

## **Policy Department External Policies**

# **ANALYSIS OF THE EU'S ASSISTANCE TO AZERBAIJAN**

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## **Abstract**

The EU's assistance to Azerbaijan is being faced with a particular situation. Due to rising revenues from gas and oil production and transit, Azerbaijan is not as dependent on EU assistance as other countries covered by the European Neighbourhood Policy (ENP). While this reduces the leverage of EU assistance, it also makes Azerbaijan a relevant partner for the EU in terms of diversity of energy supplies. However, implementation of the reform agenda provided by ENP has been slow and selective in Azerbaijan. Priorities are jointly agreed between the EU and the Azerbaijani government, and assistance is mostly channelled through government bodies, thus facilitating cherry picking and allowing the Azerbaijani government to cooperate only on reforms that suit it best and are convenient for maintaining its power. Within the last ten years, the situation of human rights and fundamental freedoms has deteriorated in Azerbaijan, despite the EU's efforts to cooperate. This current dilemma of facing a reluctant partner clearly illustrates the constraints of the ENP's methodology of soft conditionality and joint ownership. On the basis of an overview and evaluation of EU assistance, this report develops two scenarios for the EU's involvement with Azerbaijan: a pure conditionality approach that will propose to cap assistance to Azerbaijan; and a more pragmatic collaborative approach that binds Azerbaijan to European policies and international arrangements. The report argues for following the latter approach alongside with readjusting assistance to focus more on strengthening civil society and fighting corruption.

## Executive summary

**Scope of the briefing:** This briefing paper analyses EU assistance to Azerbaijan and its compliance with the general objectives specified in the relevant EU documents. Special emphasis is given to the area of human rights, rule of law, fundamental freedoms and good governance, but the two other main areas of cooperation will also be discussed, i.e. socio-economic reforms and reforms in the transport, energy and environment sectors.

Firstly, these three areas of cooperation are introduced by highlighting recent developments in Azerbaijan and main objectives in the relevant EU documents (ENP Action Plan, Country Strategy Paper, National Indicative Programme, Annual Action Programme, Progress Report, and European Parliament Resolution on the South Caucasus). Secondly, EU assistance and financial allocations are analysed with regard to the objectives and priorities laid out beforehand, drawing on the four criteria of relevance, effectiveness, efficiency and sustainability. Thirdly, a specific chapter elaborates on the conflict resolution in Nagorno-Karabakh.

On the basis of an overall assessment, the briefing then develops two alternative policy options for an EU assistance strategy towards Azerbaijan and concludes with some specific recommendations.

**Main Finding:** The European Neighbourhood Policy (ENP) Action Plan provides Azerbaijan with an adequate reform agenda. Implementation, however, has been slow and selective, as priorities are jointly agreed between the EU and the Azerbaijani government and assistance is mostly channelled through government bodies. This facilitates cherry picking and allows the Azerbaijani government to cooperate only on those reforms that suit it best and are convenient for maintaining its power. This current situation of facing a reluctant partner clearly illustrates the limits of the ENP's methodology of soft conditionality and joint ownership.

## Main Conclusions

- The current EU assistance portfolio towards Azerbaijan is constrained by a lack of interest from the Azerbaijani government towards certain topics, and ends up being overly focused on technical and energy cooperation. Moreover, the EU defines its priorities in the cooperation with Azerbaijan only as “indicative”, further reducing the formality and the conditionality of the cooperation agenda.
- The rather limited size of the financial allocations of TACIS (and the not yet implemented ENPI) prevent a decisive and sustainable impact. The available funding allows for focusing on the reform of administrative capabilities and legal approximation. Technical assistance (TAIEX, Twinning) can be qualified as successful in supporting the reform agenda of the government, but should not be perceived as sufficient to support the development of democratic governance and to impact on society on a long-term basis. Thematic budget lines could fill this gap, since they allow for direct funding of democratic governance projects by civil society and international organisations.
- There is a necessity to cast a balance between assertiveness and joint ownership, as well as between the ambitions displayed and limited financial means.

## **Main Recommendations**

- More emphasis should be put on instruments targeted at improving democratic governance, such as EIDHR and NSA-LA, paying special attention to a developing civil society which is more willing to accept and promote EU values. As soon as the EC-delegation in Baku is fully operational in autumn 2008, it should actively seek to create dialogue with non-state actors, civil society and local NGOs. ENPI must be seen as a truly policy-driven instrument and not merely a classical trade rapprochement instrument.
- Monitor and evaluate the effects of sectoral and budgetary support in general, as well as the ability of the Azerbaijani government to manage the funds appropriately. Available documents give little information about monitoring arrangements and evaluations. This shortcoming should be addressed as a priority considering that the public finance management system is far from being satisfactory, and levels of corruption remain very high.
- The EU should distinguish more clearly between trade, internal market measures and social questions. The current EU support for socio-economic reform focuses almost exclusively on regulatory approximation, technical regulations and standards as well as trade measures. Although regulatory convergence and trade as advocated by the EU is likely to have a positive impact on the general socio-economic situation of Azerbaijan, social challenges cannot be addressed exclusively through these measures.
- Due to limited financial allocations preventing EU assistance from having a decisive and sustainable impact, EU programming documents should be more focused on a few chosen strategic priorities, such as education, local democracy or environment, rather than setting a long catalogue of vague and hardly reachable targets.
- The identification of those priorities should be coordinated with other donors. Structured donor coordination needs to be improved and further reflected in EU programming documents so as to strengthen the coherence of assistance and identify complementarities of interventions. Where possible, the inclusion of information about activities of the IFIs, EIB, EBRD, other donors and forms of EU support should be highlighted.
- Other incentives than financial assistance such as access to EU programmes and agencies should be promoted strongly when discussing with Azerbaijan. For instance, access to the Energy Community might offer strong leverage in the field of energy cooperation.

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## 1. Introduction

This Standard Briefing analyses the EU's assistance to Azerbaijan in 2007 in light of:

- relevant EU objectives set out in the main European Neighbourhood Policy (ENP) and European Neighbourhood and Partnership Instrument (ENPI) documents;
- recent political, economic and social developments that may have an influence over the EU's initial objectives;
- the position stated by the European Parliament (EP) in its resolutions on the Southern Caucasus.

Hence, this paper provides an analysis of the objectives of cooperation pursued by the EU with regard to Azerbaijan, paying specific attention to analysing the priorities set out in the National Indicative Programme 2007-2010 against the financial allocation and the content of the projects effectively planned for the next four years. The ENPI is a recent instrument of EU policy without records of extensive implementation. Thus, this analysis focuses on the convergence between the objectives and the priorities set by the EU and the planned allocations of funding. The Annual Action Programme (AAP) 2007 for Azerbaijan is yet to be signed by the government of Azerbaijan and is only expected to become operational at the end of 2008. EC assistance in 2007 was therefore still financed through the "Technical Assistance to the Commonwealth of Independent States" (TACIS).

Future EU assistance to Azerbaijan will mostly be channelled through the ENPI, which is a policy-driven instrument supporting the country's reform agenda in close cooperation with the national authorities. Additionally, thematic instruments and programmes are also applied in Azerbaijan. Overall EU financial assistance aims at supporting the implementation of the Partnership and Cooperation Agreement (PCA) as well as the following ten priority areas set out in the ENP Action Plan for Azerbaijan:

- 1: contribute to a peaceful solution of Nagorno-Karabakh conflict
- 2: strengthen democracy
- 3: strengthen the protection of human rights and fundamental rights
- 4: improve the business and environment climate
- 5: improve the functioning of customs
- 6: support balanced economic development
- 7: convergence of economic legislation and administrative practices
- 8: strengthen energy cooperation
- 9: cooperation in the JLS sector and border management
- 10: strengthen regional cooperation

The ENPI National Indicative Programme (NIP) 2007-2010 translates this reform agenda into support for three priority areas and breaks down the resources according to each priority. The overall amount of ENPI assistance to Azerbaijan for the period 2007-2010 amounts to EUR 92 million:

- 1) Democratic development and good governance: EUR 30 million
- 2) Socio-economic reform, fight against poverty and administrative capacity building: EUR 29.52 million
- 3) Support for legislative and economic reforms in the transport, energy and environment sectors: EUR 29.52 million

In addition to the ENPI, EU projects in Azerbaijan are funded through newly launched EU thematic instruments and programmes which are mostly still in the planning stage.

### *1. The European Instrument for Democracy and Human Rights (EIDHR)*

The “Country based support Scheme” of the EIDHR allocates EUR 900 000 to Azerbaijan in 2007 (see Annex 2). Furthermore, 26 projects of the “Joint Management Programme with the Council of Europe” have been financed through the EIDHR (for more details see Annex 3).

### *2. Development Cooperation Instrument (DCI)*

Although the Southern Caucasus countries are generally eligible for all five thematic programmes of this instrument, the thematic programmes “Non-state actors and local authorities” (NSA-LA) and “Environment and Sustainable Management of Natural Resources, including Energy (ENRTP)” have been prioritised in Azerbaijan in 2007.

The financial assistance of the NSA-LA is quite significant, as the “country-based intervention” subheading allocates EUR 1 million to non-state actors in Azerbaijan in 2007 (see Annex 4).

### *3. Instrument for Stability (IfS)*

Azerbaijan is targeted by regional measures of the IfS to strengthen “non proliferation of weapons of mass destruction” (priority 1) and “fight against transnational threats” (priority 2). In regard of the latter, the regional project “Fight against Trafficking from and to Afghanistan” was initiated in cooperation with the member countries of the Economic Cooperation Organisation, which also includes Azerbaijan. The initial budget allocation for this project was EUR 5.2 million in 2007, and a second allocation of EUR 4.3 million is expected to be decided in 2008.

After this brief overview of the composition of EU external assistance to Azerbaijan, the second section of this briefing will provide an outline of the main political, social and economic challenges faced by Azerbaijan and link them with the EU assistance priorities. The third part will assess the relevance, effectiveness, efficiency and sustainability of the EU’s assistance in the three abovementioned NIP priorities. The fourth section will briefly tackle the specific issue of Nagorno-Karabakh.

Though most emphasis will be put on the first priority area of the National Indicative Programme (democracy, rule of law, the freedom of expression and of the media, promotion of civil society and human rights), socio-economic issues in the context of a booming oil and gas sector also need to be examined carefully, since those are intrinsically linked and underlie the way in which the EU conducts and prioritises its cooperation with Azerbaijan.

## **2. EU action and progress in Azerbaijan**

The Southern Caucasus countries (Armenia, Azerbaijan and Georgia) were incorporated in the framework of the European Neighbourhood Policy (ENP) in 2004. In the Southern Caucasus, it is Georgia that is typically seen as the most eager to get as close as possible to the EU. Azerbaijan, however, is perceived as a reluctant partner, especially as it is not assumed to be dependent on EU assistance due to its rich oil and gas revenues. Nevertheless, out of energy security and transit considerations, the EU is seeking to establish deeper forms of cooperation with Azerbaijan.

### **2.1. Democratic development, human rights and good governance**

Human rights, the rule of law, democracy, good governance and fundamental freedoms<sup>1</sup> are perceived as difficult topics in EU relations with Azerbaijan. Within the last ten years, there has been a traceable deterioration in the protection of human rights and fundamental freedoms; international human rights organisations continue to emphasise the continuing lack of freedom of assembly and freedom of the media.<sup>2</sup> Furthermore, the use of torture and inhuman treatments in prisons, corruption and politically motivated arrests of journalists are repeatedly reported.<sup>3</sup> At the moment, the state of democracy and the electoral code are of utmost concern as Azerbaijan enters a full electoral cycle. Especially relevant are the upcoming presidential elections on 15 October 2008. International observers agreed that the 2003 elections, which President Ilham Aliyev won with 76% of the vote, were neither fair nor free.<sup>4</sup> Furthermore, five years later, a politically independent media is still not a reality; opposition journalists continue to be harassed, intimidated or even sent to prison.<sup>5</sup> The Parliamentary Assembly of the Council of Europe (PACE) “*considers that the success of the reforms is less a matter of the letter of the laws than a matter of their implementation and can only express great concern about the deteriorating human rights situation which undermines any efforts made by the authorities to meet basic democratic standards in the forthcoming presidential election.*”<sup>6</sup>

Although grouped slightly differently in each of the three documents, a set of recurring objectives to strengthen democratic governance in Azerbaijan can be distinguished. In the ENP Action Plan, two out of ten priority areas fall under the general objective of democratic development: strengthening democracy with regard to free and fair elections, and the protection of human rights and fundamental freedoms.

These two priority areas are expanded into four “sub-priorities” in the NIP 2007-2010:

- 1) Public administration reform and public finance management,
- 2) Rule of law and judicial reform,
- 3) Human rights, civil society development and local government,
- 4) Support for education, science and people-to-people contacts.

In its resolution on the South Caucasus of 17 January 2008, the European Parliament (EP) “*stresses that the ENP reviews and funding must be used to promote institution building, respect for human rights, the rule of law, democratisation and regional cooperation*”.<sup>7</sup> Subsequently, a large part of the resolution is devoted to democratic governance. In paragraph 14, the EP addresses Azerbaijan directly: it reiterates its serious concerns about the deterioration of the human rights situation; calls on the Azerbaijani authorities to ensure freedom of the media and expects them to ensure freedom of assembly and an absence of restrictions on the activities of political parties; and it calls on the authorities to prevent police violence and investigate allegations of ill treatment in custody. Furthermore, the EP encourages the Commission to make full use of the EIDHR to implement the objectives of the Action Plan also in cooperation with civil society and local and regional authorities.

In its first Progress Report of April 2008 the European Commission asserts that “*there has been limited tangible progress towards meeting the Action Plan objectives in the area of*

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<sup>1</sup> From now on these four notions will be summarised by the notion of “democratic governance”.

<sup>2</sup> See annex 5 and Radio Free Europe, 30 May 2007;

<sup>3</sup> See for example Amnesty International (2007a, b, c) and Human Rights Watch (2007, 2008a, 2008b);

<sup>4</sup> See Radio Free Europe, 30 May 2007;

<sup>5</sup> See Ismayilov (2008a, b);

<sup>6</sup> Point 4 of Parliamentary Assembly of the Council of Europe, Resolution 1614 (2008) of 24 June 2008. See also Today.AZ, 24.06.2008, Human rights situation in Azerbaijan ‘deteriorating’ ahead of election, says PACE, see <http://www.today.az/news/politics/45922.html>

<sup>7</sup> EP resolution on the South Caucasus of 17 January 2008, paragraph 6, p.5.

*democratic governance*<sup>8</sup>. Although a national action plan for the protection of human rights was adopted in December 2006, its concrete and effective implementation is now needed.

## **2.2. Socio-economic reform, the fight against poverty and administrative capacity building**

Although Azerbaijan experienced the highest GDP growth rate in the world in 2007, poverty remains widespread and inequalities are rising. Economic indicators reveal a large dependence on oil and gas sectors of the economy, since energy-related activities amount to 86% of total exports and account for 54% of GDP.<sup>9</sup> Despite exceptional economic growth, Azerbaijan shares most of the structural issues of other ex-Soviet republics entailed by transition from command to market economy.

Azerbaijan is ranked 98<sup>th</sup> on the Human Development Index 2007, behind all Eastern ENP countries - with the exception of Moldova - and although living standards are improving, 21% of Azerbaijanis continue to live below the national poverty line. Large revenues from oil and gas production are not distributed equally across the population. As a result, inequalities among Azerbaijanis and also between regions are rising. Smaller towns and rural areas are particularly affected. Health and education sectors suffer from a lack of public expenditure while access to medical services proves extremely difficult and unequal. Though the literacy rate remains high - as a heritage of Soviet times - the quality of education has become a cause for concern. Real unemployment is ten times higher than official rates and the shadow economy constitutes a large part of GDP.

One of the most serious impediments to balanced growth and better socio-economic performance is corruption. Azerbaijan is ranked 150<sup>th</sup> out of 179 on Transparency International's Corruption perception Index 2007.<sup>10</sup> Although anti-corruption law exists, better enforcement is necessary. Lack of transparency and corruption remain endemic and represent a serious deterrent to the establishment of a friendlier climate for business and investment.

EU documents clearly identify all the abovementioned challenges, while the NIP 2007-2010 dedicates one entire priority area to address socio-economic issues. A total of EUR 32 million will be spent in this field, aiming at establishing a better regulatory framework, supporting the development of the non-oil economic sectors, fighting poverty, building administrative capacities, reducing regional disparities and providing support for a more efficient and balanced management of the energy revenues.

In order to pursue those objectives, three sub-priorities have been emphasised:

- 1) Promoting trade, improving the investment climate and strengthening social reform
- 2) Supporting the implementation of the respective Azerbaijani strategies and programmes to fight poverty, promote regional development and non-oil sectors
- 3) Supporting approximation of legislation and alignment of procedures on the EU's standards, including public accounting and capital market's regulatory aspects.

## **2.3. Support for legislative and economic reforms in transport, energy and environment**

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<sup>8</sup> European Commission (2008) Progress Report Azerbaijan, p. 2 and 3.

<sup>9</sup> European Commission, European Neighbourhood Policy: Economic Review of EU Neighbour Countries, Directorate-General for Economic and Financial Affairs, number 30, June 2007, p.73

<sup>10</sup> Transparency International's Corruption Perception index 2007,

A country or territory's CPI Score indicates the degree of public sector corruption as perceived by business people and country analysts, and ranges between 10 (highly clean) and 0 (highly corrupt). Azerbaijan scores 2.1.

Azerbaijan's energy sector is characterised by fast growth and continually rising levels of production in gas and oil. While it is considered the most market-oriented and reliable partner in terms of production-sharing agreements and export-related energy business,<sup>11</sup> Azerbaijan's domestic energy market is still distorted and regulation is not very deep. The main objective of EU action is the gradual convergence of energy legislation and increased market integration between the EU and Azerbaijan. This is specified in more detail and lists among its policies an increased energy convergence with EU markets, structures and systems, such as an upgrading of energy networks and increased efficiency and renewable energy sources.

The EU's third priority area is to support legislative and economic reforms in three sectors judged to be of vital importance to Azerbaijan: energy, transport, and environment. The choice of sectors is reasoned in CSP and NIP. Firstly, Azerbaijan is a relevant producer of gas and oil with considerable exports to the EU. Secondly, its geographic location allows for significant transit activity, including oil and gas deliveries from the Caspian basin and Central Asia, making transport policy an indispensable part of the government's agenda. Thirdly, Azerbaijan faces considerable environmental challenges, partly predating its independence. Its two most promising economic sectors, energy and transport, have a direct impact on the environment.

The corresponding sub-priorities are formulated as:

- 1) Energy, including reforms of the domestic legislative framework and markets,
- 2) Transport, including reforms of the domestic legislative framework and markets,
- 3) Environment, improve legislative and administrative management of environmental challenges.

Within the framework of the PCA, the EU and Azerbaijan are already collaborating through a sub-committee on Energy and Transport. In addition, on 7 November 2006, the EU and Azerbaijan signed a Memorandum of Understanding on a Strategic Partnership in the Field of Energy, which takes stock of the existing situation and outlines objectives of cooperation between the partners. It also lays down the main areas of cooperation; namely gradual harmonisation, energy supply security, and Azerbaijani energy demand policy and technical cooperation.

In the transport sector, increased competitiveness is to be achieved through legislative and economic reforms, approximating Azerbaijan's legislative framework and technical standards to the EU system, as well as the promotion of security and safety in all modes of transport. The main objectives are the development of a sustainable transport policy, the establishment of regulatory authorities as well as taking on obligations from European or international agreements in, e.g. road, air and maritime transport. Azerbaijan is actively involved in several fora, such as the TRACECA (Transport Corridor Eastern Europe Caucasus Central Asia) and the EU-Black Sea- Caspian Sea Transport Ministerial Conference. A sustainable national transport policy is needed, also providing on an institutional level for independent and functional regulatory authorities in all transport areas.

Regarding the environment, a sector clearly interlinked with and directly affected by the first two priorities, EU programming documents address in particular the administrative management of environment policies, most of which are in a nascent state in Azerbaijan. The areas in need of further institutionalisation and reform are good environmental governance (including following up on obligations under the Aarhus Convention), the prevention of

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<sup>11</sup> Aharend, Rudiger/Tompson, William (2006), Realising the oil supply potential of the CIS: The impact of institutions and policies. OECD Economics Department Working Paper No. 484.

environmental damage, as well as increased cooperation under international agreements. The EU shows clear intent to bind Azerbaijan more closely to global environmental policy, by focusing on implementing the Kyoto Protocol, Azerbaijani participation in EU programmes and possibly regional cooperation initiatives in the environmental sector.

### **3. Analysing EU assistance in Azerbaijan**

Funding of EU assistance to Azerbaijan is about to shift from TACIS to ENPI. EU officials repeatedly highlighted that this change represents a “*qualitative jump*” in EC external assistance. The ENPI addresses most of the critiques emerging from previous TACIS evaluations: insufficient sustainability of projects and a lack of coherence or efficiency of the funding programme. Under ENPI, most of the bilateral EC assistance will be provided through sectoral budget support,<sup>12</sup> which allows for a more targeted programming as it augments government funds and should be combined with a sectoral policy strategy.<sup>13</sup> There is a wide debate in the development community about budgetary support, which comes either as general budgetary support or sectoral budgetary support. Its proponents argue that it increases ownership, allows priorities to be set at national level and boosts capacity in the partner administration. On the other hand it could be argued that budgetary support is too broad to have an impact and that aid flows will fall victim of partner countries’ inefficient management of funds or corruption. Budgetary support will be likely to increase delivery rates without necessarily implying increased impact on the situation of the recipient country.<sup>14</sup> The emphasis on a specific sector during one year is intended to provide greater impact and sustainability of EC assistance. Furthermore, 20% of the annual ENPI assistance to Azerbaijan will be provided for Twinning and TAIEX, which have shown tremendous success during previous enlargements.

For each priority area, the following four criteria will be used to assess the current assistance to Azerbaijan: relevance, effectiveness, efficiency and sustainability.

#### **3.1. Support for strengthening democratic development and good governance**

##### Relevance

- The EU’s objectives to improve the rule of law and assist in public administration reform are relevant and in line with Azerbaijan’s national reform needs. However, there is an obvious gap between the EU’s priority and the willingness of Azerbaijani authorities to tackle this topic.
- A stronger insistence on improvements of democratic governance as a precondition for deeper cooperation could increase the relevance of EU assistance. However, a balance has to be achieved between two priorities: on the one hand, keeping Azerbaijan interested in cooperation to assure economic and energy interests of the EU. On the other hand, promoting democratic and human rights reforms. In the current situation, the latter remains rather optional or a commitment on paper.

##### Effectiveness

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<sup>12</sup> TACIS in contrast to MEDA, prohibited direct budget support, except for the Food Security Programme.

<sup>13</sup> European Commission (2007), Guidelines No. 2, Support to Sector Programmes, Short Version.

<sup>14</sup> For some reflections on budgetary support effects refer to :

[http://www.oecd.org/document/51/0,3343,en\\_21571361\\_34047972\\_36556979\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/51/0,3343,en_21571361_34047972_36556979_1_1_1_1,00.html)

- The assessment of coherence between the declared political EU objectives and actual financial allocations is a complex task, as several distinctive budget lines are allocated for EC assistance to Azerbaijan in 2007 and no transparent reporting mechanism exists that would provide an overview of the exact amount of assistance spent per year.
- Although one third of the ENPI allocations are devoted to democratic governance, these funds are primarily used for improving and reforming the management of national administrations. Though this is an important aspect, it should not however, be the only issue covered in this area.
- Support to non-state actors in Azerbaijan should be more stringent in the EU's assistance; it might prove more effective especially when considering the reluctance of Azerbaijani authorities to increase democratic standards. The interaction with local civil society could improve considerably as soon as the EC delegation in Baku becomes fully operational in autumn 2008.

#### Efficiency

- With regard to human rights, until now it has not really been possible to assess the degree of efficiency, as the implementation of the NSA-LA programme has only started recently with two calls for proposals. The joint programme with the CoE seems to be quite successful; EC officials would prefer to intensify this cooperation as well as the cooperation with the OECD.

#### Sustainability

- Corruption is a salient issue in Azerbaijan. As long as this problem is not tackled accordingly, the sustainability and even the possibility of any progress in other areas (human rights, economy etc.) remain questionable. Linked to this consideration is the observation that the first sectoral focus of the AAP 2007 for Azerbaijan is on energy, while rule of law and good governance are only supposed to be targeted in the AAP 2008.
- A two-folded approach (assisting reform of national administration and increased direct support to civil society) might ensure better sustainability of EU projects in the field of democracy and good governance, and eventually lead to emergence of a truly democratic society.

### **3.2. Support for socio-economic reform**

#### Relevance

- The objectives and priorities displayed in the NIP are well in line with the needs of Azerbaijan assessed throughout the Action Plan and the Country Strategy Paper. Critical challenges are correctly identified and correlated to a large scope of priorities and sub-priorities.
- However, the specific objectives reflected under the priority area "Support for socio-economic reform" are extremely broad, ambitious (if not overambitious) and sometimes vague: "to facilitate trade and to improve the investment climate and the employment and the social situation in a sustainable manner."
- Although ambitions are extremely large, sub-priorities clearly show an overriding focus on more limited aspects of cooperation, putting particular emphasis on technical issues such as regulatory approximation and trade, to the detriment of poverty alleviation, education and health related issues. The fact that the state programme for poverty reduction has not yet been adopted, seriously constricts EU assistance in this field.

#### Effectiveness

- Some sub-priorities are redundant: regulatory approximation, trade enhancement and business climate improvement are repeated twice under different chapters and are also mixed up with social objectives, entailing certain confusion in the way social problems could be addressed under ENPI.
- Diversification of the economy is clearly mentioned as one major priority but does not appear clearly under the sub-priorities. The fact that the AAP 2007 focuses on the energy sector seems to contradict the willingness displayed by the EU to promote non-oil economic sectors.

#### Efficiency

- The experience gained in Central Europe during the enlargement process as regards transition and legal approximation is likely to produce better outputs than under TACIS; the use of specific tools such as TAIEX and Twinning that have already proven successful can be expected to facilitate the implementation of structural reforms.

#### Sustainability

- The three undergoing Twinning programmes on food products, standardisation and legal approximation in the energy sector may have positive and sustainable impact in terms of trade and can help Azerbaijan to integrate into the global economy, but they may also have limited visibility as well as a weak direct impact on populations.
- Although EU assistance has put great emphasis on technical cooperation and legal approximation in Azerbaijan since 1999, the progress report points out the limited success so far in the area of regulatory convergence to the trade-related EU legislation as well as customs legislation.

### **3.3. Support for legislative and economic reforms in the transport, energy and environment sectors**

#### Relevance

- The overall sectoral choice of the priorities reflect a clear alignment with concerns of EU energy supply as both Azerbaijani oil and gas as well as Azerbaijan's role as transit country for gas and oil from other sources have a direct impact on the diversity of supplies to the European market. The Azerbaijani energy sector is at a critical juncture towards the further integration into world markets. The opening of the Baku-Tbilisi-Ceyhan pipeline and the gas production in the Shah Deniz field highlight continued development in the energy market. The modernisation of administration in the energy sector combined with strengthening of market regulation is desirable as it should have a positive impact on securing supplies from or through Azerbaijan and safeguarding private investment from Europe.
- The inclusion of environment as one of the three sub-priorities reinforces the EU's international engagement with the environment. However, environmental objectives are not translated as consistently into actions compared with the energy and transport sectors.

#### Effectiveness

- It is important to note that the chosen sectors are particularly capital-intensive and require large long-term investments. In turn, especially in the case of the environment, benefits are not immediate. Considering these sectoral characteristics, the funds allocated to the energy sector of EUR 14 Million may be insufficient. For example, the EBRD's transactions in Azerbaijan for 2007 totalled EUR 122 million, excluding a loan to a power generation company valued at over EUR 60 million.
- Programming on the energy sub-priority does reflect the calls for increased regional cooperation in the Caucasus. In all sectors, support to concrete regional initiatives is envisaged. The actual implementation of this will depend heavily on progress made in conflict settlement in the region. Azerbaijan has shown itself to be active in the cooperation with some partners in the fields of energy and transport, with the notable exception of its neighbour Armenia.

#### Efficiency

- The EU's action in the three sectors started before the establishment of the ENPI. EuropeAid projects between 1998 and 2008 included 8 energy projects, 8 transport related projects and 4 environment projects dealing with the treatment of radioactive material. While this partially reflects the weight attached to different policy areas, it is also important to note that these sectors are interdependent and sometimes share the benefits of given policies. For example, support to the Ministry of Energy for rehabilitation of oil-contaminated land improves the administrative capacity of the energy sector, but it also promotes environmental objectives.
- ENPI interventions in the three chosen sectors will be executed as budgetary support, which could reduce fragmentation and administrative burden, thereby increasing efficiency of delivery. Budgetary support, of both general and sectoral nature, is increasingly advocated by donors and multilateral bodies such as the OECD's Development Assistance Committee.

#### Sustainability

- The sustainability of action under the ENP in this sector depends largely on the willingness of the Azerbaijani government to follow through with regulatory and legislative reforms. Other donors e.g. the US government, have decided to discontinue a programme aimed at creating an independent regulatory body due to lack of government support.
- Azerbaijan seems a keen participant in cooperative fora, such as the TRACECA and the High Level Group for transport and is a candidate country in the EITE (Extractive Industries Transparency Initiative) in the Energy Sector as well as in the EU Water Initiative in the environment sector. As these institutionalised forms of cooperation require long term commitments and regular interaction, outcomes are more likely to be sustainable.

## **4. Specific issue: Nagorno-Karabakh**

The frozen conflict in Nagorno-Karabakh remains the main source of concern for the stability of the South Caucasus; it is a major point of contention that prevents deep regional cooperation from emerging. Although a ceasefire was signed in 1994, recurrent incidents on the front line, rising defence budgets on both sides, as well as politically fuelled hatred may spark an outbreak of war at any time.

Conflict settlement promotion has been ensured by the OSCE under the so-called Minsk group, which has proved unsuccessful in reaching an agreement so far. The EU has been very

reluctant to engage in conflict resolution, and unlike South Ossetia and Abkhazia, the EU has never carried out any conflict settlement projects in Nagorno-Karabakh, claiming that peace settlement falls under the exclusive mandate of the OSCE, and thereby making stronger engagement conditional upon prior political agreement between both parties. It is also worth noting that neither Armenia nor Azerbaijan have demanded an increased involvement of the EU. Azerbaijan, in particular, has always refused its approval of concrete EU actions in the field unless Armenian troops withdraw.

Yet, the EU could carry some weight on the negotiations pursued under the auspices of the OSCE by offering concrete guarantees in case an agreement is cast and by fleshing out the following principles for settlement put forward by the OSCE:

- redeployment of Armenian troops from Azerbaijani territories around Nagorno-Karabakh,
- demilitarisation of those territories,
- organisation of a referendum to determine the final legal status of Nagorno-Karabakh
- deployment of an international peacekeeping force and a joint commission for implementation of the agreement,
- international assistance for demining, reconstruction, and resettlement of internally displaced persons

The EU can deliver on many of those aspects; it is more comfortable with post-conflict rehabilitation and peace building than conflict resolution.<sup>15</sup> Its experience gained in the Western Balkans in terms of reconstruction, return of internally displaced persons, or administrative and judiciary capacity building, could prove extremely useful in the case of Nagorno-Karabakh. Firmer pledges by the EU and commitments to send military peacekeepers as well as a civilian mission would reassure the belligerents and could help them in overcoming their reserves towards the conflict settlement principles.

Armenia and Azerbaijan are, to a certain extent, satisfied with the current status quo and both believe time is on their side. However, by starting contingency planning and preparing concrete offers, the EU might have a decisive impact on the negotiations and contribute to creating favourable conditions for a switch in the belligerents' expectations that could ultimately facilitate an agreement.

## **5. Conclusions and recommendations**

Although Azerbaijan is becoming a richer country due to booming energy revenues, major structural problems remain pervasive. The remedy set by the ENP Action Plan is an accurate and adequate reform agenda that needs to be implemented with the support of EU assistance, not only through transfer of know-how and legal approximation, but also through more comprehensive projects going beyond the sole energy sector.

However, Azerbaijan has so far been extremely careful in engaging further in ENP, only achieving very limited progress with regard to domestic reforms. Azerbaijan's crucial role as energy supplier and transit country offers a revived sense of independence and definitely diminishes the attractiveness of ENP. It is an illustration of the limits of such policy and its current methodology based on soft conditionality and joint ownership. Since priorities are commonly agreed and assistance is mostly channelled through governmental bodies, it

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<sup>15</sup> International Crisis Group, *Conflict resolution in the South Caucasus: the EU's role*, Europe Report n 173, 20 March 2006, Brussels, p.2

facilitates cherry picking and allows the Azerbaijani government to cooperate on the reforms that are suitable for the preservation of its power, rather than converging on European democratic and human rights standards.

Such a cautious approach makes the National Indicative Programme appear like a vast but vague catalogue of priorities that, as pointed out by the Commission itself, must only be “understood as indicative”, thereby reducing enormously the policy-driven aspect initially attached to the ENPI. The EU assistance portfolio with Azerbaijan is constrained by the unwillingness of the Azerbaijani government, and ends up being overly focused on technical and energy cooperation, leaving aside most of all initial EU priorities. Such a statement is likely to result in a widening gap between the vast and ambitious objectives initially set and concrete reform achievements in the field.

In order to address this issue, two policy options could be envisaged: a pure conditionality approach that will propose to cap assistance to Azerbaijan; and a more pragmatic collaborative approach that binds Azerbaijan into European policies and international arrangements.

- Either the EU acknowledges that Azerbaijan’s commitment is insufficient and decides on a stricter application of conditionality by significantly cutting the resources allocated to Azerbaijan;
- Or the EU follows a pragmatic approach and decides to go even further in engaging Azerbaijan

The first option allows for more consistency with overall ENP objectives by ensuring more differentiation and more coherence. As stated by the European Commission, “the ambition and the pace of development of the EU’s relationship with each partner country will depend on its degree of commitment to common values, as well as its will and capacity to implement agreed priorities”.<sup>16</sup> Considering the poor review of Azerbaijan in terms of democratic governance and its overall reluctance to cooperate, this option would allow for reallocations of funds to more willing countries such as Georgia, or countries that have scored higher in terms of adoption of democratic standards.

Nevertheless, such a cut in funds and increased differentiation between ENP partners could also raise tensions and lead to a deterioration of regional cooperation. The consistency of relations with other EU partners could be questioned (what to do then with Russia or Tunisia?). In addition, the impact might be more harmful to civil society than to national authorities who might rely on high energy revenues anyway. Such a radical move can entail serious political consequences, probably triggering deteriorations of diplomatic relations that could eventually translate into disruptions of energy supply. Azerbaijan’s business environment in the energy sector, i.e. production sharing agreements and supply contracts, has been characterised as just as reliable and more market-oriented than those in other countries. The pure conditionality approach could lead to a negative development of the business climate and consequently have adverse effects on European public and private interest.

The second pragmatic collaborative option seems more reasonable in our view and more in line with the EU’s ambitions to act as a global power on the world stage. Dialogue with Azerbaijan, though imperfect, should be maintained. However, the EU’s offer of assistance and the way it is currently displayed could be improved to focus more attention on good

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<sup>16</sup> Communication from the European Commission, COM (2004) 373 final, *European Neighbourhood Policy, Strategy Paper*, Brussels, 12 May 2004, p.8

governance and democracy related issues. There is a necessity to cast a balance between assertiveness and joint ownership, as well as between the ambitions displayed and the concrete financial means.

## **Recommendations**

- More emphasis should be put on instruments targeted on improving democratic governance such as EIDHR and NSA-LA, paying special attention to a developing civil society which is more willing to accept and promote EU values. As soon as the EC-delegation in Baku is fully operational in autumn 2008, it should actively seek for dialogue with non-state actors, civil society and local NGOs.
- The EU should take the opportunity of the upcoming Presidential election in Azerbaijan to reaffirm its commitment to supporting democracy, rule of law and respect for human rights in Azerbaijan. ENPI must be seen as a truly policy-driven instrument and not only a classical trade rapprochement instrument.
- Intensify and upgrade joint programmes with the Council of Europe and OECD. Fundamental freedoms, free and fair elections, and strengthening of civil society should be seen as main topics for common cooperation.
- Monitor and evaluate the effects of sectoral and budgetary support in general as well as the ability of the Azerbaijani government to manage the funds appropriately. Available documents give little information about monitoring arrangements and evaluations. This shortcoming should be addressed as a priority considering that the public finance management system is far from being satisfactory, and levels of corruption remain very high.
- The EU should push for quick adoption of National Programmes on Poverty Reduction and social issues in general. Support for democratic development also requires addressing the most crucial social issues such as poverty eradication, health and/or education. They are indispensable preconditions for democracy and should be tackled as such.
- The EU should distinguish more clearly between trade, internal market measures and social questions. The current EU support for socio-economic reform focuses almost exclusively on regulatory approximation, technical regulations and standards as well as on trade measures. While regulatory convergence and trade as advocated by the EU is likely to have a positive impact on the general socio-economic situation of Azerbaijan, social challenges cannot be addressed exclusively through these measures.
- Due to the limited financial allocations that prevent EU assistance from having a decisive and sustainable impact, EU programming documents should be more focused on a few strategic priorities such as education, local democracy and environment rather than setting a long catalogue of vague and hardly reachable targets.
- The identification of those priorities should be coordinated with other donors. Structured donor coordination needs to be improved and further reflected in EU programming documents so as to strengthen the coherence of assistance and identify complementarities of interventions. Where possible, the inclusion of information about activities of the IFIs, EIB, EBRD, other donors and forms of EU support should be highlighted.

- Alternative incentives for strictly financial assistance such as access to EU programmes and agencies should be promoted strongly when discussing with Azerbaijan. Access to the Energy Community might offer strong leverage in the field of energy cooperation for instance.
- Further consolidate and simplify EU assistance. There are still too many instruments and programmes that apply to Azerbaijan and too little coordination between them, increasing the potential for confusion and misunderstanding on the recipient' side.
- Programming documents distinguish strictly between sectoral initiatives, and ignore spill-over effects. They potentially disguise contradictions in programming. It would be advisable to make linkages explicit in ENPI action.
- Measurement of achievement should be based on clearly formulated, measurable and, if possible, numerical indicators with predefined performance benchmarks. External data sources, such as the Freedom House Index, Human Development Index, World Bank Governance Indicators, should be used to assess the impact of EU assistance.

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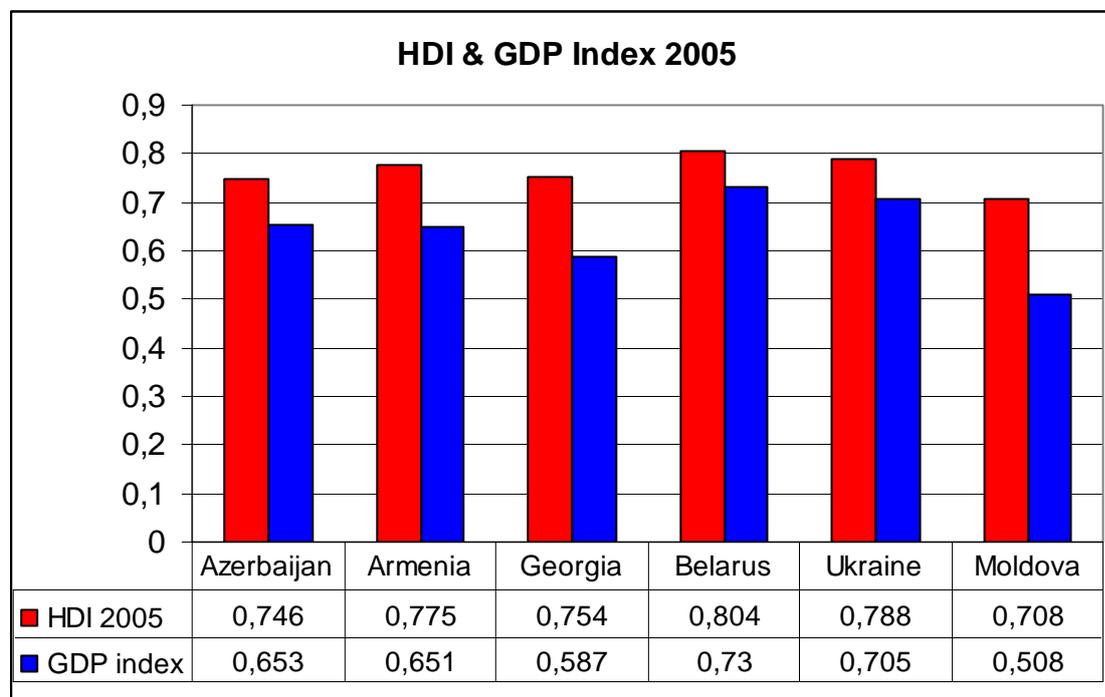
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## Annexes

### Annex 1 – Human Development and GDP Index 2005 – selected countries



Source: Human Development Report 2007/08

### Annex 2 – Country Allocations 2007 of the EIDHR country-based support scheme

Country (selection)	EUR
Armenia	600.000
Azerbaijan	900.000
Georgia	900.000
Ukraine	600.000
Moldova	300.000
Russia	1.200.000
<i>Total amount for region (ENPI and Middle East countries)</i>	8.700.000
<i>Total amount worldwide in 2007</i>	31.800.000

Note: This financial EIDHR action awards grants between EUR 10.000 and 300.000, while the maximum possible rate of co-financing is 80%.

Source: EIDHR Annual Action Programme 2007, Action Fiche 2, See also

[http://ec.europa.eu/europeaid/where/worldwide/eidhr/documents/all\\_fiches\\_en.pdf](http://ec.europa.eu/europeaid/where/worldwide/eidhr/documents/all_fiches_en.pdf)

### Annex 3 – 2007 Project of the Joint Management Programme CoE and EC

This strategic partnership is based on a recently signed Memorandum of Understanding between the CoE and the EU to cooperate in promoting democratic stability, the development of pluralist democracy, the rule of law, human rights and fundamental freedoms. The financial burdens of these projects are shared equally between the CoE and the EU, while Commission officials praise the possibility to draw on the experience and the on-site contribution of the CoE. The cooperation so far is primarily targeted towards Ukraine, Moldova and the Southern Caucasus.

<b>26 Joint Programmes in total in 2007</b>		
	<i>Programme title</i>	<i>Specific actions</i>
- 21 projects	Fostering a culture of human rights	expert assistance missions
		study visits of lawyers from Azerbaijan to the European Court of Human Rights
		development and drafting of training materials (e.g. on human rights) by national judges and prosecutors
		training for law enforcement officers
		financing vocational training for judicial staff
		several seminars for judges from Azerbaijan on European Convention on Human Rights
- 5 projects	promoting the democratic process	diverse actions as financial support for civil society representatives to join regional congresses and conferences, or the
		training of Azerbaijani officials in European norms and standards
		organisation of seminars at the Baku School of Political Studies

Source: Joint Programmes between the Council of Europe and The European Commission, see <http://www.jp.coe.int/CEAD/Countries.asp?Y=2007&CID=41>

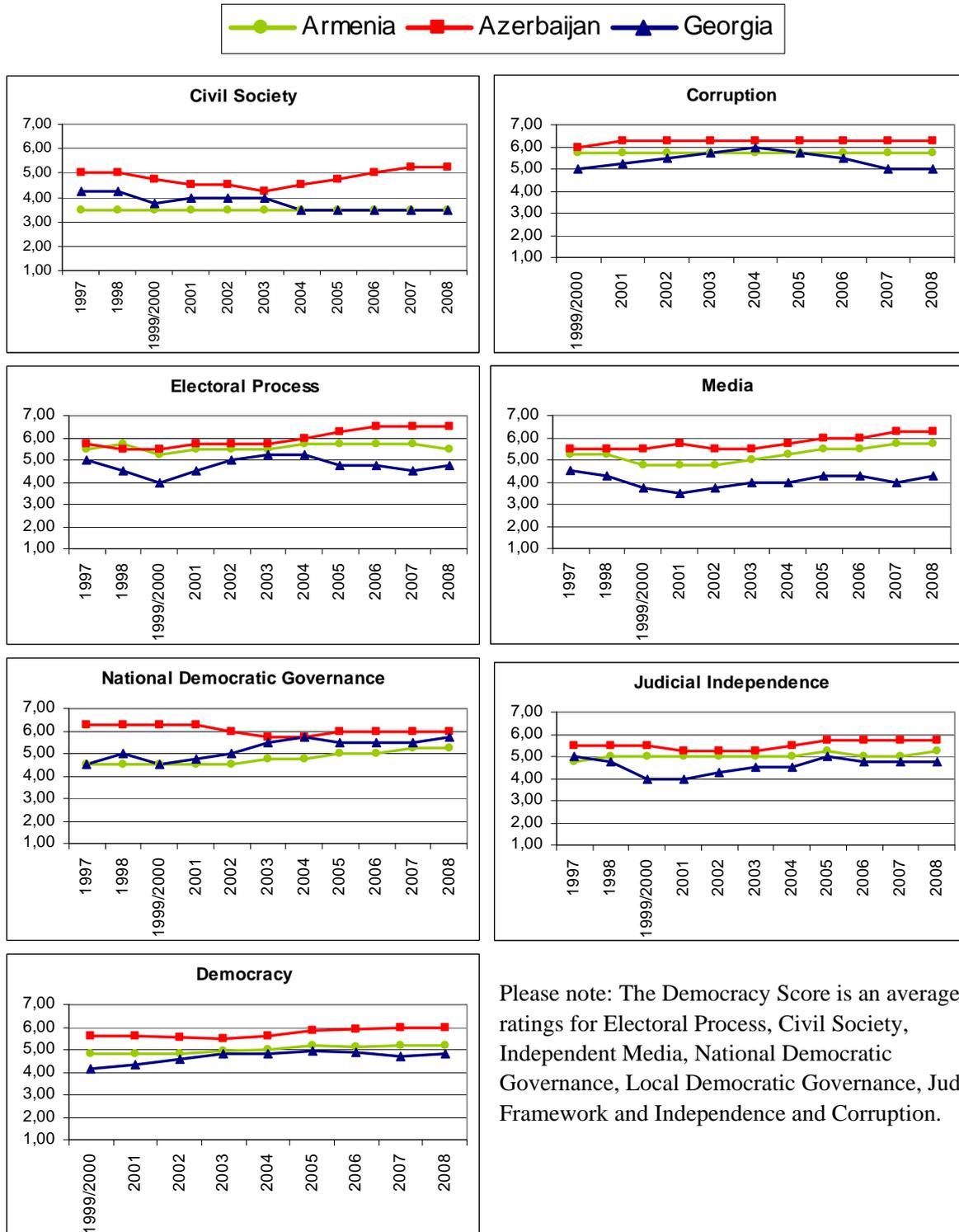
### Annex 4 – NSA-LA Country based allocations to eastern ENP countries 2007

	Million EUR
Azerbaijan	1
Armenia	1,5
Georgia	2
Belarus	1
<b>Total amount for country-based programmes 2007</b>	<b>110</b>
Note: additional assistance from other subheadings also applicable to Azerbaijan: regional initiatives (action fiche 2) and “coordination and networking activities” (action fiche 3 & 4)	

Source: Europeaid (2007), Thematic programme “Non-State Actors and Local Authorities in Development”. Annual Action Programme for 2007.

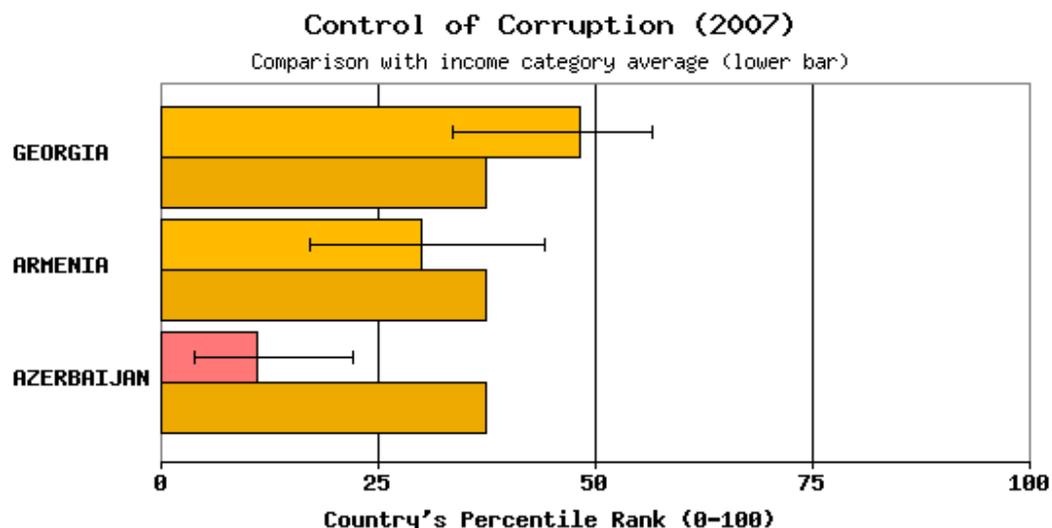
## Annex 5 – Freedom House Index – Southern Caucasus Countries – 10 years comparison

NOTE: The ratings are based on a scale of 1 to 7, with 1 representing the highest level of democratic progress and 7 the lowest. The 2008 ratings reflect the period January 1 through December 31, 2007. Data from Freedom House (2008): Nations in Transition 2008. See [http://www.freedomhouse.hu/index.php?option=com\\_content&task=view&id=196](http://www.freedomhouse.hu/index.php?option=com_content&task=view&id=196)



Please note: The Democracy Score is an average of ratings for Electoral Process, Civil Society, Independent Media, National Democratic Governance, Local Democratic Governance, Judicial Framework and Independence and Corruption.

## Annex 6 – Control of Corruption in the Southern Caucasus (2007)



Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2008: Governance Matters VII: Governance Indicators for 1996-2007

Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources or for any other official purpose.

N.B.: For this graph, percentile ranks show the percentage of countries globally ranking below the selected countries, i.e. the lower the score of the upper bar, the more countries are rated better at controlling corruption.