).

141. **Azerbaijan ranks 80th among 189 countries in the 2015 Doing Business Report, compared to the ECA average of 68th.** While the country has moved up eight ranks since 2013/14, and is one the 10 economies that have improved the most across three or more areas, significant outstanding challenges remain in the business environment. Azerbaijan continues to rank extremely low in measures related to dealing with construction permits, obtaining electricity services and trading across borders—even compared to the relatively low average for ECA

countries. On nearly all of these sub-indicators, Azerbaijan ranks below the ECA average and well below that of the OECD. In contrast, Azerbaijan ranks very highly and above the ECA average on issues related to registering property and starting a business. The country also saw a strong improvement in its ranking for paying taxes, which was accompanied by the introduction of an electronic system for filing and paying social insurance contributions to facilitate the process for companies. The 2013 Business Enterprise Survey in Azerbaijan also confirms the challenges faced by entrepreneurs relate mainly to corruption, trade, and innovation. In the ‘Entrepreneurship Survey’, —conducted by the World Bank in 2012 for 300 firms established between 2002-2010 in non-oil manufacturing and services—access to finance was identified as one of the largest obstacles to entrepreneurship along with difficulty in finding business partners, complex bankruptcy regimes, high tax rates and changing taxation regulations.

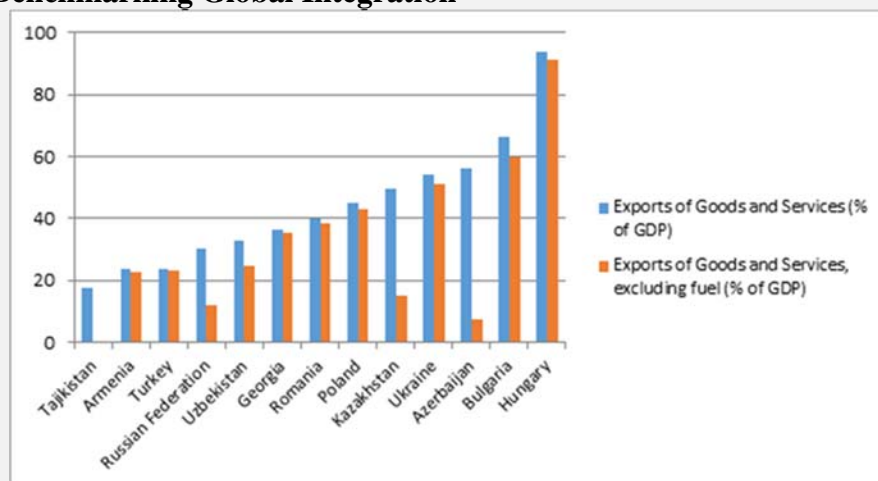


142. A measure of the extent to which business perceives the economic environment as facilitating is the pool of potential or “latent” entrepreneurs—those who are not actual entrepreneurs but want to be. Data from the 2010 Life in Transition Survey suggest that Azerbaijan compares unfavorably with other ECA countries along this dimension. Only about 10 percent of the labor force and 5 percent of the wage-employed can be considered latent entrepreneurs, far below the ECA average of 27 percent of the labor force and 22 percent of the wage-employed. There is also some evidence that the survival rate of new firms is low. According to the survey, only about a third of those who attempted to start a business succeeded in Azerbaijan compared to about two-thirds in the ECA region as a whole (Kuriakose, ed., 2013). Perhaps not surprisingly, Azerbaijan has a relatively small private sector. For instance, of the 106 countries included in the IFC database of micro, small and medium enterprises (MSMEs), Azerbaijan ranked

a low 81 in the number of MSMEs per 1,000 people in 2008. In 2006, the state sector accounted for 32 percent of total employment (World Bank, 2009).

143. **Trade integration is however limited in comparison to other countries of the region, suggesting that a significant channel towards strengthened competition, scaling up and modernization has not been exploited.** Azerbaijan's economy is also characterized by limited competition between firms. For instance, there is large gap between farm gate and retail prices for agricultural products, which could be due to the small number of wholesalers in regional markets, local monopolists and undeveloped cooperation between producers and other actors in agro-food value chains. In the oil sector, Azerbaijan maintains a full range of downstream activities, but these are dominated by state-owned firms (SOEs) and there is little effective competition (Onder, 2013). This limited competition extends to weak integration with global markets. The small domestic market in Azerbaijan requires private sector companies to be able to tap the regional export market to achieve economies of scale. However, tensions with Armenia and a conflict in the region limit Azerbaijan's trade potential with its neighbors. According to data from the 2013 Enterprise Survey, only two percent of firms export directly or indirectly, compared to 18 percent on average in ECA—with less than 9 percent of inputs being of foreign origin. Survey results show that Azerbaijan's economy is very domestically oriented, with over 99 percent of total annual sales being accounted for in the domestic market. Over 15 percent of these domestic sales were accounted for by government or public agencies; compared to an average of 11 percent for ECA countries.

**Figure 65: Benchmarking Global Integration**



144. **Weaknesses in the trade enabling environment and a complex political geography limit the prospects of improving global integration.** Difficulties in processes increase the cost of trading to a significant extent for Azerbaijan. The cost of exporting a container from Azerbaijan is 3.4 times that from Turkey for example and it takes 4 times longer to export from Azerbaijan

than from Georgia. Similarly, despite recent reforms implemented to streamline internal customs processes, importing or exporting a standard container of goods still requires at least nine steps, takes almost a month, and costs over \$US 3400.

<b>Table 2: Trading Across Borders Sub-Indicators, Doing Business 2015</b>			
Indicator	Azerbaijan	Europe & Central Asia	OECD
Documents to export (number)	9	7	4
Time to export (days)	27	23.6	10.5
Cost to export (US\$ per container)	3,460.00	2,154.50	1,080.30
Cost to export (deflated US\$ per container)	3,460.00	2,154.50	1,080.30
Documents to import (number)	11	8	4
Time to import (days)	25	25.9	9.6
Cost to import (US\$ per container)	3,450.00	2,435.90	1,100.40
Cost to import (deflated US\$ per container)	3,450.00	2,435.90	1,100.40

*Source: Doing Business Report, 2015.*

145. **Being a small economy, integration with international markets is critical to the growth of local firms.** Azerbaijan's wages have been growing faster than productivity, making it difficult for firms to compete internationally. As highlighted in a recent analysis conducted by the World Bank, although the contribution of productivity to growth has increased in recent years, this is mostly due to productivity growth in the oil sector (Onder, 2013). In 2009, when productivity growth within the oil sector plummeted, total labor productivity experienced negative growth. Hence, the growth strategy should be about creating conditions that enable the growth of productive, competitive firms and on easing trade. Beside access to new market opportunities, greater openness to trade and competition can affect shared prosperity by improved access to/cheaper prices for goods consumed by the bottom 40, and by improved access to imported inputs. The latter is increasingly significant to competitiveness in view of the growing importance of international value chains in production.

146. **Access to finance, especially for small and medium enterprises (SMEs) and new firms, remains limited and financial outreach in the rural areas needs to be enhanced.** Lending to SMEs has grown recently, in response to the Central Bank of the Republic of Azerbaijan's (CBAR) efforts to promote real sector growth and limitations on banks' rapidly growing consumer lending. Still, SMEs lending remains constrained by a number of factors, first of all high cost of loans and collateral requirements. On the other hand, non-transparent reporting of firms or absence of reliable financial statements, along with low financial capability of firms in the absence of proper secured transactions and credit reporting framework increase lenders' credit risks and result in higher costs to borrowers.

147. **Overall use of credit products remains very low, especially by smaller enterprises, which hampers productivity growth.** Available credit reportedly tends to be heavily concentrated towards larger and well-established firms, while smaller and young businesses rely upon self-financing and limited funding from financial institutions. SMEs identify access to finance to be one of the top constraints to private sector growth. A robust, deep and stable financial sector, with diverse products and portfolio is essential for boosting investment, private sector growth and job creation. While 71.4 percent of enterprises have bank accounts, only 15.4 percent of enterprises have outstanding loans or lines of credit (although 17.3 percent of smaller businesses have personal consumer loans with banks for business purposes), and only 6 percent have bank deposits. Close to three quarters of MSMEs have never applied for a loan. Banks are the predominant source of loan financing for MSMEs (97.4 percent), as non-bank lending is small. While many oil and state owned (usually larger firms) have access to external markets, government funding or capital markets, majority of micro, small and medium enterprises, especially in such sectors as agriculture, construction, manufacturing, lack access to working capital and longer term finance for modernization and scaling up. High lending rates are also a problem.

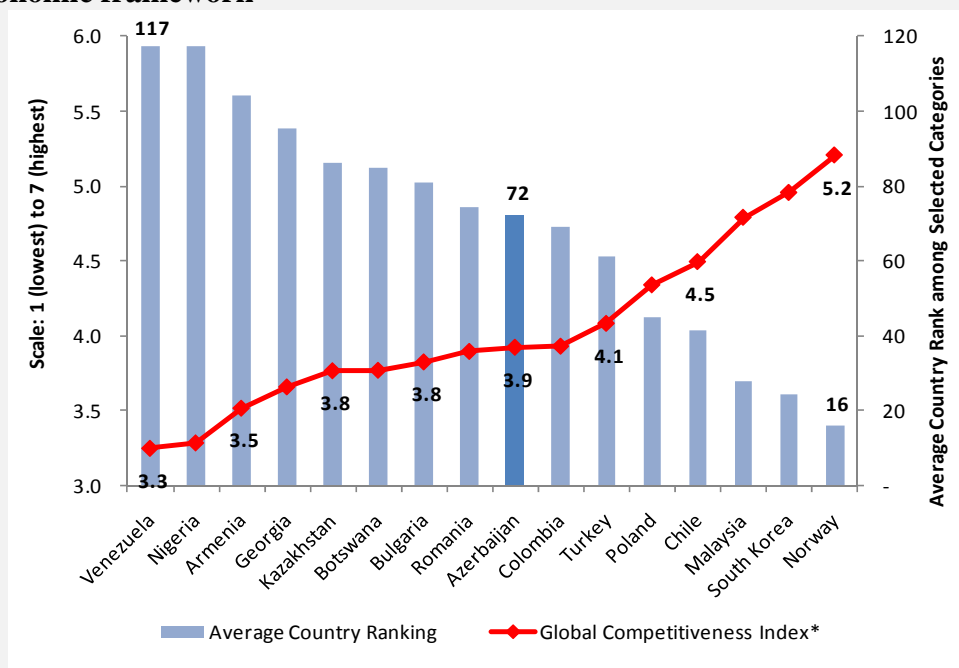
<b>Table 3: Manufacturing Firms Financial Access, Enterprise Survey 2013</b>				
<b>Indicator</b>	<b>Azerbaijan</b>	<b>Georgia</b>	<b>ECA</b>	<b>World</b>
Percent of firms with a checking or savings account	69.8	94.2	88.2	88.4
Percent of firms with a bank loan/line of credit	14.5	35.7	36.7	35.5
Percent of firms whose recent loan application was rejected	21	4.5	8.8	11.7
Percent of firms using banks to finance purchases of fixed assets.	27.6	22	26	25.9
Proportion of purchases of fixed assets that was financed from internal funds/retained earnings (%).	77	75.2	73.6	71.5
Percent of firms using banks to finance working capital.	15.9	27.6	31	31.1
Percent of firms identifying access to finance as a major constraint.	21.2	18.3	16.8	28.7
<i>Source: Enterprise Survey 2013,</i> <a href="http://www.enterprisesurveys.org/data/exploreeconomies/2013/azerbaijan">http://www.enterprisesurveys.org/data/exploreeconomies/2013/azerbaijan</a> .				

### *Innovation and skills*

148. **Innovation and will be critical for helping develop export competitiveness – a driver of productivity.** Competition has long been acknowledged as an important force for bringing about economic development and growth. A number of studies have found that competition

improves both firm productivity levels and productivity growth<sup>61</sup> in several ways: by promoting equal opportunity, providing managers with incentives for increasing efficiency, and encouraging innovation and better use capacity. In transition economies in particular, competition has been found to lead to greater innovation, especially through the introduction of new products. Competitive markets may also generate incentives to improve institutional quality and thereby promote an investment friendly business environment: by contrast, if the market consists of a few firms engaged in a small number of transactions, the marginal benefit of reducing transactions costs and improving efficiency may be small.

**Figure 66: Low ranking on Global Competitiveness Index after adjusting for macroeconomic framework**



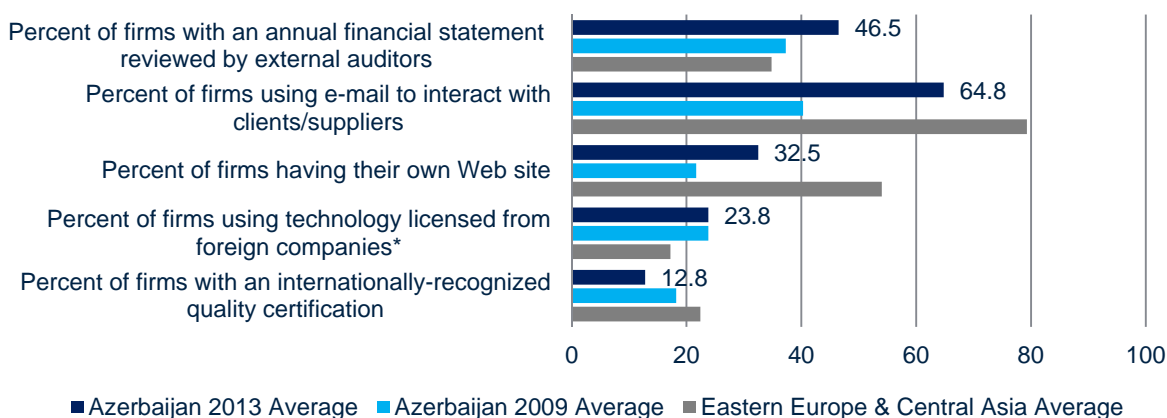
*\*The Global Competitiveness Index has been re-computed without the macroeconomic environment dimension. The calculation of the country ranking follows the same criteria. Source: Global Competitiveness Index, 2011.*

**149. Innovation by firms is a critical source of productivity growth which remains a challenge in Azerbaijan.** A survey of new and young firms in Azerbaijan, the 2012 World Bank Entrepreneurship Survey, suggests that they undertake little innovative activity (Kuriakose, ed., 2013). The majority (97 percent) of surveyed firms had no research and development (R&D)

<sup>61</sup> For Section II A, See Vickers, John, "Concepts of Competition," Oxford Economic Papers, Oxford University Press, vol. 47(1), pages 1-23, 1995; Nickell, Stephen J. "Competition and Corporate Performance." Journal of political Economy 104 (4), 1996: 724-46; World Bank 2002; Baily, Martin Neil, and Hans Gersbach, "Efficiency in Manufacturing and the Need for Global Competition." Brookings papers on Economic Activity, 1995; Djankov, Simeon, and Peter Murrell. "Enterprise Restructuring in Transition: A Quantitative Survey." Journal of Economic Literature, 2002; Porter, Michael. "The Competitive Advantage of Nations." New York, 1990; Porter, Michael, and Mariko Sakakibara. "Competing at Home to Win Abroad; Evidence from Japanese Industry." Review of Economics and Statistics, 2001; EBRD Transition Report, EBRD 1999; Schneider, Friedrich, and Dominik H Enste. "Shadow Economies: Size, Causes and Consequences." Journal of Economic Literature 38, 2000: 77-114; Hoekman, Bernard, Hiau Looi Kee, and Marcelo Olarreaga. Markups, Entry Regulation and Trade: Does Country size Matter? World Bank, 2002.

expenditures in the previous five years, and did not envision spending on R&D in the next two years.<sup>62</sup> Only 12 percent of the respondents indicated that they had introduced a new or substantially improved product or service in the previous three years. Azeri firms also score low on indicators of external competitiveness. For instance, only 7 percent of the firms surveyed in the survey sold their products in international markets. Among firms that reported an innovation, the main objective behind introducing a new product or service was to diversify the firm's product mix for the domestic market. Increasing foreign sales was not cited by any of them as an important objective. Moreover, while increasing numbers of firms are using technology such as email and websites to interact with clients, these rates remain well below the ECA average.

**Figure 67: Innovation and Technology Enterprise Survey Sub-Indicators**



*Source: Enterprise Surveys, the World Bank.*

150. **Human capital is central for driving innovation, but there is a key distortion related to the skill mismatches supplied by the education system and demanded by the economy as noted earlier.** The tertiary education system “produces” specialists primarily in areas such as education, health and oil-related manufacturing, while current demand in the economy is for skills in sectors such as services, agriculture, and non-oil related manufacturing. A large percent of the graduates of higher education is specialized in education, where employment is only 8.6 percent and with low wages. On the other hand, about 70 percent of the unemployed population has general secondary education, whereas only 60 percent of all jobs require that level of qualifications. This mismatch leads to a higher unemployment rate among workers with general education, resulting in labor shortages in other specialties, such as employees with computer proficiency, managers, qualified crafts and trade personnel, and technicians.<sup>63</sup> The shortage of skills could escalate due to the poor quality of education, lack of adequate higher and vocational education, and limited space for private sector participation in the development of training schemes. This gap in skills is further

<sup>62</sup> The survey covered firms that are less than 10 years old.

<sup>63</sup> World Bank, 2009, *Country Economic Memorandum: A New Silk Road: Export-led Diversification*.

evidenced by Skills Towards Employment and Productivity Survey (STEPS)<sup>64</sup> data which reveal that employers identify the greatest critical skills gaps for college graduates to be related to technical skills, problem solving, and leadership. Clusters of excellence in tertiary education describe a potential path towards higher productivity and diversification of the economy and further highlight the need for investment in quality and access.

151. **Even though at 38<sup>th</sup> Azerbaijan ranks reasonably well in the overall 2014-2015 Global Competitiveness Index, on the higher-education and training pillar it ranks quite low at 90<sup>th</sup>; while, at 104<sup>th</sup> the rank in health and primary education pillar is even further behind; and “inadequately educated workforce” is quoted as the fourth most problematic factor for doing business after corruption, access to finance, and tax rates.**<sup>65</sup> Tertiary, vocational and secondary education do not seem to be providing relevant skills to support a competitive economy. The failings of the education system have led to public agencies and foreign firms establishing their own universities to educate future employees. For instance, British Petroleum (BP), the key investor in the oil sector, established a large training center in Azerbaijan to address the low competence levels. A similar trend is observed in the public domain, with the Ministries of Emergencies, Tourism, Border Service, National Security, and Customs having opened their own academies and universities.<sup>66</sup>

## SUB-SECTION REVIEW AND KEY EMERGING PRIORITIES

### Challenge II: Unleashing Productivity Growth for greater economic competitiveness

*The second structural challenge to accelerating and sustaining progress on the twin goals is bringing the private sector to center-stage as the main driver of growth, especially in light of important emerging macroeconomic risks that have already led to the 2015 growth projection following to half of its earlier level. Growth over the past decade or so was largely driven by increases in oil production and prices, and, especially after the crisis and peaking of oil output, by the non-tradables sectors, mainly construction and services, also supported by high public investment. With non-oil exports at less than 5 percent of the total in 2013, the tradables sectors are clearly not quite taking off. This is not sustainable. The roles of the public and private sectors need to be rebalanced, with the former becoming a facilitator rather than the main driver of growth. This is also important to create space in the budget for more investment in priority areas while ensuring fiscal sustainability. In other words, private investment needs to start replacing public investment, which would also take the pressure off the budget, leaving room for higher spending on human capital and infrastructure and encouraging growth in non-oil revenues. The transition of the private sector to front and center will be an important component of a new and sustainable growth model needed to combat external pressures, especially the risks emerging from the Russian crisis – recipient of two-thirds of Azerbaijan’s non-oil exports – and the near 50 percent decline*

<sup>64</sup> Demand for Skills in South Caucasus. Presentation prepared by Jan Rutkowski. World Bank, Washington DC. November 2014.

<sup>65</sup> Shwab, Klaus, ed., 2013, *The Global Competitiveness Report 2013-2014: Insight Report, Full Data Edition*, Geneva: World Economic Forum.

<sup>66</sup> Huseynov, E. & Allahveranov, A, 2013, *Costs and Benefits of Labor Mobility between the EU and the Eastern Partnership Partner Countries. Country Study: Azerbaijan*, produced for the European Commission.



*in oil prices. Unleashing productivity growth will be critical for new sources of growth to develop. And this will only be possible with asset diversification and accumulation.*

*Unleashing productivity growth for economic competitiveness is already a stated priority of the Government and will call for comprehensive reforms to tackle a wide range of constraints. There are several constraints on the asset diversification needed to achieve non-oil competitiveness. Productivity levels have not been increasing, especially in the sectors that seem to employ the largest shares of the work force. Particular challenges are low agricultural productivity and limited growth of employment opportunities that could pull workers into higher wage jobs in the private sector. The skills gap affects labor mobility and therefore is a constraint on productivity growth as is informality, which remains widely prevalent with only 30 percent of workers under contract (this may be overstating the share of workers in agriculture, understating the role of construction in generating jobs, distorting investment incentives – including in worker training – and undermining fiscal revenues). There is limited churning of firms from low productivity to higher productivity industries even though this process – which also facilitates labor mobility and encourages private investment – is critical to overall productivity growth. Another constraint in Azerbaijan is the absence of provision of a level playing field and of well-regulated markets to private enterprise, both of which have been found to be critical to promote private investment and entrepreneurship. Also innovation is constrained as is financial access while weak competition and governance in the financial sector hinder the intermediation of capital to its best potential use. Currently the portfolio in the sector reflects the existing growth dynamics in the economy. This portfolio composition can only change once the tradable sectors start to grow and expand their share in the economy, which will call for a strong focus on trade and trade facilitation given the small size of Azerbaijan’s domestic market. For this logistics need to improve – both the highways and local roads and customs governance and efficiency.*

#### **Key Emerging Priorities**

- **Developing market institutions:** competitive markets, well-defined property rights, rule of law and low transactions costs are critical to foster private investment, productivity growth, and job creation
- **Investment in human capital,** in particular tertiary education and technical-training. This is essential for driving innovation and reducing the skills gaps constraining the labor market.
- **Investment in highways and local roads.** This is a prerequisite for overcoming logistical barriers which hinder access to markets and constrain trade facilitation.
- **Reforms to customs governance and efficiency.** Transparency and uniformity is needed in customs regulation in order expand trade beyond Azerbaijan’s domestic market and promote a better business environment.
- **Improved access to finance, in particular for SMEs.** Lack of financial access alongside weak competition and governance in the financial sector hinder the intermediation of capital to its best potential use.

## 4 The bottom-up story: Challenges and constraints for ensuring sustainable inclusive growth

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*From the bottom-up perspective, households will need to be better equipped to participate in this new economic environment. In order to ensure inclusive growth in the coming years, Azerbaijan faces two additional challenges: (i) fostering the accumulation of a diversified asset-base for all households in the country (in particular those in the bottom 40); and (ii) enhancing opportunities for households to use their assets more intensively.*

152. **As seen in the previous sections, Azerbaijan has made significant progress in poverty reduction and shared prosperity as the poor and the bottom 40 percent have benefitted from growth in terms of income growth.** However, households have not managed to increase their accumulation and use of assets at the speed which would have been expected. This is largely due to a combination of limited and unequal—both geographically (territorial and urban/rural) and across demographic groups (men/women and IDPs)—investments in public service provision as well as limited access to productive economic opportunities.

153. **In addition to strengthening the accumulation of diversified assets and promoting productivity at the level of the economy (as explained in Section 3), which is requisite to sustain growth, it is essential that these gains reach the household level so that individuals are better equipped to both benefit from and contribute to the growth process.** It is only in this way that inclusive growth can be achieved. This section seeks to provide a more disaggregated view of the nature of the challenges that the poor and the bottom 40 (with particular attention to those geographic and demographic groups over-represented in this segment of the welfare distribution) face in accumulating and using assets more intensively. Data limitations and limited access to data have prevented a more in-depth analysis of the micro patterns.

### 4.1 Challenge 1: Accumulation of a diversified asset base at the household level

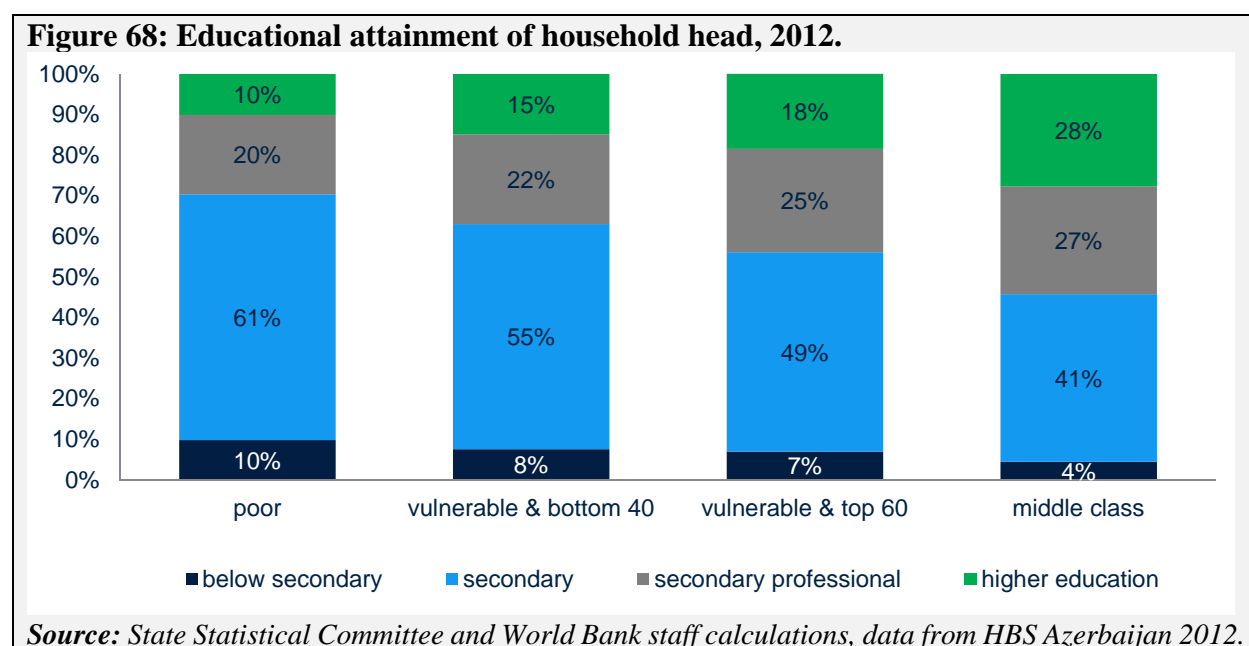
154. **The accumulation of diversified assets is a key factor to facilitate access to economic opportunities and protection against shocks, contributing to reduce vulnerability.** The profile and asset composition analysis illustrates that the vulnerable in Azerbaijan look more like the poor than the middle class.

## Human Capital

155. **Human capital enables individuals to generate higher incomes and contribute more actively to the national growth process.** Through the channel of labor markets and other economic opportunities, both education and health can lead to productive employment and ultimately be transformed into income. Descriptive statistics on household demographics, health and education show systematic differences across the welfare distribution, revealing that poor and bottom 40 households (i) have household heads that report lower levels of education, (ii) have a higher dependency rate than the middle class, and (iii) show inferior health outcomes.

## Education

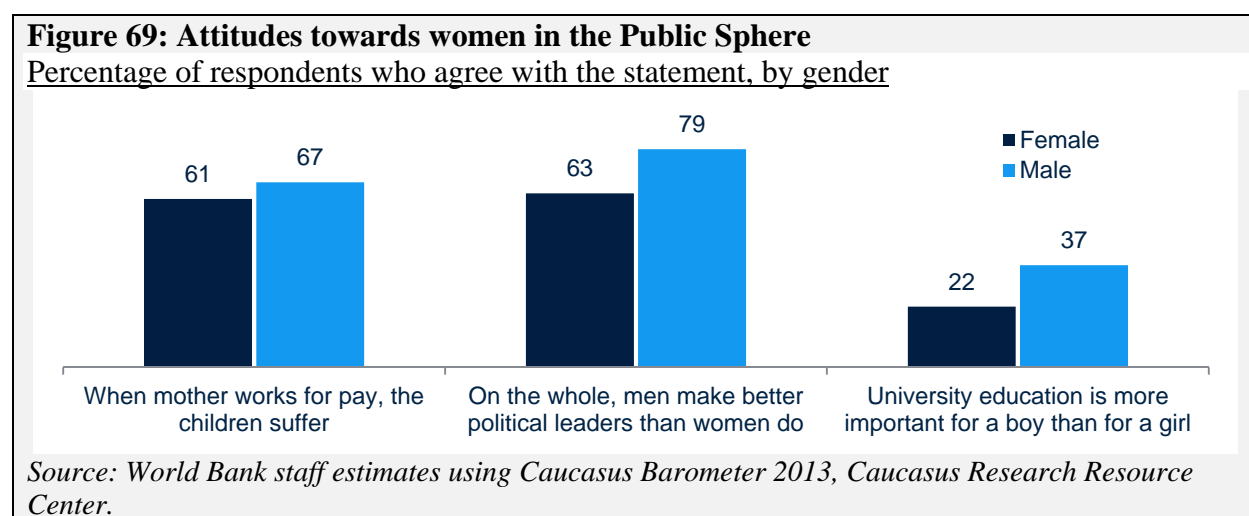
156. **In terms of education, the educational attainment of the household head in the country is higher for middle class households than for the bottom 40** (Figure 68). The large gap between the poor, the vulnerable and the middle class—especially in terms of secondary professional and tertiary education—draws attention to many of the constraints surrounding the national demand and supply of education discussed in Section 3.1, commanding a more disaggregated view.



157. **Access to tertiary education is not only limited at the national level, but it is also inequitable across regions and urban/rural areas.** The proportion of students who applied for tertiary education after high school varies significantly across regions. While in 2009, 74 percent applied for the student admission examination on average, across regions the rate varies widely: from 44 percent in the Kurdamir district to 94 percent in Sumgait city. An important factor behind the wide geographical gaps in enrollment and attainment rates is the lack of tertiary education

institutions outside Baku. Forty-two of the 54 higher education institutions and 19 of the 42 tertiary vocational colleges are located in Baku city, accounting for 76 percent of university students and 57 percent of college students, respectively.<sup>67</sup>

158. **Moreover, despite widespread support for women pursuing tertiary education, social norms against it persist in certain areas.** Some girls are taken out of school at an early age or discouraged from pursuing higher education due to traditional beliefs regarding the importance of women's role in the household. This tends to affect more women in rural areas, where traditional beliefs are stronger and where fewer formal job opportunities may exist. However, data from the 2013 Caucasus Barometer Survey suggests that this type of discrimination is held by a share of the population overall, as 22 percent of women and 37 percent of men report the belief that university education is more important for boys than for girls.



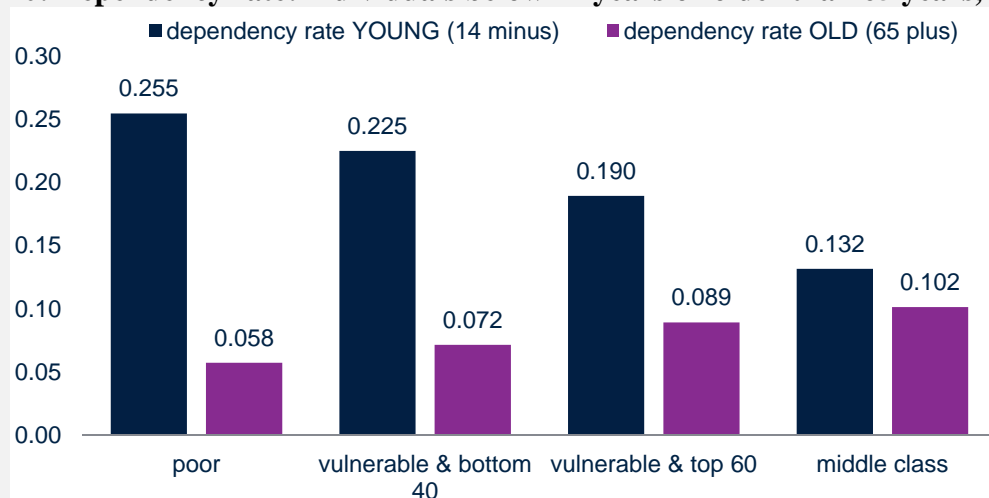
### Health and demographics

147. **Health does not only have an intrinsic value, it also boosts returns to human capital and enables households to participate in the income generation process.** Individuals' health status impacts their ability to participate in and benefit from the income generation process through the labor market—analogueous to what happens in the context of the use of educational assets. Public health hazards due to poor environmental quality, contaminated water and land, significantly undermine an individual's ability to contribute to the economy and generate income.

159. **Households in the bottom 40 percent of the welfare distribution show a higher dependency rate than the middle class.** Both poor and vulnerable households present a higher dependency rate than those of middle class households, with more individuals below 14 years or older than 65 years (Figure 70).

<sup>67</sup> Kataoka, S., 2011, *Background Paper: A Strategic Vision for the Future of Tertiary Education in Azerbaijan*, unpublished.

**Figure 70: Dependency rate: individuals below 14 years or older than 65 years, 2012**

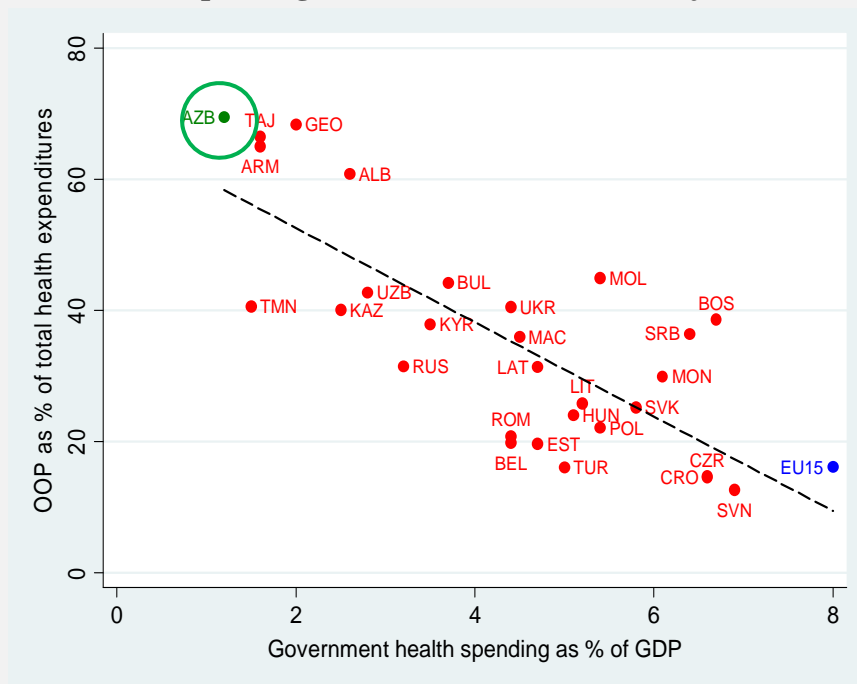


*Source: State Statistical Committee and World Bank staff calculations, data from HBS Azerbaijan 2012.*

160. **Even though aggregate trends suggest steady improvements in national health outcomes, regional gaps and differences across the welfare distribution remain large.** The health system is very much centralized around Baku and generates geographic and economic imbalances in terms of quality of health care services. Especially in rural areas, outpatient visits remain very low with 2.5 visits per person per year in Guba-Khachmaz compared to 6 visits in Baku and 7.3 in Absheron in 2009. These disparities relate to a lack of health financing, a high dependence on out-of-pocket health expenditure and substantial inefficiencies in the provision of primary and secondary health care.

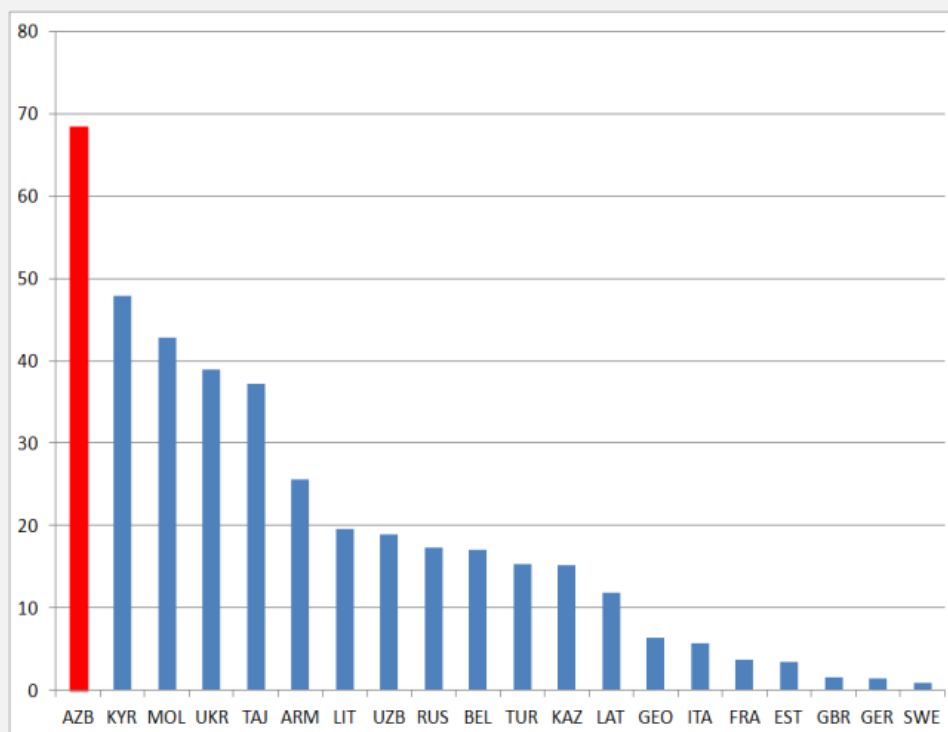
161. **The health system relies heavily on private out-of-pocket expenditure for services and drugs relative to other ECA countries, affecting bottom 40 households particularly.** Large out-of-pocket health expenditure put people at risk of facing catastrophic expenditures when falling ill, particularly for households in the bottom 40 percent. Furthermore, frequent requests for informal payments (also driven by low salaries for health workers) jeopardize the effectiveness of the health system and impose additional financial stress, especially on poorer households. Findings from the LiTS showed that prevalence of informal payments for health is the highest in Azerbaijan among 30 ECA countries (see Figure 71). Mandatory universal health insurance coverage would provide financial protection for the entire population and potentially increase the demand for health services.

**Figure 71: Out of Pocket Spending as share of GDP in Azerbaijan, EU15 and the CIS**



Source: Public Expenditure Review, 2012.

**Figure 72: Share of population with informal payments for health services over previous year**

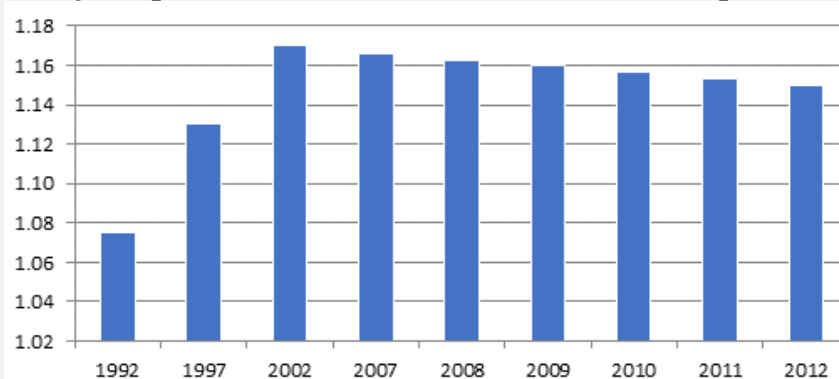


Source: EBRD Life in transition Survey, 2010.

162. **Additionally, Azerbaijan’s skewed sex ratio at birth—a summary measure encapsulating the persistence of gender inequality—is among the highest in the world.** According to WDI data (World Bank), the sex ratio at birth for Azerbaijan is 1.15. This ratio has been increasing since the late 1990s. Medical studies conclude that elevated sex ratios at birth are achieved through sex selective abortions in Azerbaijan (Marc, et al. 2013). Draft legislation that would ban sex-selective abortions is being developed in Azerbaijan. International best practice suggests however, that underlying cultural norms should rather be tackled via social and economic policies, given evidence on the limited impact of sex selective abortions bans.<sup>68</sup> Not only does research suggest that pre-natal sex selective abortions bans are ineffective, but they can also be counter-productive as women may resort to more risky methods to end pregnancy.

163. **Emerging lessons learned from other countries<sup>69</sup> provide relevant insights for choosing more effective policy options that could be employed in the context of Azerbaijan.** Two potential policy options which have been evaluated include offering financial incentives to encourage the birth of girls and using media exposure to influence parents’ perceptions. In addition to being expensive, cases in India provide weak evidence regarding the effectiveness of providing financial incentives. Moreover, this option has the potential of reinforcing the negative perceptions associated with having a daughter. Using targeted media campaigns to promote the value of girls, however, has been proven in Tanzania, Brazil, India, and Benin to have a relatively high chance of success in addressing the issue of skewed sex ratios at birth. This type of campaign would be most effective if combined with broader efforts to increase gender equity in areas such as education, labor markets, earnings, inheritance, and voice. In the context of Azerbaijan, focus groups suggest that a focus on domestic violence is particularly relevant.

**Figure 73: Azerbaijan’s present sex ratios at birth (in male births per female births)**



<sup>68</sup> Guilmoto (2012) provides a comprehensive review of issues related to son-preference at birth, which is a widespread phenomenon in South Asia and China and lately in the South Caucasus and Eastern Europe. Governments and development organizations have been jointly working on this issue and lessons could be learned from international experience. The literature suggests that measures focused on the symptoms of the problem often overlook the roots of the issue.

<sup>69</sup> Das Gupta, Monica (2014). “Missing Girls” in the South Caucasus countries: trends, possible causes, and policy options.” Background paper for the World Bank Europe and Central Asia region’s report “Missing Women in the South Caucasus” led by María E. Dávalos.

164. **Gender-based violence is also a serious issue in the country, with close to 35 percent of women reporting experiencing physical/psychological violence in their lifetime.** Domestic violence is generally not considered a crime by the public but rather a domestic dispute, which puts women's and children's health at risk. The Government of Azerbaijan supports the fight against gender-based violence and the State Committee on Family, Women and Children Affairs has the responsibility for implementing the country's law preventing gender based violence. In order to increase the government's efforts in this area, greater enforcement and public awareness are important complements to the passage of this legislation.

### *Natural Capital*

165. **Access to adequate environmental infrastructure and services is important for minimizing health risks and ensuring quality of life.** Legacy pollution by industries, mainly the oil sector, has been among the most serious environmental issues and carries the highest risk for poor people who can only afford to live in inexpensive locations (such as abandoned industrial zones) and rural areas. Both the 'flow' and 'stock' of industrial pollution are acutely observed in many locations in the Absheron Peninsula, which is the center of oil and chemical production for decades. This affects the poorest, who reside in affordable, but polluted areas in the immediate proximity to oil fields and are exposed to environmental and health risks. The complex issue of landscape degradation implies not only contamination of soil but also contamination of water sources. Unattended legacy pollution and uncontrolled discharge of untreated effluents, which are not covered by existing wastewater treatment facilities, should seek a targeted plan to rehabilitate these areas rather than isolated plots or water bodies.

### *Physical Capital*

166. **Despite considerable progress in improving the main road network over the past decade, poor connectivity in regions and rural areas remains a major constraint.** While 61 percent of the poor live in rural Azerbaijan and 40 percent of the active labor force is concentrated in the agricultural sector, about 80 percent of local roads remain in bad condition—compared to only 25 percent in FYR Macedonia or 54 percent in Albania. During the next 10 years, rehabilitation of regional and local roads will need to be implemented in a cost-efficient and sustainable manner. In parallel, the Government will have to complete implementing the ongoing modernization program for highways and railways, and develop a modern logistics system.

167. **Vulnerable groups are more adversely affected by poor connectivity.** Data from a recent socio-economic study demonstrate that basic social services are often unreachable in the remote areas, with some villagers having to travel as much as 46 km for the nearest district medical point and up to 15 km for the nearest schools. In many instances, the local roads are in such a poor state that buses and taxis often refuse to drive through certain villages. In the absence of reliable public transport or private vehicles, many trips are done by foot. The elderly, women, and children



face particular disadvantages, especially, during adverse weather conditions. In 2013, about 40 percent of seventy-five IDP communities—which are widely scattered across the country and represent one of the most socially vulnerable groups in Azerbaijan—identified the improvement of poor road conditions as their top social and physical infrastructure constraint.<sup>70</sup>

### *Financial Capital*

168. **The banking sector has improved on many outreach indicators in recent years, including an increase in the number of non-branch based points of service (POS).** There were 665 bank branches at the end of 2012, or about 9.9 bank branches per 100,000. As of 2012, Azerbaijan's had 193 ATMs per million inhabitants (a 52 percent increase since 2006) and 986 POS terminals per million inhabitants (a 304 percent increase since 2006, Table 4). Deposit accounts almost tripled since 2006. A positive evolution was also noticed with regard to the outstanding amount of loans and deposits, which increased from 12.3 percent and 11.5 percent of GDP, respectively, in 2006 to 17.9 percent and 13.4 percent in 2011. Data on the number of deposit accounts per 1,000 adults (only available since 2010) confirm this positive trend with an increase in the number of deposit accounts from 443.2 to 569.2 between 2010 and 2011.

<b>Table 4: Financial Access to and Use of Financial Services, 2013</b>											
	Azerbaijan	Georgia	Denmark	Czech Republic	Israel	Moldova	Qatar	Russia	Singapore	Ukraine	Slovenia
ATMs per 100,000 adults (number)	33.5	55.56	56.63	48.96	123.73	33.82	65.12	155.5 5	58.96	103.12	100.46
ATMs per 1,000 km2 (number)	29.3	29.72	61.44	56.95	327.68	30.59	99.74	11.53	3,737.14	69.65	88.13
Commercial bank branches per 100,000 adults (number)	10.28	24.86	30.28	24.25	19.89	12.05	13.16	38.39	10.16	0.91	34.36
Commercial bank branches per 1,000 km2 (number)	8.99	13.3	32.85	28.21	52.68	10.9	20.16	2.84	644.29	0.62	30.14
Outstanding deposits w commercial banks (% of GDP)	17.06	30.36	59.09	69.56	94.83	59.07	45.12	39.27	155.57	45.49	52.71
Outstanding loans from commercial banks (% of GDP)	27.76	39.69	49.25	53.42	74.71	48.01	47.46	48.36	166.16	62.85	69.55

<sup>70</sup> Social Fund for Development of Internally Displaced Persons.

169. **Despite these positive developments, the level of financial inclusion and outreach remains insufficient, especially among micro, small and medium enterprises and households,** in particular in rural areas, with the access to financial services (e.g. loans, deposits, e-services and payments) and infrastructure (including ATMs, branches, other vehicles) in Azerbaijan below the ECA average and lower than in Georgia and in other higher middle income and oil economies. To address this issue, further development of modern financial infrastructure and financial services to increase financial inclusion and penetration is needed. Of special concern is the practice of selling off assets and inventory to address cash flow emergencies, a backward step in business development. This practice is most common for the least financially included MSME segments, such as the smallest enterprises and those working in agriculture.

170. **To increase financial access to services in rural areas, the Government along with the CBAR has supported comprehensive reform of Azerpost but more needs to be done to strengthen rural access.** Azerpost allows use of its 1600 branch network to facilitate provision of the basic standard financial services (such as remittances transfer, wire transfers and debt collection, utilities and other payments) to the households in isolated rural areas where banks and non-bank credit institutions traditionally would not have outreach. The current modernization program aims at building capacity, products, skills and marketing strategy of Azerpost in financial services provision and it resulted to significant improvement of Azerpost revenues in 2014 as compared to 2013 and earlier years. The reform will need to advance and finalize, with Azerpost providing agent services for other financial institutions and reaching breakeven in the near future. This will help achieve three objectives, i.e. increase financial inclusion and outreach, financial sustainability of Azerpost, and reduced fiscal cost. Unmet demand is largely an issue in rural areas, which brings up the issue of inadequate access to finance for agricultural producers. To this end, it may be interesting to look into alternative delivery channels (beyond Azerpost), such as branchless banking (e-money, mobile banking) and take stock of latest regulation (if any) or opportunities/impediments.

## **SUB-SECTION REVIEW AND KEY EMERGING PRIORITIES**

### **Challenge I: Accumulation of a diversified asset base at the household level**

*Fostering the accumulation of a diversified asset-base in Azerbaijan is a key challenge to be addressed in order to enhance households' access to economic opportunities and protection against shocks. The evidence suggests that, currently, the poor and bottom 40 have fewer opportunities to accumulate assets. In terms of human capital, these households present lower levels of education, a higher dependency rate and inferior health outcomes vis-à-vis the middle class. Access to tertiary education, for instance, is not only limited at the national level, but it is also inequitable across regions, and urban/rural areas; while social norms influence its access according to gender. On the other hand, gaps persist in health outcomes across the welfare distribution, where the heavy reliance of the health system on private out-of-pocket expenditures affects bottom 40 households particularly. In addition to human capital constraints, poor*

*connectivity in certain regions and rural areas remains a major restriction affecting more adversely the more vulnerable groups. Additionally, the level of financial inclusion and outreach remains insufficient, especially among micro, small and medium enterprises and households.*

#### **Key Emerging Priorities**

- **Investment in access to tertiary education.** Education policy should include a focus on closing the gap in higher educational attainment across regions, rural/urban areas, as well as across income groups. This is fundamental for building the skills base needed for these groups to participate more actively and productively in the labor market.
- **Investment in access to affordable quality health care.** Health policy should include a focus on establishing protection against impoverishing health expenditures by strengthening access and quality across regions and welfare groups.
- **Investment in infrastructure, in particular regional and local roads in areas with vulnerable populations.** Poor local connectivity is of particular importance as it also influences the ability of basic social services to be delivered as well as the demand for education and health services.
- **Investment in the development of modern financial infrastructure and financial services.** This is especially important in rural areas and among micro, small and medium enterprises and households.
- **A more local perspective on delivery.** Disparities in service delivery and public investment needs are stark at the regional level. Public spending needs to be realigned with local development needs and more autonomy granted at the municipal level to address constituencies' concerns.
- **Enhanced collection of disaggregated data.** Collecting data at a disaggregated level promotes more inclusive development through the identification of disparities between regions and social groups.

## **4.2 Challenge 2: Enhancing opportunities for households use assets more intensively**

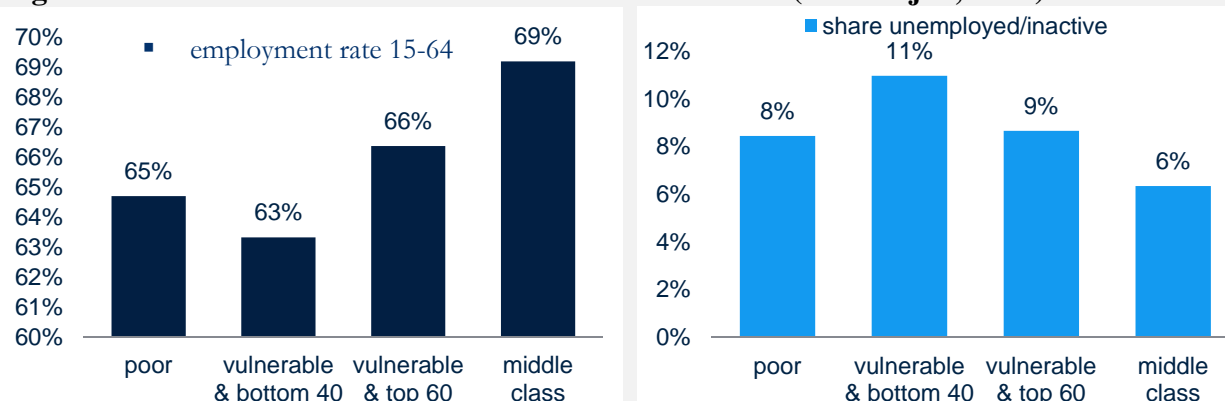
171. **The stock of assets that people own influences their income generation as does the intensity with which they are used, given associated returns.** The evidence suggests that the bottom 40 households have fewer opportunities to use their assets productively, as bottom 40 households face higher unemployment than their middle class counterparts, and the employment they do obtain tends to be in low-productivity low-wages sectors.

### *Employment outcomes across groups*

172. **The employment rate of the bottom 40 in the country is lower than that of the middle class.** Unemployment and inactivity are also associated with a lower position in the welfare distribution. As labor is the main source of income, improving the quality of labor market

engagement can have a significant impact on living standards. There are, however, challenges in improving the employment opportunities for the bottom 40 in Azerbaijan.

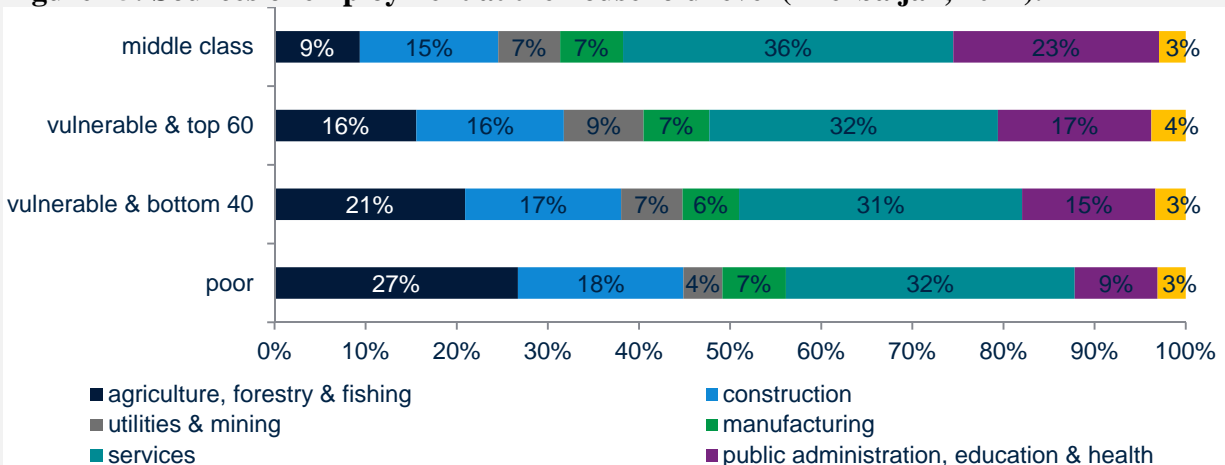
**Figure 74: Labor market outcomes at the household level (Azerbaijan, 2012)**



*Source: State Statistical Committee and World Bank staff calculations, data from HBS Azerbaijan 2012.*

173. **Employment appears to be not only a problem of less quantity but also of lower quality for the bottom 40 percent.** This is related to lower educational attainment (as discussed above). The concentration of the bottom 40 in low quality sectors of employment (Figure 75) is further exacerbated by a rural/urban divide, as about 18 percent of the income of the bottom 40 arises from agriculture. Income generation capacity tends to be weaker in rural areas overall, alongside low productivity. Individuals situated higher along the income distribution appear to have more stable sources of income.

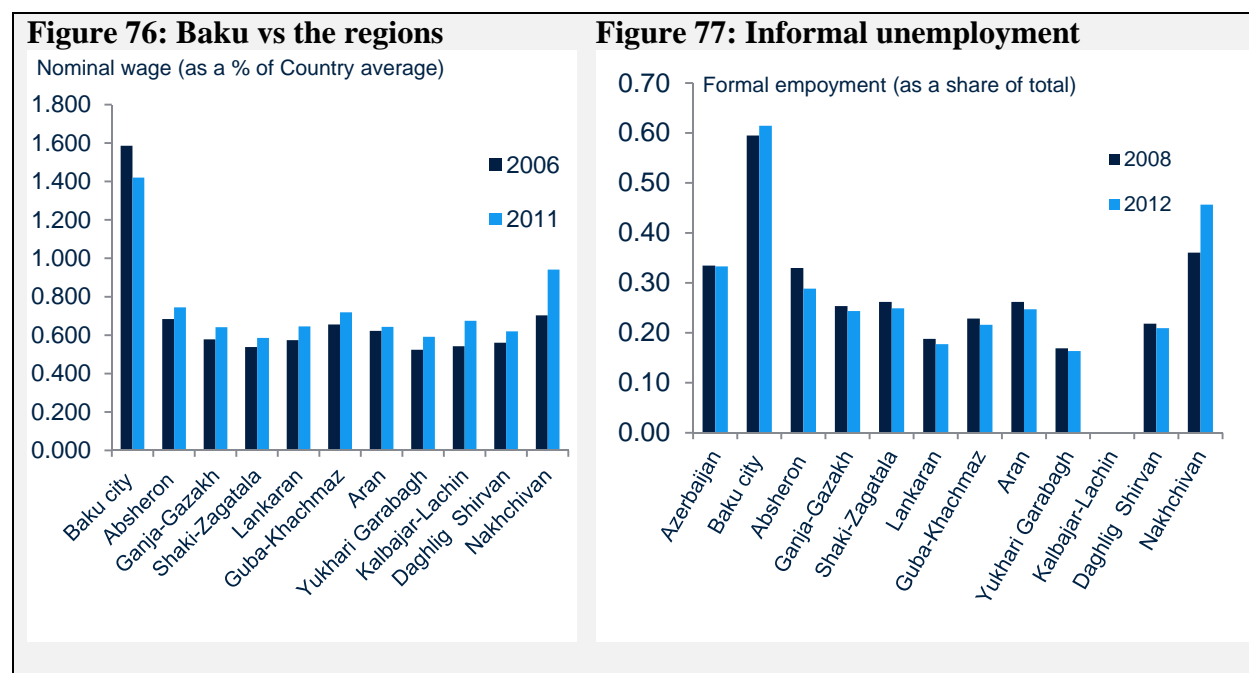
**Figure 75: Sources of employment at the household level (Azerbaijan, 2012).**



*Source: State Statistical Committee and World Bank staff calculations, data from HBS Azerbaijan 2012.*

174. **Economic growth in Azerbaijan has been accompanied by a growing degree of labor informality, which likely disproportionately affects the poor and lagging regions.** Only 30

percent of the employed have formal labor contracts in Azerbaijan and the problem is more severe in the regions and is also reflected in average wages. Most of the regions outside Baku are well above the national average in terms of informality. In Baku, formal employment accounts for 60 percent of the total. By contrast less than 20 percent of the employed in Lankaran have formal contracts. Significant differences in nominal wages also persist between Baku and the rest of the country.



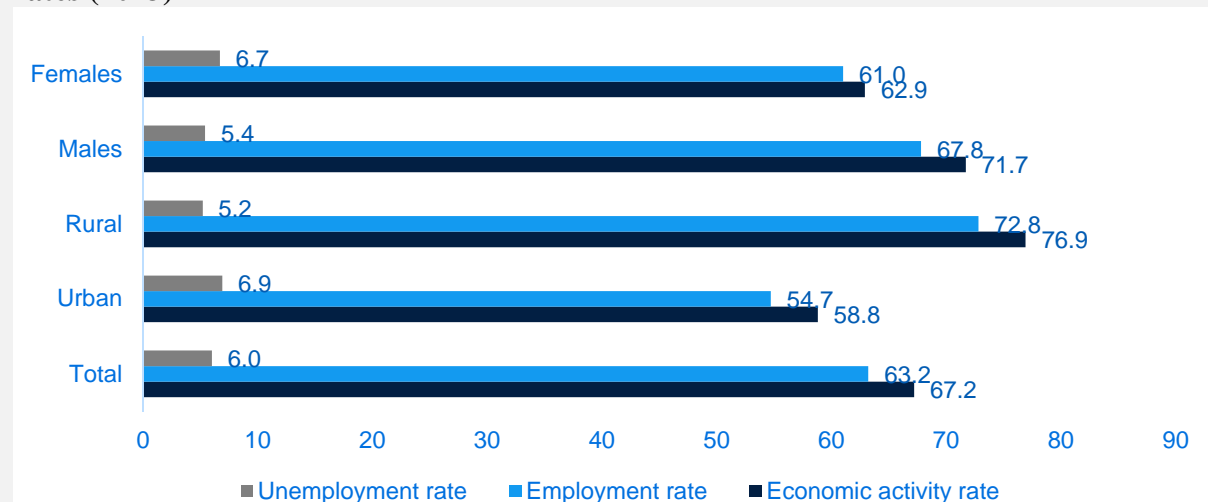
175. **Women lag behind men in employment rates, although the rapid economic growth has helped narrow down the asymmetries in the labor market.** Women's labor force participation increased significantly during 2002-2012, leading to growing gender convergence in the labor market. The convergence was also a result of a slight decrease in men's participation rate. Women made up almost half of the labor force (49 percent) in 2012. Yet, women lag behind men in employment rates (61 percent versus 68 percent in 2013), and experience higher unemployment compared to men. Women saw the greatest growth in jobs in the agriculture sector, mirroring the exodus of men who moved to the industrial sector. The gap between men and women and in particular the high unemployment rate among women suggests that there are less labor market opportunities for women.

176. **Additionally, there is a clear gender divide in terms of sectoral, occupational, and wage differences in the labor market.** Women are more likely to work in sectors such as education, health and social services—which tend to be lower paid. This situation begins at the tertiary education level, where women tend to pursue academic fields that prepare them for jobs in those sectors. In addition, women are also concentrated in particular occupations, such as

administrative assistants and clerks, which are also low-paying service jobs. Consequently, women experience lower returns to education despite their investment in human capital.

177. **Labor market statistics for Azerbaijan also show significant gaps by location.** The economic activity rate and the employment rate for rural areas are significantly higher than for urban areas which reflects differences in economic activity such as the share of population working in agriculture. Inclusive growth and in particular access to opportunities for the bottom 40 of the welfare distribution require connectivity which in turn enhances mobility between regions (and labor migration between urban and rural areas) which fosters the efficient allocation of resources, especially in labor markets. Gaps between labor market outcomes in urban and rural areas illustrate frictions which limit regional mobility between urban and rural areas. In consequence to these frictions, Azerbaijan is not transforming from an economy based on agriculture to further employment growth in manufacturing and services.

**Figure 78: Labor market outcomes in Azerbaijan: unemployment rates and employment rates (2013)**

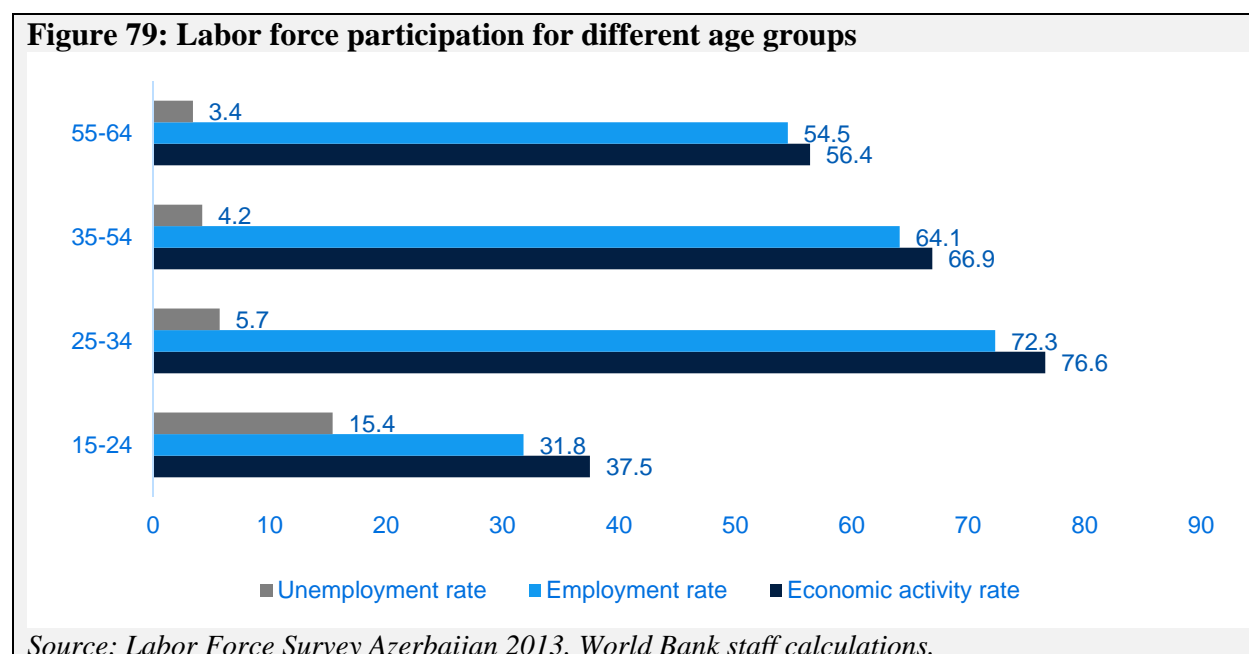


Source: Labor Force Survey Azerbaijan 2013. World Bank staff calculations.

178. **IDPs display lower employment rates and higher work inactivity than the non-displaced.** IDPs use their (few) asset holdings with low intensity, due to limited opportunities in accessing employment and entrepreneurship opportunities. As a result, IDPs in Azerbaijan are particularly vulnerable in a range of areas: they are more likely to be poor, reside in worse living conditions. IDPs also are broadly reliant on social transfers and other subsidies.<sup>71</sup> The self-reliance of IDPs is constrained by deficits in human, physical, natural, financial and social assets. Addressing these deficits is essential if IDPs are to achieve self-sufficiency through independent and sustainable sources of livelihoods.

<sup>71</sup> State benefits continue to be the main source of income for more than 70 percent of IDPs. This includes the monthly allowance for IDPs, currently set at just around \$23, and other social assistance for vulnerable groups.

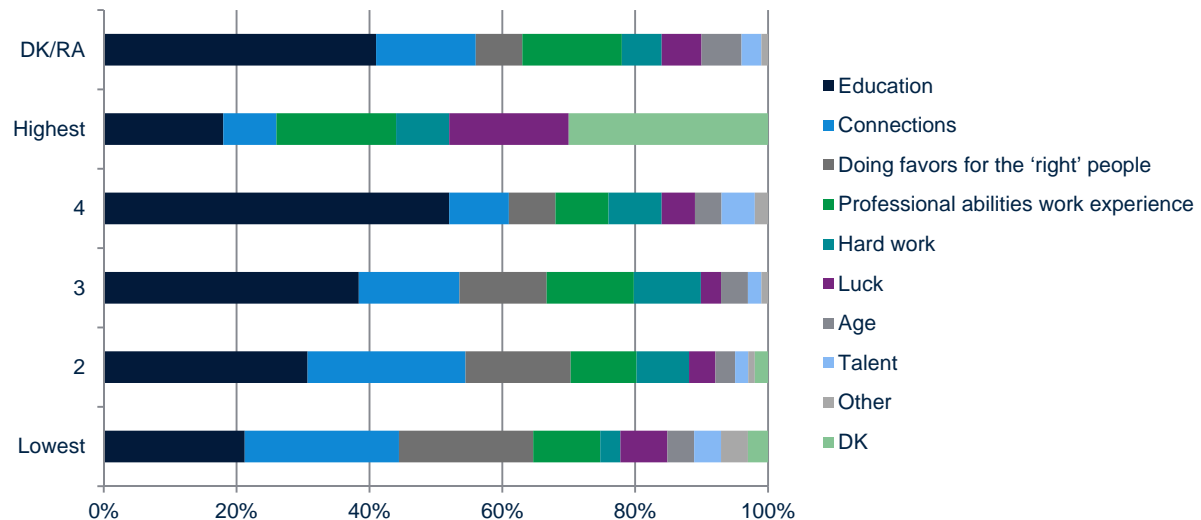
179. **Among older cohorts, an early retirement reduces the supply of labor for men and women between 55 and 64 years.** The official retirement for men is 63 years whereas women remain in the labor force until the age of 60 (early retirement schemes are available). Labor market outcomes from the LFS 2013 illustrate how this has a negative impact on labor force participation for individuals above the age of 55. The government has taken actions to increase the retirement age gradually which also increases fiscal sustainability.



#### *Determinants of access to productive opportunities*

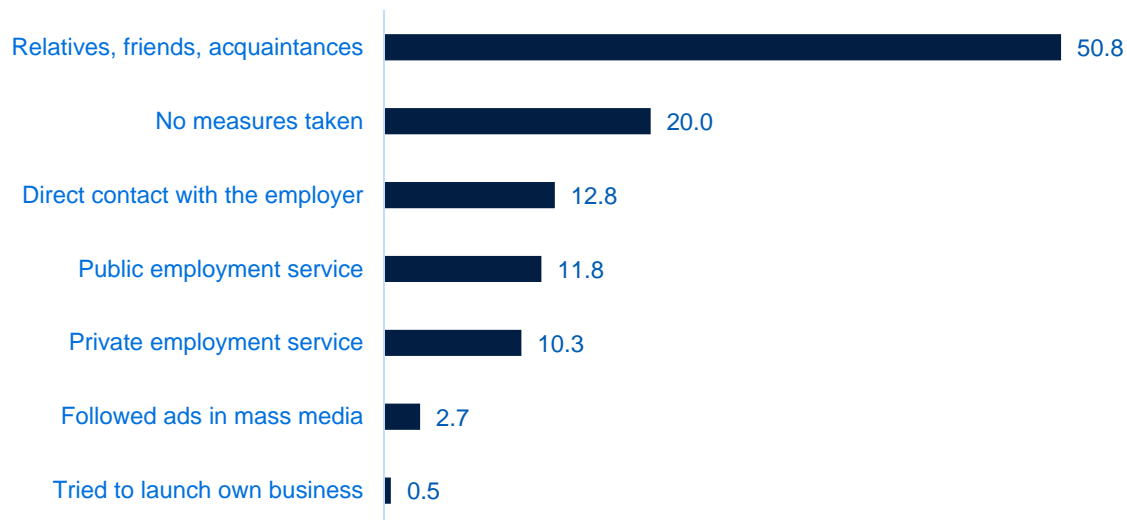
180. **Access to productive assets (such as education, health, and financial capital), access to networks, and access to markets are central for determining access to productive opportunities for households.** Poor labor market outcomes such as high unemployment rates could also be linked to frictions in the matching process between workers and firms. Findings from the LFS 2013 show that informal search channels play an important role when escaping unemployment (50.8 percent of unemployed) whereas only 11.8 per cent of unemployed search for a new job using services provided by the public employment service.

**Figure 80: The most important factor for getting a good job by current perceived economic rung**



Source: Caucasus Barometer 2013 Azerbaijan.

**Figure 81: How do unemployed persons search for a job?**



Source: Labor Force Survey Azerbaijan 2013. World Bank staff calculations.

181. The degree of *social capital*<sup>72</sup>—or the set of norms and social networks that facilitate collective action- that individuals have can play a key role in being admitted to an education institution, obtaining a license, or getting a job, ultimately influencing the ability to generate

<sup>72</sup> Social capital networks can be formal, such as an association of professionals, or informal, including friends, family, acquaintances, and relate to the production of goods and services. A typical output of informal networks includes help repairing a house, child care, or the provision of advice and contacts.



**income.** The importance of ‘having connections’ to get ahead and the expectation of future social mobility have been identified as important bottom-up constraints in Azerbaijan, binding further progress in poverty reduction and shared prosperity.

182. **According to the Life in Transition (II) survey, having connections in Azerbaijan is very important to obtaining high quality (including government) jobs.** Fifty-five percent of adults consider connections to be vital for obtaining a good government job—higher than in other CIS and EU countries, and only lower to the case in the Western Balkans (Table 5). The perceived importance of connections for public sector jobs in Azerbaijan is also considerably higher than for other opportunities—less than 40 percent of adults thought that connections are important for good private sector jobs, and only 22 percent of adults viewed them to be important for getting into university. The large difference between government and private sectors is only mirrored by the estimates from the Western Balkans.

**Table 5: Share of adults who view the need for connections as very important or essential (%)**

Country groupings	Government job	Private sector job	University	Permits	Disputes
Western Europe	38.4	36.2	13.1	15.3	17.5
EU11	48.8	40.9	20.3	21.1	20.2
Western Balkans	66.9	49.9	38.0	35.2	31.0
CIS	49.8	42.8	31.2	22.8	13.9
Azerbaijan	55.5	38.8	22.4	14.9	10.8
Overall	44.8	39.5	20.9	19.2	17.1

*Source: LiTS II survey.*

183. **The importance of connections appears to be driven by the relevance of the opportunity sought.** Connections are viewed as less important for better-off individuals in terms of getting a government job, and more important in terms of accessing higher education (Table 6). The importance of connections for government jobs declines with consumption quintiles, whereas for private sector jobs the distribution is more uniform. In terms of getting into university, the importance of connections is higher for higher consumption quintiles, likely due to the fact that higher education may not be perceived as an attainable goal for poor households in the first place. The greater importance of connections for obtaining permits for the higher quintiles may be similarly driven by the greater demand for permits among the better off.

**Table 6: Share of adults in Azerbaijan who view the need for connections as very important or essential, by quintile (%)**

Consumption quintile	Government job	Private sector job	University	Permits	Disputes
1	62.0	38.4	14.9	12.5	8.2
2	60.7	34.7	21.2	16.9	11.6
3	55.4	38.8	18.9	8.6	10.7
4	53.2	40.6	29.1	18.3	12.7
5	47.0	41.8	26.2	17.1	10.6
Overall	55.5	38.8	22.4	14.9	10.8

Source: LiTS II survey.

184. **The belief that connections in any of the above areas are important appears widespread in Azerbaijan.** Based on the responses to the above questions, Cojocar (2014a) constructs a measure of *perceived inequality of opportunity* (see details in Annex 2). Perceived inequality of opportunity appears to be more widespread in Azerbaijan compared to Western European and new EU countries—although lower than in Western Balkans (Table 7). The table also reports the share of adults who stated that they do not have any connections to rely upon. Azerbaijan appears to be quite different from other CIS countries in this regard (whereby 37 percent of respondents report having no connections vis-à-vis 8.7 percent in CIS countries). Predictably, the share of those with no connections is higher at the bottom of the distribution and for those with lower levels of education (Table 8).<sup>73</sup> At the same time, the perception of inequality of opportunity perceptions in Azerbaijan is highest in the bottom quintile.

**Table 7: Inequality of opportunity and availability of connections across countries**

Regions	Connections are vital	No connections are available
Western Europe	56.4	46.6
EU11	61.2	29.2
Western Balkans	77.0	32.4
CIS	64.0	8.7
Azerbaijan	68.9	37.5
Overall	60.4	31.1

Source: LiTS II survey.

**Table 8: Inequality of opportunity and availability of connections in Azerbaijan, by quintile**

Consumption quintile	Connections are vital	No connections are available
1	75.2	42.3
2	71.1	47.3
3	66.0	33.6
4	70.6	36.8
5	62.2	27.4
Overall	68.9	37.5

Source: LiTS II survey.

<sup>73</sup> Results comparing across levels of education are available in the Annex 2.

185. **The presence of an uneven playing field can also dampen expectations of future social mobility, which appears to be the case in Azerbaijan.** Cojocaru, 2014b shows, based on LiTS II data, that expectations of future social mobility are important determinants of current policy preferences, in particular with respect to redistribution.<sup>74</sup> The estimates confirm the hypotheses: when the playing field is uneven, availability of connections is associated with greater expectations of future upward mobility (see Annex 2).

186. **In addition to productive assets and networks, access to markets is essential for enabling access to productive opportunities.** Poor local connectivity in Azerbaijan is seen as a major bottleneck for boosting the income of the bottom 40 and shared prosperity. The rural access index (RAI) which estimates the proportion of the rural population who reside within an all-weather road was 67 percent in 2002, meaning that over 1.2 million people residing in rural areas lack access to adequate transport. This contrasts with the case in Latvia, Bulgaria, and Romania, which in the same year had RAIs of 90 percent, 98 percent and 89 percent, respectively. Data from a recent socio-economic study shows that the limited access to transport and high user costs for roads affect households' income, especially in agriculture, which absorbs 40 percent of the total workforce in the country (see Box 9).<sup>75</sup> Travel distances to the nearest markets in the surveyed area range from 8 to 25 km, with up to 30 percent of trips made by foot. The farm-gate prices are significantly lower, sometimes even two or three times lower, when sold in the farm than retail prices in markets due to the high transportation cost. The improvement of roads infrastructure in regions could have a long term impact on opening up and stimulating agricultural markets for the poor.

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<sup>74</sup> Expectation of future mobility are defined based on responses to the questions inquiring about the respondent's position on a 10-step socio-economic ladder today, and four years hence.

<sup>75</sup> Azerbaijan Regional Roads Development Project: *Socio-Economic Study to Support Pro-poor Project Design*, Final Report, June 2014.

**Box 9: Poor road condition constrains income and livelihood opportunities for population living in the regions outside Baku**

A socio-economic study was conducted to assess the potential impact of the proposed World Bank financed operation to improve regional and local roads in Azerbaijan. The study covered the South-western part of the Aran region (Salyan, Neftchala, Shrivani and Sabirabad), which has a 500,000 individuals population and one of the lowest per capita incomes in the country, on average.

Data from the study shows how basic social services are often unreachable in the remote areas, with some villagers having to travel as much as 46 km to the nearest district medical point and up to 15 km to the nearest schools. Access to health and education facilities is further constrained by the limited availability of public transport—local roads are in such poor state that buses and taxis often refuse to drive through villages. In the absence of reliable public transport or private vehicles, many trips are done by foot with women and girls being the most adversely affected. Another important gender dimension of the problem is that the education level among women is lower than men in the area, with poor road connectivity being one of the reasons behind this, as identified by focus group discussions.

The study further revealed that the limited access to transport and high user costs for roads negatively affect the households' income, especially in agricultural sector. Travel distance in the area to the nearest markets range from 8 to 25 km, with up to 30 percent of trips made by foot. The farm-gate prices in the area are significantly lower when sold in the village than when taken to the local markets. For example, the farm-gate price of live fish in Neftchala is 2.5-3 manats per kg, while it is sold for 6-7 manats per kg in Baku markets, about a 180 km distance. Distant markets and limited transportation opportunities result in fewer options to sell produce and obtain competitive prices. The study concludes that the improvement of road infrastructure in the South-western Aran region can have a long term impact in opening up product markets for the poor and could help stimulate agricultural and other markets.

*Source: Azerbaijan Regional Roads Development Project: Socio-Economic Study to Support Pro-poor Project Design, Consultant Report, June 2014.*

## SUB-SECTION REVIEW AND KEY EMERGING PRIORITIES

### Challenge II: Enhancing opportunities for households to use assets more intensively

*Azerbaijan also faces the challenge of enhancing opportunities for households to use assets more intensively. The analysis indicates that the bottom 40 have fewer opportunities to use their assets productively, as these households face higher unemployment than their middle class counterparts, while the employment they do obtain tends to be low-quality—concentrated in low-productivity low-wages sectors. Economic growth in Azerbaijan has been accompanied by a growing degree of labor informality, which disproportionately affects the poor and lagging regions. On the other hand, women lag behind men in employment rates, while a gender divide persists in terms of sectoral, occupational, and wage gap in the labor market. IDPs are another group that displays lower employment rates and higher work inactivity than the non-displaced. Access to productive opportunities is also influenced by social networks and access to markets. In this sense, the analysis indicates that having connections in Azerbaijan is very important to obtaining quality jobs, while the presence of an uneven playing field may be dampening expectations of future social mobility in the country.*

#### Key Emerging Priorities

- **Strengthen regulatory environment to reduce inequality of opportunity to access the formal labor market.** The presence of an uneven playing field can dampen expectations of future social mobility, and the perceived importance of requiring connections to access productive opportunities is especially a concern for those in the lower end of the welfare distribution. Improved governance, especially rule of law, is essential for promoting equitable access to jobs and moving qualified people into higher productivity and higher wage sectors in the formal economy.
- **Investment in local connectivity, in particular regional road infrastructure.** This is essential for ensuring access to markets, a major bottleneck for boosting the income of the bottom 40. This could have a long term impact on opening up and stimulating agricultural markets for the poor.

## 5 Prioritization: Key binding constraints

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187. **The set of constraints faced to address the stated challenges includes several actions, but a prioritization is needed to tackle those that can have the largest impact.** Such an exercise is limited by the availability of information, which leads to the use of second-best criteria. The prioritization exercise, which derives from the analysis, relied on three key elements: (i) benchmarking whenever data allowed (ii) expert advice and verification, and (iii) an emphasis on constraints that are likely to impact several factors at a time, showing an effect that overlaps across challenges. The latter element, namely the high weight imposed on cross-cutting constraints, implies a more systemic approach –rather than project or sector-based approach.

188. **Conceptually, the decision to assign a higher weight to constraints that are connected to more than one outcome can be simply understood from the perspective of network analysis.** In a traditional regression-based analysis, such as a growth-diagnostics exercise – assuming information on prices is available or can be estimated—the priorities would be determined by those constraints whose associated “price” reflects the scarcity value of the specific element. Such analysis, however, is extremely demanding in terms of data and poses important challenges to introduce non-linearities, which reflect the *systemic value* of certain constraints. In a network-based logic, where the density of connections in one node shows the potential impact of interventions in several dimensions, it is clear that those elements that are more “connected” to a larger set of elements could have a larger impact on the outcomes. Such analogy is useful to understand the main element in the prioritization exercise: the higher weight assigned to cross-cutting impact of the removal of constraints.

189. **Bearing in mind the above, selection criteria focused on those constraints that would have the greatest impact on the twin goals; cross-cutting factors underlying the removal of the constraints (i.e. decision-making processes); impact on both top-down and bottom-up challenges, as well as the potential time-horizon of expected impacts.** After a systematic review of the identified constraints through this lens, the SCD proposes the following as the most binding—those whose removal in the next years would enhance the potential for Azerbaijan to overcome its pending challenges and continue on a path toward sustainable and inclusive growth.

### *1. Intangible capital: Governance and institutions*

190. **An important lesson from international experience is that resource-based development is intensive in institutions, where institutions refer to fair and accountable governance, the management of volatile natural resource revenues, provision of essential social services, and regulation of private enterprise.** From the top down perspective, a

comparison of the development experiences of the upper middle and upper income countries in North America, Europe and East Asia undertaken for the Diversified Development flagship report suggests that resource-rich countries find development institutionally more challenging, partly because of the macro-fiscal pressures imposed by volatile natural resource rents and the difficulties in many countries of ensuring a level playing field through effective, transparent and accountable governance. The difference between Chile and Venezuela, or between Canada and Norway on the one hand and Nigeria on the other, would suggest that the soft side of the national asset portfolio is indeed critical.

**191. Institutional capital determines how a country governs, and its effectiveness, through regulatory bodies, mechanisms, and norms.** The quality of institutional capital influences the possibility of more dynamic private and external sectors (rule of law, lower ownership concentration and bureaucratic capacity); also, it influences the potential to tackle territorial disparities through the bureaucratic ability to deliver quality services and by strengthening accountability, and influences financial inclusion and social capital through regulatory environments. Thus, reflecting on the constraints discussed in previous sections, both from the top-down (competitiveness concerns, private investment-related restrictions, limited human capital, etc.); as well as from the bottom-up (such as issues related to education, health, water, infrastructure), it becomes clear that a key underlying common theme behind these constraints—or symptoms—relates to four key aspects of governance: **(i) fiscal management; (ii); service delivery (iii); rule of law; and (iv) data. In the context of Azerbaijan, these aspects of governance need to be addressed in particular with a focus on shifting toward (i) a longer term perspective (ii) a more local perspective; (iii) greater transparency and accountability, and (iv) and more evidence-based decision making.**

### *1.1 Fiscal management*

**192. Strengthening fiscal governance is paramount, particularly in terms of the planning and execution of natural resource-related revenues and the creation of fiscal space.** Azerbaijan has made progress towards credible, accountable and transparent fiscal management but progress needs to accelerate, especially in the light of deteriorating growth and fiscal trends and the urgent need for budgetary adjustment. Stabilization is a priority because it is a necessary condition for maintaining economic health. Azerbaijan has accumulated nearly half of GDP in reserves, which has helped take the edge of real exchange rate appreciation and will also provide a buffer to smooth spending as oil prices fluctuate. However in the absence of effective fiscal rules and governance norms that assist in an objective prioritization of expenditures and guard against pro-cyclical spending, SOFAZ is not enough. The State Oil Fund has financed a public investment program supporting both immediate needs and long term development goals, however to ensure that oil wealth benefits future generation in a sustainable way, further institutional building is needed for transparent project identification, planning, prioritization and execution. The main

areas where further effort is needed to strengthen capabilities include independent scrutiny and oversight in relation to tax administration, procurement, internal audit and external audit.

**193. Results-focused programmatic budgeting could support this objective, which also calls for supporting the development of a public investment management mechanism to ensure the identification of projects is in line with development priorities and for ensuring that the management of the public investment cycle is resource efficient and performance oriented.** Azerbaijan has strengthened its public expenditure framework as evidenced by improving scores on the PEFA<sup>76</sup>. However, further improvements in three areas would lead to higher transparency, predictability and efficiency in the PFM system, in particular, (i) internal and external audit coverage could be expanded and international standards applied more comprehensively, (ii) comprehensive, integrated medium term budgeting, and (iii) consistency of functional classification with GFSM2001 would serve better budget planning and execution.. This will help channel public expenditures toward the provision of accessible and quality infrastructure and social services.

**194. In the medium term, the tax system can also be enhanced by further strengthening tax collection, increasing the role of indirect taxes and levies on luxurious consumption, moving toward cashless transactions and modern system of price transfer legislation, increasing transparency, and expanding the tax base by improving the business environment to attract more investment.** Additionally, strengthening the transparency and accountability of public procurement would be an important aspect of public resource management. PPPs could support the financing and operation of infrastructure related services and could support the creation of fiscal space.

## *1.2 Service delivery*

**195. Strengthening the State's capacity for delivery of quality services is a key binding constraint, with a particular focus on improving accountability and transparency.** It is specifically suggested that local capacity and accountability are strengthened by empowering local government structures. This would be require measures both politically and in terms of budget execution. Citizen engagement and customer feedback for monitoring delivery will be an important aspect to ensuring accountability as well as demographic and geographic inclusion- especially in terms of gender, IDPs, and the rural poor.

**196. Coordination in sectors such as land, food safety, water, and agriculture is hampered by the involvement of multiple ministries with overlapping competencies with adverse**

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<sup>76</sup> The second PEFA assessment in Azerbaijan was conducted jointly by the World Bank, EU and SECO. Full PEFA report is published on the official web-site of the Ministry of Finance of the Republic of Azerbaijan: <http://www.maliyye.gov.az/node/1780> (in Azerbaijan); <http://www.maliyye.gov.az/en/node/1779> (in English).



**implications for the quality of public service delivery.** Informal networks, including a nexus between business and administrative officials, weaken accountability mechanisms and corruption remains a problem, though the Government has progressed strategically through the formal adoption of a national anti-corruption plan. Moreover, while ASAN has made significant progress in expanding service delivery throughout the country; additional review and evaluation are needed to ensure the accountable governance of the program as well as reforms to improve the efficiency and scope of its programs. Reforms in areas such as customs services and tax administration could have significant impacts on the business environment, for example by helping to promote cross-border trade and reducing labor informality - ultimately improving productivity and fostering private sector led growth.

197. **It would be also important to further strengthen environmental aspects of public service provision, given the importance of sustainable land use for the bottom 40 and the overall risks imposed on health, especially of the demographically and geographically vulnerable, of environmental damage and chemical pollution.** Environmental sustainability is at risk in Azerbaijan if the depletion of resources continues at the rate of the last decade and this would primarily impact the bottom 40. While the Greater Baku area enjoys relatively improved provision of services in terms of water treatment and solid waste management; rural areas, and secondary and tertiary towns where the majority of the poor live remain critically underserved. In particular, landscape degradation, desertification, limited waste water treatment leading to significant pollution of river waters and of the Caspian, and poor quality of drinking water are major concerns

### *1.3 Rule of law*

198. **Enhancing the technical and administrative capacity of the judiciary, as well as its autonomy from the executive, both in terms of civil and corporate matters, will be key for Azerbaijan.** Azerbaijan is taking steps to modernize the judiciary through building and upgrading court houses, improving case management, training and evaluation of judges, applying new information systems, providing legal aid to citizens to boosting trust in the judiciary. These efforts have resulted in some improvements on rule of law indicators as discussed in more depth above. In 2013, on WGI Azerbaijan ranked in the 30th percentile on this indicator, up from the 21st percentile in 2011. However, it remains below the ECA average of 47 on gaps in access to and quality of judicial services remain. To raise effectiveness of checks and balances, it also needs to take measures toward judicial independence on which the country ranks 99th of 144.

199. **Promoting rule of law will be fundamental for addressing the challenge of unleashing productivity growth and shifting the private sector into a key driver of growth.** The application of legal norms and the arbitration of disputes in courts has to be impersonal, in the sense that rules should apply equally for all. This is a foundation for the development of sound market institutions and a business environment capable for promoting private sector investment

and fostering competition. Without the mechanisms in place to ensure an even playing field for all firms, well defined enforceable property rights, and a lower concentration of ownership in financial, manufacturing and key service sectors.– other private sector reforms may have limited impacts. This strengthening of the business environment will importantly support the SME sector, allowing firms to grow in terms of productivity and labor force. Moreover, the importance of a level playing field cannot be overstressed in the context of inclusion. Access to productive opportunities is influenced by social networks and access to markets. As discussed, analysis reveals high perception of the importance of having connections to obtain quality jobs in Azerbaijan, and indicates that the uneven distribution of social capital may be dampening expectations of future social mobility in the country. Improved governance, especially rule of law, is essential for promoting equitable access to jobs and moving qualified people into higher productivity and higher wage sectors in the formal economy.

#### *1.4 Data*

**200. Improving systematic data collection and analysis to strengthen the provision of public services and improve the design and effectiveness of policy interventions targeting private sector competitiveness.** This allows for evidence-based policy making which is fundamental to (i) improving bureaucratic capacity and service delivery, facilitating focus on performance, enhancing monitoring and evaluation and enabling course correction where needed; (ii) early identification of emerging disparities and observation of progress to improve design of inclusive development policies; (iii) fostering transparency and accountability by providing the basis for informed feedback into the decision making process. The knowledge gaps evidenced throughout this report underscore the need for improved data collection and analysis.

**201. The coordinated collection of frequent, timely, and disaggregated data strengthens the capacity of public administration to better measure and monitor progress on development goals and policy interventions.** Frequent and timely data collection increases bureaucratic capacity to closely observe progress on long term trends as well as respond to short term developments in the environment such as external shocks. Moreover, collecting data at a disaggregated level promotes more inclusive development through the identification of disparities between regions and social groups. Finally, the provision of data through integrated systems helps administrative bodies to coordinate and increases efficiency, transparency, and accountability of policy interventions.

**202. Analytical instruments such as monitoring and information systems and impact evaluations allow for more efficient allocation of resources and the delivery of high quality services.** Monitoring and information systems provide instruments which generate knowledge on the status of delivery and provision of services. This can help to report on progress, provide feedback into the decision making process, and lead to greater accountability. Impact evaluations

deepen understanding of causal mechanisms, establish best practice examples on how to achieve certain goals, and ultimately influence the design of future of policy interventions.

## *2. Human capital: Skills and health care*

203. **No diversification strategy can be successful without a more solid human capital base – the link between education and employment – as well as innovation, productivity, competitiveness is well established.** It is especially relevant for Azerbaijan, where the skills gap is a significant constraint on private sector competitiveness. For that, it is needed to increase the coverage of and access to tertiary education. Moreover, it is important to improve quality of secondary education. In terms of health care, it is important to ensure access and quality of healthcare through effective risk pooling, autonomy of service providers, and the development of payment after service mechanisms for reimbursable services. More data must be made available for performance based decision making in the provision of both education and health services. Azerbaijan should be benchmarking itself regularly through participation in international tests for example.

204. **The relatively low level of public spending and inefficient use of resources in health and education has had perverse impact on service delivery, which predominately affected the bottom 40.** Government health spending at only 1 percent of GDP, one of the lowest in the ECA region, is compensated by out-of-pocket spending as high as about 70 percent of total health expenditures and 10 percent of total household spending. Likewise, public spending on education, which dropped from 3.4 to 2.7 per cent of GDP between 2004 and 2013, did not provide adequate opportunities for improved quality and skills development while stimulated informal payments. Lack of transparency and informal payments jeopardize the effectiveness of the health and education systems and impose additional financial stress on poor and vulnerable households, depriving them from receiving higher quality service. To address these challenges, the Government introduced the system of per capita financing in tertiary education and resumed its effort to reform health financing with focus on health insurance to protect the population and increase demand for services.

### *2.1 Coverage and access to tertiary education*

205. **Education policy should include a focus on closing the gap in higher educational attainment across regions, rural/urban areas, as well as across income groups as this is fundamental for building the skills base needed for these groups to participate more actively and productively in the labor market.** There is a large gap between the poor, vulnerable and middle class in terms of tertiary education. This draws attention to many of the constraints surrounding the national demand and supply of education. As discussed in the analysis, access to tertiary education is not only limited at the national level, but is also inequitable across regions and

urban/rural areas. While in 2009, 74 percent applied for the student admission examination on average, across regions the rate varies widely: from 44 percent in the Kurdamir district to 94 percent in Sumgait city. An important factor behind the wide geographical gaps in enrollment and attainment rates is the lack of tertiary education institutions outside Baku. Forty-two of the 54 higher education institutions and 19 of the 42 tertiary vocational colleges are located in Baku city, accounting for 76 percent of university students and 57 percent of college students, respectively.

**206. Improved enrollment in quality tertiary or other post-secondary educational programs is also fundamental for increasing productivity growth and promotion economic diversification at the national level.** According to the Global Competitiveness report, an ‘inadequately educated workforce’ is the fourth most problematic factor for doing business in Azerbaijan. It is important that the educational system focuses on developing those skills in demand by firms to help close the current skills gap and promote a more competitive economy. In particular, employers cite technical, problem solving, and leadership skills as their most critical need. In addition to addressing the basic incongruities between the supply and demand sides of the labor force, greater investment in the development of advanced human capital is essential for driving innovation - a critical source of productivity growth which remains largely untapped in Azerbaijan.

## *2.2 Quality of secondary education*

**207. While Azerbaijan has achieved universal access to basic education, thus strengthening the foundations of its human capital base, its student performance has not improved.** Reforms to tertiary education are essential, but will have limited impact without a stronger foundation of quality secondary education. Data from the 2013 Caucasus Barometer suggest that only 65 per cent of the population fully trust or somewhat trust the educational system. PISA results reveal that Azerbaijan’s performance lags behind other countries with similar levels of GDP. Teacher quality is a key determinant of the quality of education in the system. The lack of a de-centralized system constrains municipal governments from making decisions regarding content and educational practices, as well as budget planning and execution to make service provision more responsive to local needs.

## *2.3 Investment in health*

**208. Health reforms should include a focus on establishing protection against impoverishing health expenditures by strengthening access and quality across regions and welfare groups.** Overall, Azerbaijan has made significant progress in improving health outcomes in recent years, but life expectancy remains stagnant. Demand for existing health services remains low, and facilities are largely outdated. An inadequate location of primary and secondary health care units constrains access to adequate health services, in particular for rural population outside

major agglomeration centers. The health system is heavily centralized around Baku generating geographic and economic imbalances in terms of quality of health care services. Health service delivery is also constrained by the lack of quality standards for health professionals and absence of incentives. The low level of health workers salaries and subsequent high demand for informal payments jeopardize the effectiveness of the health system as a whole.

**209. Inadequate supply of piped water and sanitation services is another constraint with important implications for public health, especially in rural areas.** Azerbaijan inherited a relatively extensive water supply system from the Soviet times and at present about 95 percent of the population in Baku and about 83 percent of those living in secondary cities and small towns are connected to piped water. However, the quality of infrastructure and services has deteriorated severely since independence due to a lack of investment and deferred maintenance. Despite substantial public investment including through the Bank and other development partners' support, in many secondary and small towns, water treatment facilities remain largely dysfunctional or are lacking completely, leaving the population in these towns without access to safe water and undermining the reliability of water supply. In many areas the piped water is often available for less than 12 hours per day. Less than 33 percent of the population have access to a piped water supply in rural areas where centralized piped water supply systems are rare.

### *3. Connectivity*

**210. Improving connectivity, particularly in terms of local roads that reduce transport costs for products and people, a key input to promote private sector investment, rural productivity and access to economic opportunities, is a priority.** The development of main transport corridors, along with relevant logistical services, will improve connectivity and open way for producers to reach out to local and international markets in a faster and cheaper. Modernization of key highways and railways infrastructure is essential for the country to compete for more cargo transit in the region and capitalize on its strategic geographic position. As discussed in the analysis, regional integration and cross-border trade facilitation are key areas of opportunity for Azerbaijan to improve its business environment and spur greater private sector led growth. Greater access to markets through improved local connectivity is important for promoting labor mobility and creating more opportunities for the poor and the bottom 40 to use their assets more productively. In particular, investment in local connectivity is key in terms of increasing productivity in the agricultural sector where increased access to markets could have long term impacts on stimulating rural incomes which will directly benefit the bottom 40. Finally, improved connectivity also impacts human capital accumulation – a key constraint discussed in the previous section- as it influences the demand for education and health services.

211. **Investments in connectivity, however, must be made with a concern for sustainability.** Sustainability of the significant public investment in the construction and rehabilitation of infrastructure, particularly roads and railways, is undermined by the lack of proper maintenance systems. Adequate maintenance systems are also important for modernization of the asset management system. In particular, a maintenance system for the key road network the main highways of which are to be completed over the next 5 years is not functional. As a result, even some of the recently rehabilitated major road assets are deteriorating. If maintenance is neglected, Azerbaijan will start losing the benefits of ongoing investments while the current asset value of the main road network will decline by about 10 percent by 2020. Ongoing reforms in the railway sector need to be completed to improve its competitiveness, financial sustainability, operational and cost efficiency. The construction of rural and regional roads, multi-modal corridors, railways, and inland waterways has great potential for alleviating poverty, boosting macro and micro economic activity and reducing income inequality.

A summary of the above priorities is shown in the next table:

<p>Short-term ( <math>\leq</math> 3 years)</p> <p><b>Challenges:</b>  <b>Top-down</b> <i>Ensuring fiscal trends are sustainable and growth is stable, sustainable and shared</i></p> <p>Sustainable asset diversification and productive use at the macro-level through</p> <ol style="list-style-type: none"> <li>1) Strategic use of oil rents and effective fiscal management;</li> <li>2) Unleashing Productivity Growth (Private Sector Including Agriculture); Trade and Trade Facilitation</li> </ol>	<ul style="list-style-type: none"> <li>• Creating fiscal space through strengthened accountability, transparency and efficiency of public spending by instituting credible fiscal rules of the game, implementing PEFA recommendations, the Government's own national anti-corruption strategy, and developing the institutional capacity and mechanisms needed for results-based programmatic budgeting.</li> <li>• Strengthening of local authorities as a decentralization strategy established and implemented.</li> <li>• Strengthening governance of private sector to ensure even playing field, well defined property rights, facilitate financial inclusion, and support integration and trade facilitation.</li> <li>• Completing roll-out of ASAN, review and evaluation to ensure governance accountable of the program, customs reforms completed and customs services integrated into ASAN; tax administration integrated into ASAN.</li> <li>• Continued investment in irrigation, boosting agricultural productivity to</li> </ul>
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<p><b>Bottom-up: Sustainable accumulation of human, physical and financial capital</b></p>	<p>address rural income inequality and roads infrastructure; other key public services including housing, water and sanitation, and social services, particularly targeting IDP communities.</p> <ul style="list-style-type: none"> <li>• Capacity building and autonomy of judiciary.</li> <li>• Strengthening data collection and use relating to public spending, especially public investment, and public services with a view to strengthening monitoring and evaluation of impact on b40 and facilitating evidence based decision making and course correction where needed.</li> <li>• Education policy established and implementation initiated for quality improvement at secondary level and strengthened access and coverage at tertiary level.</li> <li>• Risk pooling in health care and reforms to support autonomy, standards and quality; establish protection against impoverishing health expenditures by strengthening access and quality.</li> <li>• Programmatic budgeting established and disaggregated data published; preliminary performance indicators established.</li> <li>• Review of data management and publication practices completed at both macro and micro level and reforms implemented.</li> <li>• Drafting of PPP framework, public investment management methodology and piloting.</li> <li>• Time-bound strategy for environmental sustainability incorporating integrated landscape management and cleanup of contaminated land; wastewater management and improved local environmental services established.</li> </ul>
<p>Longer-term (3+ years)</p>	<ul style="list-style-type: none"> <li>• Overhaul local connectivity.</li> <li>• Implement education policy focused on access to tertiary and quality of secondary.</li> </ul>

	<ul style="list-style-type: none"> <li>• Continue to strengthen access and quality of health care while ensuring adequate financing mechanisms.</li> <li>• Performance-based programmatic budget established and implemented.</li> <li>• Capital budgeting methodology established and implemented.</li> <li>• PPP framework established and functional, both in terms of financing of and provision of infrastructure and social services.</li> <li>• Irrigation overhauled.</li> <li>• First phase of strategic plan for environmental sustainability implemented; with next phases for medium and long term actions defined.</li> </ul>
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212. Interventions aimed at lifting the key constraints identified above, following the cross-cutting criterion, could impact a wide set of elements, such as quality of service provision --basic and secondary education, enhancement of health services—but also better investment climate and enhancement of productivity in rural sectors and for SMEs. Removing those constraints would indeed have a systemic impact on addressing the identified challenges in this SCD, and ultimately keep Azerbaijan on a path of progress towards achieving the twin goals.



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## Annex 1: The Medium term Macro Framework

### Medium-Term Macroeconomic Framework for the Azerbaijan Economy

**Economic growth is projected at an annual average of 2.2 percent over the medium-term based on weak oil price, oil production decline and low public investment.** Oil production has been on a gradual decline since the peak production year of 2010. Despite the fall in oil output over the past 5 years, the Azerbaijan economy grew on the back of non-oil growth, led by construction and supported by high public investment. Going forward the oil price is projected to average low at \$53 per barrel for 2015 and \$59 per barrel for 2016-17, suggesting constrained capital expenditures, with public investment projected to average 11 percent of GDP over 2015-17 leading to lower non-oil growth. The devaluation of manat by 33.6 percent on February 21 2015 has mitigated budget pressures and represents an important realignment with new economic fundamentals. It also has generated uncertainty in expectations, upward though potentially temporary pressure on inflation, and some balance sheet effects, including systemic risks due to high dollar denominated liabilities of the International Bank of Azerbaijan, which represents 33 percent of the sector. In addition, there are emerging pressures on State owned Enterprises, both due to falling oil prices and the devaluation that will need to be closely monitored.

Table A2.1: Macroeconomic Trends and Projections<sup>77</sup>

(In percent of GDP, unless otherwise indicated)

	2010	2011	2012	2013	2014e	2015p	2016p	2017p
	Actuals				Projections			
<b>National Accounts</b>								
Real GDP growth (percent change)	5.0	0.1	2.2	5.8	2.8	1.4	2.5	2.6
Oil GDP	1.8	-9.3	-5.0	0.9	-1.5	-1.5	-1.1	-1.1
Non-oil GDP	7.9	9.4	9.7	9.9	7.0	3.5	3.8	3.9
Consumer Price Index (percent change)	5.7	7.8	1.1	2.4	1.4	0.9	1.2	1.2
GDP per capita (in U.S. dollars)	5,922	7,285	7,594	7,977	7,938	6,609	6,861	7,128
Gross investment	18.5	21.2	23.8	25.6	21.2	21.8	21.8	23.1
Public	10.9	11.3	14.7	15.1	12.0	11.1	11.0	10.9
Private	7.6	9.9	9.0	10.5	9.2	10.8	10.8	12.2
Gross national savings	46.6	47.6	43.4	43.3	35.1	22.7	25.2	28.0
<b>General Government Operations</b>								
Revenues and grants	45.8	45.4	41.4	39.7	38.9	35.0	34.5	34.4
Non-oil revenues	10.4	9.8	12.6	11.6	12.7	16.0	16.1	16.0
Expenditure and net lending	32.1	34.3	37.2	37.8	36.2	45.6	40.9	39.2
Current expenditure	21.2	23.0	22.5	22.7	24.2	34.6	30.0	28.3
Capital expenditure and net lending	10.9	11.3	14.7	15.1	12.0	11.1	11.0	10.9
Overall fiscal balance	13.7	11.1	4.2	1.9	2.7	-10.6	-6.4	-4.8
Non-oil fiscal balance	-21.7	-24.5	-24.6	-26.2	-23.5	-29.6	-24.9	-23.2
<b>External Sector</b>								

<sup>77</sup> Reflects projections prior to the devaluation

Current account balance	28.4	26.5	21.7	16.6	14.2	0.9	3.4	4.9
Exports of goods and services	53.6	56.2	53.7	48.8	47.1	35.9	35.8	35.8
Imports of goods and services	19.8	24.0	25.6	26.5	26.8	30.4	27.8	26.5
Non-oil current account balance	-9.1	-12.7	-12.4	-13.4	-12.5	-12.6	-11.3	-11.0
FDI (net)	0.6	1.4	1.2	1.5	1.5	1.8	1.7	1.8
Total public sector debt	11.1	10.2	11.3	11.7	14.4	14.5	14.6	14.6
<i>Memorandum items:</i>								
Nominal GDP, billion AZN	42.5	52.1	54.7	58.2	58.9	49.4	51.7	54.1
Nominal exchange rate (AZN/\$)	0.798	0.787	0.785	0.785	0.785	0.785	0.785	0.785
Oil Fund assets, million USD	22,767	29,800	34,129	35,878	37,104	31,863	28,537	25,958

*Source:* World Bank staff estimates based on data from the IMF and the Azerbaijan authorities.

*Note:* Oil price is based on the projection in the GEP 2015 January report. The recent devaluation on February 17 is not reflected in this table.

**Due to low projected oil revenues, the fiscal balance will deteriorate markedly with a deficit at about 7 percent of GDP over the medium term.** Lower revenues will call for reduced spending on future capital projects to avoid running a large fiscal deficit. However, with the oil price dropping fast in a short period of time, a projected cut in public investment will only partially cushion the fall in oil revenues, since many capital projects are still on-going. The fiscal deficit is projected to reach 10.6 percent of GDP in 2015, narrowing as the oil price recovers gradually and the government consolidates its expenditures over the medium term. Oil fund transfers are expected to help finance the fiscal deficits. Since the oil fund reserves currently stand at about 50 percent of GDP, financing annual fiscal deficits averaging 7.3 percent of GDP over the medium term is unlikely to deplete the fund but will reduce it significantly suggesting a strong case for fiscal consolidation.

**The Central Bank of Azerbaijan maintained a de-facto peg of the manat to the US dollar before it changed its exchange rate policy and devalued in February 2015.** There is not any official exchange rate target the CBA commits to defend: however the value of manat has been closely pegged to the US dollar since 2009. From 2006-08 the CBA allowed an appreciation of manat to accommodate large amount of public spending out of surging oil revenues. In late 2008, a series of currency devaluations across the region put tremendous depreciation pressure, leading the CBA to sell 20 percent of its reserves to defend the peg to the dollar. Since 2009, the exchange rate was kept as a close peg to the dollar, with a slight appreciation of 2.3 percent over the past five years. Meanwhile foreign reserves reached \$15 billion by mid-2014 but fell to \$11.2 billion in late February as the Central Bank needed to intervene in forex markets to stabilize the exchange rate. On February 16 2015 the CBA moved to peg the manat to the dollar and the euro from its prior dollar only peg. Subsequently on February 21, the CBA set the official rate to 1.05AZN/USD, a 33.6 percent overnight devaluation.

**The current account surplus is projected to fall to 3.1 percent of GDP over the medium term but the external sector will remain resilient.** The current account surplus has been on a decline since 2011 and the drop in oil price will exacerbate this fall. Value of exports follow the movement of oil price closely since crude oil accounts for 84 percent of all exports and 93 percent of merchandise exports from Azerbaijan. Import growth is expected to lose steam due to reduced public investment over the medium term. In addition, the weakening of the Russian economy coupled with erosion of competitiveness due to the depreciation of several currencies in the region pose a challenge for Azerbaijan's non-oil exports, more than 60 percent of which went to Russia in 2014. Although oil exports to European countries will continue to dominate, the fall in non-oil exports due to the deteriorating external environment will also adversely impact current account surplus. FDI is expected to remain small at under 2 percent of GDP over the medium term and the majority of foreign investment will still flow to the oil sector. In addition, with a smaller current account surplus going forward, reserve accumulation is expected to slow-down.

**Monetary policy is anchored to the fixed exchange rate with limited flexibility.** Although capital flows are not controlled, equity inflow is limited due to underdeveloped domestic capital markets and the high cost of doing business. Fiscal dominance, high share of cash in circulation, dollarization and absence of interbank money market also undermine the monetary policy transmission. During 2006-08 for example, the fiscal expansion led to a substantial increase in money supply - by 7.5 folds. This led to inflation reaching double digits despite limited sterilization efforts by the CBA. Low oil prices in 2009 moderated the fiscal expansion and drove down inflation. In addition, as a stabilization measure the CBA lent directly to state enterprises that had significant liquidity programs. Since 2009 inflation has been moderate and fell to 1.4 percent annual average in 2014.

**Inflation is projected to increase in 2015 but remain under 2 percent reflecting weaker growth and aggregate demand from 2016 onwards.** Due to the exchange rate increase, there will likely be a sharp rise in inflation above the Central Bank's indicative target of 5 percent in 2015. Higher prices of imported goods, which account for 45-50 percent of the basket of consumer goods, will generate considerable inflationary pressures. As the economy slows down in the medium term and the oil price falls, medium-term inflation is projected to be even lower than the 1.4 percent in 2014. In response the Central Bank is expected to loosen monetary policy though transmission channels are weak.

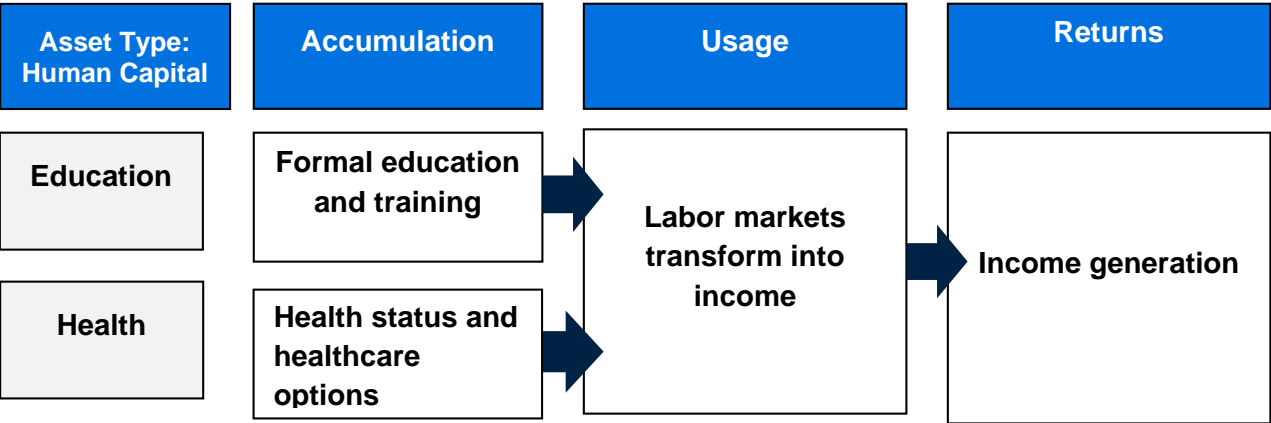
**Public debt will remain sustainable over the medium term.** Despite a \$1.25 billion Eurobond issuance in early 2014, the debt-to-GDP ratio is expected to stay below 15 percent of GDP in 2014. Over the medium term, as the Federal Reserve raises interest rate and Azerbaijan economy faces high uncertainty, financing via bond issuance is likely to incur a higher cost. Under this circumstance, the government is expected to finance future budget deficits using transfers from the Oil Fund. And according to the most recent Debt Sustainability Analysis (IMF 2013), the level

of debt will increase slowly over the long term, but will remain low under different scenarios of large shocks.

Annex 2: Shared Prosperity Diagnostics

This annex exemplifies how human capital endowments, specifically health and education, can impact the income generation capacity of households and identify constraints to this process. Figure 1 below illustrates this process of accumulation, usage and returns. However, it is important to note that the process is a multi-directional. For example, expectations of returns feed into incentives to invest in accumulation. In order to understand the underlying factors which determine the returns to education and health for the BOTTOM 40, this analysis identifies potential demand and supply constraints which could affect the accumulation and use. While in many cases, supply and demand constraints are closely interconnected, attempting to disentangle these channels can be useful for understanding differing policy implications.

Figure 1: Accumulation, Use, and Returns to Human Capital



This annex demonstrates this process using the example of education, including both formal and non-formal education. Formal education is mostly obtained through schools or university while non-formal education such as (vocational) training often relates to firm specific capital which increases productivity within one firm but cannot necessarily be transferred between firms or sectors.

When considering constraints to the *accumulation* of education, we look at both the supply and demand factors. In terms of supply, constraints may include factors such as coverage, selectivity, availability of quality teachers, transportation costs to access educational services and geographic location of schools, availability of public funding, and national/local administrative management systems. Whereas on the demand side, constraints may include factors such as social norms such as discrimination against girls or minorities, opportunity costs for being school instead of the labor force, educational quality, and relevance of education and skills training to the job market and future opportunities to generate income.



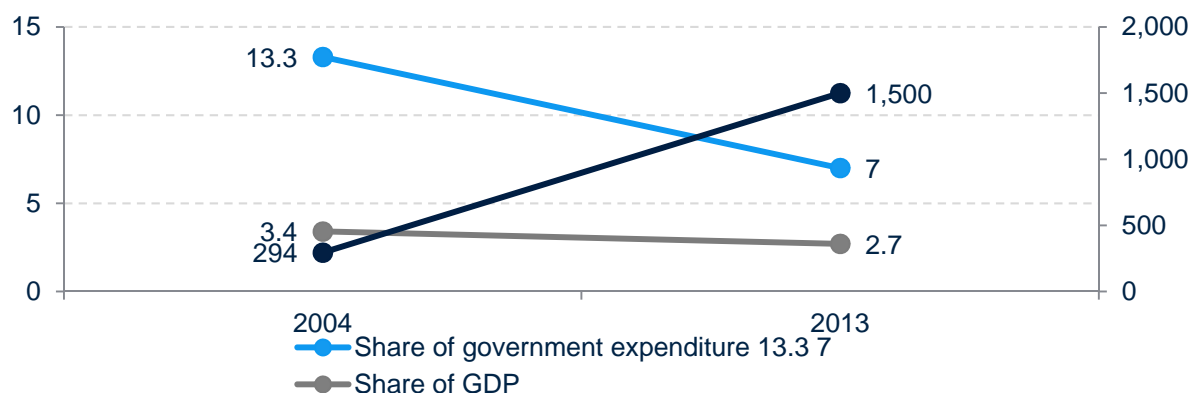
**As with the above example, constraints to the use of education are broken down into supply and demand factors.** Types of constraining factors to the use of education on the supply side may include social benefit or tax systems that provide disincentives to work, commuting costs, restrictions on labor mobility, lack of flexible working arrangements, social norms such that women are not expected to join the work force, and high transactions costs for finding employment. On the demand side factors may include skills mismatch, insufficient investment and lack of firm growth, tax rates for firms, social norms regarding employment and sector-specific employment for women and minority groups, access to capital to invest in private sector, restrictive business environments, and lack of trust from firms in the quality of education.

**In order to understand the extent to which each of these factors is or is not an important constraint affecting the returns to education for the bottom 40 in the context of Azerbaijan, each factor needs to be broken down into measurable indicators available in current data sources.** For Azerbaijan, some key databases for measuring these factors include the 2103 Enterprise Survey, 2014 Doing Business survey, 2002-2008 BOOST data, 2011 Global financial Inclusion Database 2006/2010 Life in Transition Survey, annual Caucasus Barometer survey, 2009 PISA, 2005/2007/2012 HBS data, national legislation, and recent World Bank reports focused on a national assessment of gender, global returns to schooling, and regional jobs challenges. However, it is an important to note that many of these data sources are limited in their ability to offer disaggregated information across welfare groups which presents a challenge when attempting unpack how these factors may be different for the bottom 40. Furthermore, the lack of availability of many recent data sources, and in some cases any data sources at all, presents a challenge in trying to identify current constraints. The box below offers a sampling of the types of indicators which could be used for this type of analysis. A more comprehensive list is available in Annex X.

#### Box: Quantifying constraints for education - Sample indicators

*Measuring potential supply constraints to education accumulation*

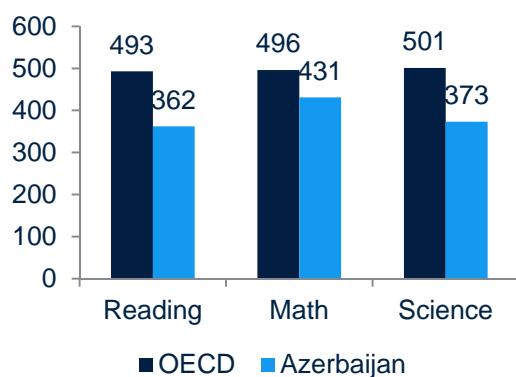
##### Public expenditure on education 2004-2013



Source: 2014 World Bank Group Azerbaijan Partnership Program Snapshot.

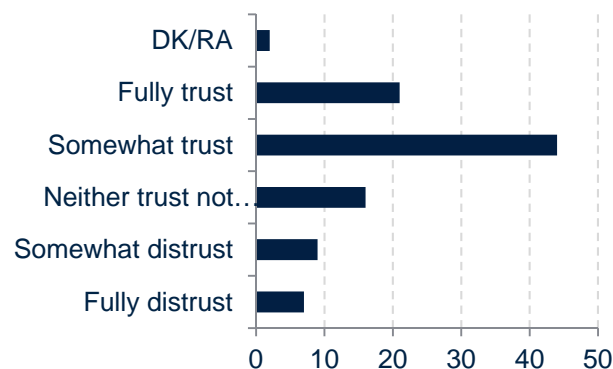
*Measuring potential demand constraints to education accumulation*

**Educational outcomes, 2009 PISA Scores**



Source: 2009 PISA.

**Trust in the Educational System, Frequency Distribution (%)**



Source: 2013 Caucasus Barometer Azerbaijan.

*Measuring potential supply constraints to education use*

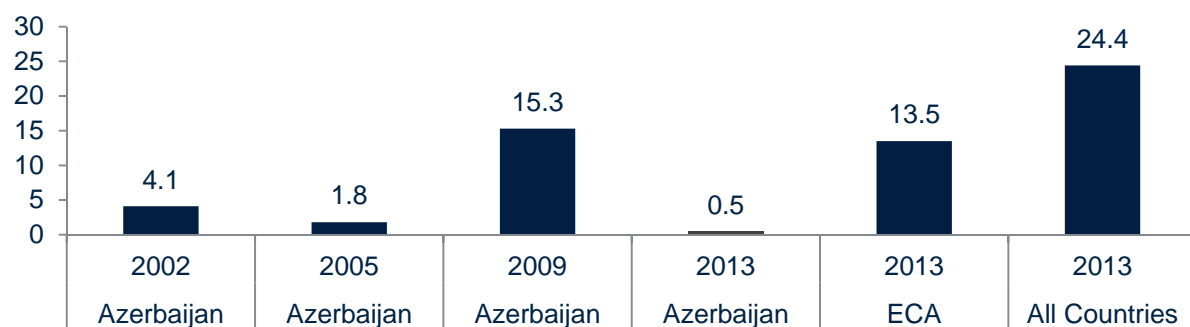
**Legislative support for flexible work arrangements**

Do employees with minor children have rights to a flexible/part-time schedule?	Yes	Labor Code, Art. 245
Does the law mandate paid or unpaid maternity leave?	Yes	Labor Code, Art. 125
Does the law mandate paid or unpaid paternity leave?	Yes	Labor Code, Art. 130 B
Does the law mandate paid or unpaid parental leave?	Yes	Labor Code, Art. 127
What is the mandatory minimum length of paid maternity leave (in calendar days)?	126	Labor Code, Art. 125.1
What is the mandatory minimum length of paid paternity leave (in calendar days)?	0	No applicable provisions could be located
What is the mandatory minimum length of paid parental leave (in calendar days)?	1039	Labor Code, Art. 127
Is there public provision of childcare for children under the age of primary education?	Yes	Law on the State Budget of the Republic of Azerbaijan for 2013 (original language), Art. 8.4.1

Source: 2013 Azerbaijan, Women, Business, and the Law.

*Measuring potential demand constraints to education use*

**Percent of firms identifying an inadequately educated workforce as a major constraint**



**Source:** 2013 Azerbaijan Enterprise Surveys.

### *Measuring returns to education*

#### **Returns to Schooling in Azerbaijan (1995)**

Return to another year of schooling	7.2
Standard deviation of return to another year of schooling	2.9
Returns to education total primary	19.8
Returns to education total secondary	2.2
Returns to education total tertiary	8.1
Returns to schooling male primary	28.2
Returns to schooling male secondary	
Returns to schooling male tertiary	7.8
Returns to schooling female primary	11
Returns to schooling female secondary	4.2
Returns to schooling female tertiary	7.5

**Source:** Comparable Estimates of Returns to Schooling Around the World, World Bank 2014.

## Annex 3: Indicator Tables

### Education

**Table 1: Returns to education**

Indicator	Data Source	Data sensitivity to welfare distribution
<ul style="list-style-type: none"> <li>Return to another year of schooling</li> <li>Returns to education total primary</li> <li>Returns to education total secondary</li> <li>Returns to education total tertiary</li> </ul>	WB report: Comparable Estimates for Returns to Schooling Around the World	

**Table 2: Constraints to the accumulation of education**

Supply			
Factors	Indicators	Data Source	Data sensitivity to welfare distribution
Coverage at each level Selectivity: Competition to enter higher level of education (due to lack of resources or social beliefs)	<ul style="list-style-type: none"> <li>Available seats</li> <li>Share of applications rejected</li> </ul>	Admin data	
Availability of quality or certified teachers	<ul style="list-style-type: none"> <li>Student-to-teacher ratio</li> </ul>	PISA	
Availability of financial resources for education	<ul style="list-style-type: none"> <li>Public Expenditure on schooling</li> </ul>	BOOST	
Management of educational system: Autonomous or centralized schooling system		PISA National legislation	
Training on the job: Need for for firm specific human capital	<ul style="list-style-type: none"> <li>Enrollment rate for boys and girls</li> </ul>	South Caucus Skills Development (P144377)	
Connectivity: transportation cost and (geographical) access to educational services.	<ul style="list-style-type: none"> <li>Regional disparities in educational enrollment</li> </ul>		
Demand			

Factors	Indicators	Data Source	Data sensitivity to welfare distribution
Social Norms: discrimination against girls or minorities	<ul style="list-style-type: none"> <li>Gender gap in educational attainment and returns to schooling</li> <li>Schooling outcomes for minorities</li> </ul>	<ul style="list-style-type: none"> <li>AZE Gender Assessment</li> <li>LiTs</li> <li>Caucasus Barometer</li> </ul>	
Opportunity costs to education	<ul style="list-style-type: none"> <li>Employment rate for age group 16-18</li> </ul>	<ul style="list-style-type: none"> <li>HBS</li> </ul>	
Educational quality: does the educational system provide the right skills; is curriculum up to date	<ul style="list-style-type: none"> <li>Learning outcomes</li> <li>Accreditation</li> </ul>	<ul style="list-style-type: none"> <li>PISA</li> </ul>	
Financial costs	<ul style="list-style-type: none"> <li>Fees for schooling</li> </ul>	<ul style="list-style-type: none"> <li>National legislation</li> </ul>	
Relevance of education to generate higher income in the future.	<ul style="list-style-type: none"> <li>Estimated coefficient from mincer regression</li> </ul>	<a href="#">Comparable Estimates of Returns to Schooling Around the World</a> , page 20	
Parental value	<ul style="list-style-type: none"> <li>Parental education</li> </ul>		
Social values and beliefs about educational attainment			
Failure to meet entrance requirements	<ul style="list-style-type: none"> <li>Pre- school enrolment rate</li> </ul>		
TRAINING ON THE JOB: opportunity costs of foregone work days			
TRAINING ON THE JOB: Is firm specific knowledge transferable to other firms or sectors	<ul style="list-style-type: none"> <li>Frictions between sectors</li> </ul>		

**Table 3: Constraints to the usage of education**

Supply			
Factors	Indicators	Data Source	Data sensitivity to welfare distribution

Generosity of social benefits schemes providing disincentives to work	<ul style="list-style-type: none"> <li>• Payments through social benefits</li> </ul>	HBS Data National Accounts	
Structure of tax system	<ul style="list-style-type: none"> <li>• Marginal tax rate on income</li> <li>•</li> </ul>	Back to Work	
Connectivity: transportation cost to commute			
Restrictions on labor mobility			
Lack of flexible work arrangements	<ul style="list-style-type: none"> <li>• Childcare facilities</li> <li>• Paternity leave</li> </ul>		
Social norms: women are not expected to join the work force.	Intra household bargaining.	LiTS data Caucasus Barometer	
Labor mobility across sectors reduced because of certificates and licenses		National legislation	
Transaction costs (information) or further job finding constraints imply low matching speed between workers and firms	Time to find a job	ILO	
Long term unemployment: stigma and demotivation			
Demand			
Factors	Indicators	Data Source	Data sensitivity to welfare distribution
Social Norms	For women and minority groups: employment by sector, unemployment rate, labor force participation	ILO, Barometer, Quali data	
Skills mismatch	Share of firms indicating that skills become an obstacle to operations	South Caucas Skills Development (P144377) Enterprise Survey	
Insufficient investment and lack of firm growth	Size distribution of firms Private investment in different sectors	Firm Survey, BEEPS	

Firms need to pay taxes which induces a wedge over marginal productivity of labor	Tax rates	National legislation Back to Work	
Access to capital in order to invest in private sector	Capital requirements and collateral	Enterprise Survey	
Restrictive business environment	Firing costs, severance payments	Enterprise Survey Doing Business	
Firms do not trust the quality of education (lack of quality control and independent evaluation)		Firm Survey	

## Health

**Table 1: Constraints to the accumulation of health**

Supply			
Factors	Indicators	Data Source	Data sensitivity to welfare distribution
Limited number of doctors			
Lack of financial resources to invest in infrastructure, equipment and medicine	Public expenditure on health (national and regional level)	BOOST data	
Backwardness related to technology and innovation			
Lack of health education or under-provision of prevention measures through government			
Demand			
Factors	Indicators	Data Source	Data sensitivity to welfare distribution
Lack of awareness			
Financial constraints and no coverage through health insurance	Out of pocket payments, insurance coverage, cost of insurance	National legislation  WHO	

Connectivity and limited access to services	Average distance to health center; regional disparities		
Parental conditions and early childhood investments			
Social value of health			
Health behavior	Drinking and smoking	WHO	



#### Annex 4: Equality of Opportunities and Social Capital: Azerbaijan in Context

Cojocar (2014a) constructs a measure of *perceived inequality of opportunity* that is consistent with the belief that connections in *any* of the above areas are either very important or essential. This cutoff is arbitrary, but it is consistent with the belief that fair access to government positions, or education, etc. is severely constrained. Note also that inequality of opportunity thus defined is in the spirit of John Rawls. Recall that the second part of the Second Principle of Justice proposed by Rawls (1971) requires that offices and positions in society be open to all on a fair basis.<sup>78</sup> This is precisely what is queried by the above survey questions, since need for connections to get jobs in various sectors, or to get necessary permits for business activity is in direct contradiction of the Second Principle as it denies equal access to all.

The share of those with no connections is higher for those with low levels of education. Across levels of education, overall perceptions of inequality of opportunity do not appear to be systematically more widespread among those with lower levels of education.

**Table 1: Inequality of opportunity and availability of connections in Azerbaijan, by education level**

Education level	Connections are vital	No connections are available
Primary or less	69.1	46.1
Secondary	71.4	40.3
Post-secondary	65.1	32.4
Overall	68.9	37.5

Source: LiTS II survey.

Cojocar (2014a) explores whether the presence of an uneven playing field can dampen one's expectations of future social mobility. This is an extension of related work (Cojocar, 2014b) that shows, based also on LiTS II data, that expectations of future social mobility are important determinants of current policy preferences, in particular with respect to redistribution.<sup>79</sup> The link between IO, connections and expectations of future mobility is explored, in a multivariate framework, based on the following formulation:

$$Status_i^{f*} = \delta_1 Conn_i^1 + \delta_2 Conn_i^2 + \delta_3 Conn_i^3 + X_i' \gamma + \epsilon_i,$$

<sup>78</sup> The two principles of justice proposed by Rawls are as follows: First Principle – “each person is to have an equal right to the most extensive total system of equal basic liberties compatible with a similar system of liberty for all”; and Second Principle – “Social and economic inequalities are to be arranged so that they are both: (a) to the greatest benefit of the least advantaged, consistent with the just savings principle, and (b) attached to offices and positions open to all under conditions of fair equality of opportunity.” (Rawls, 1971: p.302).

<sup>79</sup> Expectation of future mobility are defined based on responses to the questions inquiring about the respondent's position on a 10-step socio-economic ladder today, and four years hence.

Where  $Status_i^{f*}$  is the expected future ladder position,  $Conn_i^j$  dummies represent the factorial interaction between respondent's view on the importance of connections (either vital or not, defined as before) and the availability of connections. This interaction creates four categories, namely: (i) connections are not vital but available (reference category); (ii) connections are not vital and not available  $Conn_i^1$ ; (iii) connections are vital and available  $Conn_i^2$ ; and (iv) connections are vital and not available  $Conn_i^3$ . The vector  $X_i$  includes a number of factors expected to influence expectations of future mobility, including current position on the ladder, the individuals past mobility experience, degree of risk aversion, the impact of the recent financial crisis, beliefs about the key determinants of need in society, as well as important socio-demographic characteristics such as age, sex, education, employment status, religion (for details, see Cojocaru, 2014a). Several hypotheses are tested empirically:

**Hypothesis 1** ( $\delta_2 - \delta_3 > 0$ ) : when the playing field is not even, connections improve the expectations of future socio-economic mobility;

**Hypothesis 2** ( $\delta_1 - \delta_3 > 0$ ) : if informal connections are unavailable, an uneven playing field dampens the aspirations of future socio-economic mobility.

The estimates for the pooled sample, as well as those for non-EU countries, and, separately, for Azerbaijan, are consistent with both of the above hypotheses: when connections are unavailable, an uneven playing field is associated with lower expectations of future mobility, and, concurrently, when the playing field is not even, availability of connections is associated with greater expectations of future upward mobility. The hypotheses are not borne out by the data in the EU sample, which can be due to it being less common – and possibly less socially acceptable – to rely on information connections in EU countries, where formal institutions are stronger.

## **Annex 5: Micro data in Azerbaijan**

Source: Azerbaijan Poverty Note, 2014

In 2010, a Global Assessment of Azerbaijan's National System of Official Statistics was conducted by the European Commission (Eurostat), European Free Trade Association (EFTA), and United Nations Economic Commission for Europe (UNECE). The Assessment identified a need for developing a proactive and transparent dissemination policy targeted to all groups of users as well as the development of tools for data dissemination. The Assessment also noted the need to increase trust in official statistics and to promote use of statistics in decision-making processes.

### **Official micro data**

The Law on Statistics ("Law") recognizes the State Statistics Committee (SSC) as the official data producer making the SSC an important point of dissemination of data. The SSC also conducts a detailed household budget survey (HBS) annually following a panel of households first selected into the survey in 2006. The sample consists of 4000 households interviewed each quarter on topics including consumption, expenditures, income, labor/employment, health, education, ownership of assets, receipt of transfers. The survey also asks if household has IDP or refugee status.

Following the Law and in an effort to preserve confidentiality, the SSC does not disseminate anonymized micro data. Instead the SSC publishes detailed tables using the most recently available survey. Tables using the 2013 HBS were recently published. The tables cover the following topics:

- Average size of household by economic regions
- Income of household
- Consumption expenditures of the households
- Consumption of food products in households
- Chemical structure and calories of consumed food products in households
- Distribution of households by total and living place
- Distribution of households according to amenities
- Number of durable goods possessed by household
- Distribution of households by access to land, average size of land and type of land
- Production of agriculture in households
- Economically activity of population by age and sex by urban and rural living place
- Basic source of the incomes of population by urban and rural living place
- Basic source of the incomes of population by economic regions
- Education level of population by urban and rural living place
- Distribution of members of households by health conditions
- Body mass index of population by age and sex

The most recent housing and population census was conducted in 2009. Tables based on the census are also available on the SSC website.

### **Other sources of micro-data**

#### Ministries/administrative sources

- Pensions (State Social Security Fun) Funds
  - Data on those who contribute to social security system (from pensions fund)
  - This data is available on request.
  - Limited coverage of the population by database (consists of contributors) is a concern but the team plans to access this information to understand distribution of top incomes.
- Ministry of Labor has collected a Labor Force Survey, and a household survey (called Living Standards Measurement Survey) in 2008 and 2011.

#### World Bank sponsored surveys

- Life in Transition 2007-2010
- Housing affordability survey for Baku (under planning)
- Household survey conducted as part of AzRIP

#### Other agencies:

- Caucasus Barometer –an opinion survey with several questions similar to the LiTS
  - Fielded each year
  - Data and tables available from Caucasus Barometer website

## Annex 6: Map of Azerbaijan



## Annex 7: National Official Poverty Statistics Tables

Source: Statistical Yearbook of Azerbaijan 2014, pages 159, 72. State Statistical Committee of the Republic of Azerbaijan.

### 5.14 Yoxsulluq həddi və yoxsulluğun səviyyəsi *Poverty line and poverty level*

	2005	2006	2007	2008	2009	2010	2011	2012	2013	
Yoxsulluq həddi, manat	42,6	58,0	64,0	78,6	89,5	98,7	107,2	119,3	125,2	<i>Poverty line, manat</i>
Yoxsulluq səviyyəsi, faizlə	29,3	20,8	15,8	13,2	10,9	9,1	7,6	6,0	5,3	<i>Poverty level, per cent</i>

### Məqsəd 1. İfrat yoxsulluğu və aclığı aradan qaldırmaq *Goal 1. Eradicate extreme poverty and hunger*

#### 28.1 Milli yoxsulluq həddindən aşağı yaşayan əhəlinin xüsusi çəkisi *Population below national poverty line*

İllər <i>Years</i>	Faizlə <i>Per cent</i>
2001	49,0
2002	46,7
2003	44,7
2004	40,2
2005	29,3
2006	20,8
2007	15,8
2008	13,2
2009	10,9
2010	9,1
2011	7,6
2012	6,0
2013	5,3

## ADDENDUM

The Azerbaijan Systematic Country Diagnostic (SCD), disclosed in Info Shop on June 8, 2015, should be read together with this Addendum. The Addendum comprises amendments of two kinds: (i) updates and/or corrections to data, and (ii) changes in language to the main document of the SCD.

### **I. List of updates and/or corrections to data in the report**

1. On page 1, paragraph 1 now reads: **“Between 1995 and 2013 Azerbaijan has made substantial progress towards the World Bank Group’s twin goals<sup>1</sup>.** In particular, over the last decade, the nation’s strong economic performance has been matched by a positive track-record in terms of poverty reduction, shared prosperity and middle class growth. The national poverty rate declined from close to 50 percent in the early 2000s to 6 percent in 2012, while extreme poverty is now insignificant.<sup>2</sup> At the same time, households in the bottom two quintiles of the distribution (i.e. ‘the bottom 40 percent’) experienced consumption growth of over 2 percent per year between 2007 and 2012, over twice the rate of the top 60. This growth rate is positive, although it lies below the regional Europe and Central Asia (ECA) average of 3.8 percent per year. Ultimately, improvements in living standards, particularly among those who were initially worse-off, have been accompanied by the emergence and growth of the middle class in Azerbaijan, in line with the country’s middle income status.

2. On page 16, paragraph 36 now reads: **“National averages also mask significant disparities in welfare across social groups, such as internally displaced persons (IDPs).** Approximately 11 percent of Azerbaijan’s population (around 1 million persons) is either displaced—forced to leave their homes in response to the conflict with Armenia— or has refugee status. In fact Azerbaijan has among the highest number of IDPs per capita in the world. This group is particularly affected by circumstance-driven inequalities. Both the Government and the World Bank estimate the poverty rate of IDPs to be significantly higher than among the non-displaced. The most recent government estimates state that the IDP poverty rate is around 10 percent, or approximately twice that of the official overall poverty rate. IDPs remain a core stratum in the bottom 40, in spite of public investment, which has helped relieve living conditions through improved housing and infrastructure. Figure 4 illustrates that within the group of poor households, 14 percent are considered IDPs; the share of this group decreases among the higher income groups.”

3. On page 43, para 74 now reads: **“An important concern in this context is how Azerbaijan’s ‘youth bulge’ may put additional pressure on the labor market.** The country has a large youth

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<sup>1</sup> The World Bank Group (WBG) recently defined two strategic goals: ending extreme poverty and boosting shared prosperity. The goals are to be measured by the reduction in the share of people living on less than \$1.25 a day - to 3 percent globally by 2030 – in the first case; and as fostering the income growth of the bottom 40 percent of the population (the “b40”) in the case of the second. Both goals are to be pursued with a concern for sustainability.

<sup>2</sup> 2005 was the last time this measure was estimated by the World Bank.

population and a large influx of the young into the labor market will continue over the next three decades. As of early 2014, the population under 25 years of age constituted 40 percent of the total, and nearly 60 percent of the total population is under 35. More than 70 percent of the population is within the working-ages of 15 to 62 for men and 15 to 58 for women. This share is expected to remain as high until 2025. By 2025, the working-age population will have increased by a net number over 350,000. The dependency ratio has reached a historic low, about 39 percent, in recent years and will only pick up gradually in the future. This sustained low dependency ratio up to year 2050 predicts a large influx into the labor market for the next decades. By comparison, dependency ratios in ECA region and the EU were much higher at 47 and 51 percent, respectively (Figure 41).

4. On page 49, paragraph 84 now reads: **“While natural resource rents have allowed for public spending increases, expenditures on education remain low.** In 2013, Azerbaijan's GDP was 58.2 billion AZN (USD 74.2 billion), and the government's consolidated budget was 37.9 percent of GDP, of which only 7.0 percent was spent on education. Over the last decade, public spending on education has dramatically increased in nominal terms from AZN 294 million in 2004 to AZN 1.5 billion in 2013, but it has not grown as fast as GDP. In 2004, public spending on education was 19.6 percent of government expenditure and 3.4 percent of GDP. By 2013, it dropped to 7.5 percent and 2.5 percent, respectively. In particular, higher education spending declined in absolute terms since 2011—from AZN 150 million (USD 190 million) in 2011 to AZN 109 million (USD 140 million) in 2014 when the number of students steadily increased. As a result, per student spending dropped from AZN 1004 in 2011 to AZN 755 in 2014.<sup>3</sup>” [Figures 44 and 45 have been deleted].

5. On page 57, paragraph 99 now reads: **“Baku accounted for 72.6 percent of Azerbaijan’s total output as of 2013 and provided 72 percent of the total government revenues.** The city is growing rapidly and will accommodate an estimated population of more than 3 million people and 1.2 million employments by 2030. The city is becoming a regional metropolitan center with increasing difficulties in meeting urban mobility needs. The development of an integrated urban transport system for Baku will require (i) the adoption of a holistic and multi-modal approach for urban transport; (ii) the development of integrated urban transport infrastructure, and (iii) the establishment of an adequate institutional set up.

6. On page 92, paragraph 157 now reads: **“Access to tertiary education is not only limited at the national level, but it is also inequitable across regions and urban/rural areas.** The proportion of students who applied for tertiary education after high school varies significantly across regions. While in 2009, 74 percent applied for the student admission examination on average, across regions the rate varies widely: from 44 percent in the Kurdamir district to 94 percent in Sumgait city. An important factor behind the wide geographical gaps in enrollment and attainment rates is the lack of tertiary education institutions outside Baku. 41 of the 51 higher

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<sup>3</sup> Figures provided by Ministry of Education, Government of Azerbaijan



education institutions and 23 of the 49 tertiary vocational colleges are located in Baku city, accounting for 78 percent of university students and 47 percent of college students, respectively.<sup>4</sup>

7. On page 92, paragraph 167 now reads: **“Despite considerable progress in improving the main road network over the past decade, poor connectivity in regions and rural areas remains a major constraint.** While 61 percent of the poor live in rural Azerbaijan and 40 percent of the active labor force is concentrated in the agricultural sector, about 80 percent of local roads remain in bad condition, and more than half of local roads require urgent repair and rehabilitation—compared to only 25 percent in FYR Macedonia or 54 percent in Albania. During the next 10 years, rehabilitation of regional and local roads will need to be implemented in a cost-efficient and sustainable manner. In parallel, the Government will have to complete implementing the ongoing modernization program for highways and railways, and develop a modern logistics system.

8. On page 104, paragraph 181 now reads: **“Access to productive assets (such as education, health, and financial capital), access to networks, and access to markets are central for determining access to productive opportunities for households.** Poor labor market outcomes such as high unemployment could also be linked to frictions in the matching process between workers and firms. Findings from the LFS 2013 show that informal search channels play an important role when escaping unemployment (50.8 percent of unemployed) whereas only 11.8 percent of unemployed search for a new job using services provided by the public employment service (according to the Government this figure is only 3.3 percent).

## **II. Amendments to language in the body of the report**

9. On page 4, paragraph 13 now reads: **“Ensuring the accumulation of a diversified asset-base in the economy is the first challenge to overcome.** Double digit growth rates were supported by large increases in public spending made possible by growing oil production (until 2010) and booming oil prices (until the second half of 2014). Looking forward to the medium-run, annual GDP growth is projected to average 2.3 percent (2014-2017) in the baseline scenario, i.e. in the absence of new drivers of growth and on the assumption that oil GDP shrinks. Deteriorating fiscal trends suggest that the high and pro-cyclical public spending that drove non-oil growth in the past is not sustainable. Rather, the experience of other resource-rich developers suggests that managing oil revenues to support the accumulation of a diverse portfolio of assets, namely built capital – both human and physical – and institutional capital is the only means to ensuring stable, sustainable, and shared growth. Azerbaijan has made progress on institutional asset accumulation – for example through efforts to accumulate reserves in the state oil fund (SOFAZ), modernize the judicial system and provide a one-stop-shop for several kinds of public and private services – but

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<sup>4</sup> Kataoka, S., 2011, *Background Paper: A Strategic Vision for the Future of Tertiary Education in Azerbaijan*, unpublished.

there is a significant pending structural reform agenda to be addressed. In particular, closing the infrastructure deficit efficiently while strengthening focus on human capital accumulation will be essential if conditions are to be created for greater geographic and demographic inclusion. Ultimately this asset diversification is also the best way to ensure at the macro level that oil wealth is shared with future generations.

10. On page 7, paragraph 19 now reads: **“Azerbaijan also faces the challenge of enhancing opportunities for households to use assets more intensively.** The analysis indicates that the bottom 40 have fewer opportunities to use their assets productively, as these households face higher unemployment than their middle class counterparts, while the employment they do obtain tends to be low-quality—concentrated in low-productivity low-wages sectors. Economic growth in Azerbaijan has been accompanied by a growing degree of labor informality, which disproportionately affects the poor and lagging regions. On the other hand, women lag behind men in employment rates, while a gender divide persists in terms of sectoral, occupational, and wage gap in the labor market. IDPs are another group that displays lower employment rates and higher work inactivity than the non-displaced. Access to productive opportunities is also influenced by social networks and access to markets. In this sense, the analysis indicates that having connections in Azerbaijan is very important during job search (Source: Labor Force Survey 2013) and to obtaining quality jobs especially in Government.<sup>5</sup> This would suggest the presence of a somewhat uneven playing field, which may be dampening expectations of future social mobility in the country.<sup>6</sup>

11. On page 35, paragraph 63 now reads: **“The decline in fiscal trends is more pronounced when the non-oil deficit is measured in relation to non-oil GDP.** This ratio averaged 47 percent a year between 2009 and 2013 and has been growing steadily as shown below. This is mainly because of the fact that the relatively robust performance of the non-oil sector in recent years has not translated into higher non-oil tax revenues. Non-oil taxes to non-oil GDP fell from 17.6 percent in 2009 to 15.7 percent in 2013 a period over which non-oil GDP growth averaged 8.1 percent, significantly higher than oil GDP growth, which averaged 0.4 percent over the same period. At the same time expenditures increased steadily, to 38 percent of GDP by 2013.”

12. On page 47, paragraph 81 now reads: **“Growth in public spending suggests a strong bias in favor of construction though nominal increases have been sharp across the board.** A look at the composition of the consolidated state budget and how it has changed between 2006 and 2013, suggests a growing share in expenditures for “industry, construction, and minerals” and

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<sup>5</sup> According to the Azerbaijan Labor Force Survey 2013, 50.8 percent of job search is through friends and relatives while 12 percent is based on direct contact with employers.

<sup>6</sup> Micro data was published through the Life in Transition Survey II (LITS) which is publicly available from the webpage of the European Bank of Reconstruction and Development. For further information see: Life in Transition Survey II – Draft technical report (2011) published by Ipsos MORI.

general government administration and a declining share for housing, transport and communications, agriculture, health, education, social protection, municipal infrastructure such as water and sanitation and waste management (including industrial waste and clean-up of contaminated lands). At the same time, the level of spending in nominal terms has of course been significant across the board, as the size of the budget increased overall from 3.8 to 19.1 billion Manat. While public spending is not the criteria for determining if service provision is adequate it is not clear, given our current knowledge of outcomes, that the budget is aligned with development needs. We have already noted significant pockets of persistent vulnerability and poverty and regional disparities.”

13. On page 50, paragraph 85 now reads: “**Azerbaijan has achieved universal access to basic education, thus strengthening the foundations of its human capital base.** Gross enrollment rates for primary and secondary education in Azerbaijan in 2012 were 98 and 100, respectively. However, while primary and secondary enrollment rates are high and on par with ECA averages, pre-primary and tertiary enrollment rates lag behind other countries. To enhance preschool enrollment, the government launched pre-school preparation groups in 89 general education institutions. On the other hand, Azerbaijan still has the second lowest enrolment rate in tertiary education in the ECA region, second only to Uzbekistan. The gross enrolment rate for tertiary education in 2012 was 20.4 percent, significantly below the ECA average of 55.6 percent.

14. On page 51, paragraph 86 now reads “**Although access to basic education (grades 1-9) is near universal, it is unclear whether student performance has improved.** While the situation may have improved in recent years, the last test under the Program for International Student Assessment (PISA) was in 2009, according to which, for 15 year olds, Azerbaijan ranked 64th out of 65 countries in reading, 63rd in science, and 45th in Mathematics. The PISA scores on reading and science show that Azerbaijan lags behind countries with similar levels of GDP per capita<sup>7</sup> and are only internationally competitive in the area of mathematics. It is important, however, to account for the change in the alphabet in Azerbaijan in 1991, which potentially explains why the country performs relatively poorly in the area of reading. Alternatively, students’ skills to solve analytical problems and science-related issues show gaps compared to other countries. Azerbaijan did not participate in the 2012 PISA but did register for the Progress in International Reading Literacy Study (PIRLS) 2016, which may help evaluate more recent reforms that could have led to improved performance.”

15. On page 52, paragraph 87 now reads: “**Low teacher quality is a key determinant of the quality of education in the system.** Teacher salaries have been low at all levels, failing to attract and retain high quality teachers. For instance, primary teachers earned only 80 percent of per capita GDP after 15 years of service until this year when the government substantially raised the salary

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<sup>7</sup> See PISA 2012 Results: What Students Know and Can Do (Volume I, Revised edition, February 2014): Student Performance in Mathematics, Reading and Science; DOI:10.1787/9789264208780-5-en

scale to help improve teacher quality. The government has also started piloting programs for teacher assessment. Looking ahead, holistic reforms should be considered including pre-service teacher training; employment and deployment of teachers; as well as professional teacher support and performance assessments.”

16. On page 52, paragraph 88 now reads: “**The education system lacks trust of the public.** Data from the 2013 Caucasus Barometer suggest that only 65 percent of the population fully trust or somewhat trust the educational system. Governance of the education system could be re-defined to make the service provision more responsive to needs of students and parents”

17. On page 56, paragraph 96 (new paragraph) reads: “**Health policymaking, quality assurance, M&E, and IT constitute key areas of opportunity.** Despite the National Strategy for Health Information System (HIS) Development (2008), introduction of health E-cards and creation of integrated HIS roadmap, the health information system remains fragmented, incompatible with other systems, the on-line exchange of health care data and referrals between providers is absent and capacity for analysis remains weak. If in place, it will be of high value for managing the health system, ensure evidence-based decision making, reduce large inefficiencies and additional costs and tracking performance.”

18. On page 56, paragraph 97 reads: “**Higher than PI based spending can be rationalized if it is on productive investments in infrastructure and/or human capital.** This would imply that these investments generate returns for the current and future generations in excess of the returns on wealth accumulated in the Oil Fund. In Azerbaijan, capital expenditures almost tripled between 2007 and 2011 and grew at an average annual rate of 39 percent during this period. However, investment of oil revenues in human capital have fallen as a percentage of government revenues and GDP. Further investment in human capital is warranted. The same applies to physical capital, though Azerbaijan has made more progress here. It should also be noted that the returns on public investment spending would need to be weighed against the resulting exchange rate appreciation, which adversely affects competitiveness and non-oil exports.

19. On page 62, paragraph 111 now reads: “**Financial development is critical to both private sector growth and inclusion.** In terms of financial capital, Azerbaijan has been growing rapidly in the past decade, supported by the record high economic growth since 2004, with the composition reflecting underlying growth patterns. Rapid growth of the financial sector in the recent years was supported by high growth of consumer lending and the construction boom, fueled by the rapid poverty reduction and high public sector spending. “

20. On page 93, paragraph 158 now reads: “**While there is widespread support for women pursuing tertiary education – men and women attend university in near equal proportions –**

**social norms against it persist in certain areas.** Some girls are taken out of school at an early age or discouraged from pursuing higher education due to traditional beliefs regarding the importance of women's role in the household. This tends to affect more women in rural areas, where traditional beliefs are stronger and where fewer formal job opportunities may exist. Data from the 2013 Caucasus Barometer Survey suggests that this type of discrimination is held by a share of the population overall, as 22 percent of women and 37 percent of men report the belief that university education is more important for boys than for girls.”