



## Investment (FDI) Policy for Azerbaijan Final report

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## **1. Introduction**

This report is intended to develop a mid- to long-term strategy for (foreign direct) investment in the Azerbaijan economy in the non-oil-sector with suggestions for the design of an investment policy. The recommendations are given against the background of and with reference to examples from Central and East European transition economies including East Germany. The comparative approach, however, is limited and has to pay attention to the fact that the Azerbaijan economy has very different starting conditions in many respects.

The oil-sector in Azerbaijan has experienced heavy domestic and foreign investments, and due to the existence of substantial natural resources can be regarded as a self-running process. It provides the country with massive economic growth and the companies involved with remarkable profits. However, since natural resources are limited, the country needs to diversify and build up capacity in the non-oil-sector, too. Therefore, the focus of this report is on the question how to stimulate investment in the non-oils-sector of Azerbaijan. Particular reference will be made to the attraction of foreign direct investment and the experience on transition economies of CEE.

So far, Azerbaijan has experienced (foreign direct) investment mainly in the oil-sector. The non-oil industrial sector has been rather neglected so far, but needs to be developed in order to reduce dependence of the oil-sector and offer the Azerbaijan economy future development perspectives. A comprehensive investment policy is needed to support the process of industrialization in the non-oil-sector. In the long run, this is the only way to restructure the economy and to increase the standard of living.

This report provides information on the nexus and importance of economic policy, investment, and the promotion of FDI. Looking at the development of current domestic and foreign investment in Azerbaijan, the report is going to discuss the main economic motives for potential future investment in the non-oil-sector. Subsequently, we review the progress made in terms of improving the general investment climate of Azerbaijan. We pay particular attention to indicators of the ease of doing business as well as institutional and legal aspect of the current investment regime. The main part of this report is going to provide an overview of investment policy in transition economies of CEE and tries to relate best practice to the Azerbaijani context. Thereby, we look firstly at corporate taxation and investment incentive design, before we focus on the role of investment promotion agencies. Finally, the report sums up and tries to elaborate on the idea of a comprehensive approach to investment policy in Azerbaijan. Each section of the report offers a short overview of recommendations made.

## 2. Economic Policy, investment, and FDI promotion

Before going into the details of investment policy in Azerbaijan, the following question should be raised: Why does industrial investment, and especially foreign direct investment, matter at all? And why is an investment policy needed for Azerbaijan?

Generally speaking, in a market economy, investment plays an indispensable role for economic growth, employment and competitiveness. In the process of economic transition or catching-up development, investment in capital goods through private companies serves the process of structural change and technical modernisation. In this process, foreign direct investment plays an important role since it usually comes along with new technology and managerial knowledge. The local economy can strongly benefit from a technology and knowledge transfer as many examples of transition economies in Central and Eastern Europe show.

For Azerbaijan, there are several reasons why foreign direct investment could benefit the local economy. First of all, the economy is so far highly dependent from the flourishing oil-sector which also means a dependency of oil-price fluctuations. Recent developments at the oil market have demonstrated severe fluctuations of prices. This calls for a sectoral **diversification** of the Azerbaijan economy. This is only possible through heavy investments in the non-oil industrial sector. Due to revenues from the oil business, Azerbaijan has financial means to carry out investments in manufacturing industry, but this is not enough. As important as the building of fixed capital is on the one hand the technological expertise and innovative potential of investments and on the other hand the integration of Azerbaijan into the global economy. In the process of catching-up development and transition, these important requirements – technological/innovative potential and integration into the global economy – can best be served through foreign direct investment. Thus, an important step forward on the way of economic diversification is the combination of domestic and foreign investment. The two sources of investment should be regarded as complementary, also in order to avoid heavy dependence on foreign investors in the sense of a dual economy.

While foreign direct investment is virtually an automatism in the oil-sector, the attraction of investors in other industries is much more difficult for Azerbaijan. Without a **strategic investment policy**, including **investment incentives**, it is hardly possible to attract substantial investment from abroad. From an economic perspective, incentives are justified since they do not only benefit the individual private investor, but also the economy as a whole. The follow-up effects, such as employment, local demand, technical spillovers etc., should not be underestimated. Furthermore, the situation of Azerbaijan calls for the introduction of incentive schemes because nearly all alternative investment locations in the region offer favourable investment incentives, and a similar corporate taxation. In the global

race for large strategic investments of multinational companies, the situation of Azerbaijan, so far is not competitive.

### **Recommendations (I): Economic Policy, investment, and FDI promotion**

In order to reduce the dependence of Azerbaijan from the oil-sector and oil-price fluctuations, there is a strong need to **diversify** the economy through investments in the non-oil-sector in a mid- and longterm perspective.

In the **global race for large international investments**, a strategic investment policy, including an investment incentive scheme, needs to be implemented in Azerbaijan.

**Domestic and foreign investors** are needed to serve the non-oil-sector with capital and technological knowledge. Foreign investors with their multinational company group and locations all over the world should be seen as a means to integrate Azerbaijan into the global economy, too.

The implementation of an investment policy has to be regarded as a **multi-dimensional task** involving the co-ordinated action of a number of different actors and authorities.

### 3. Economic motives for (foreign) investment in Azerbaijan

In international business literature (see e.g. Dunning, 1993), location-specific advantages explain why a firm would rather invest abroad than at home, and which countries possess advantages as locations for FDI. **Location-specific advantages** of host countries are, thus, factors that determine attractiveness of a country for foreign investors. Host country determinants of FDI could be classified into the fundamental economic determinants, which represent the actual reason for investing in a particular country, the policy framework, and business facilitation. Policy framework and business facilitation create a more or less favourable environment for the realisation of basic motives of foreign investors.

This implies that the primary determinants of country's attractiveness as FDI location are factors such as market characteristics (host market size and growth, per capita income, access to regional and global markets etc.), the availability, quality, and relative costs of production factors such as labour, raw materials and other inputs including technological and other created assets, or physical infrastructure. When an investors has identified a host country for a set of economic motives, the general regulatory and policy framework of a host country comes into play. This refers in its broadest sense to factors that affect the investment climate including economic, political and social stability, privatization policy, trade regime and policy, tax rates and structure, labour market and product markets regulations. It is argued that only after these more general policy and regulatory considerations, FDI specific policy and regulation issues come into play. Elements of a FDI regime and policy are the relevant legal framework for FDI, marketing of the host country as an investment location, investment incentives, and business facilitation services supplied to foreign investors. Although issues related to investment climate, regulatory and policy framework are of secondary importance, they certainly have an impact on the decision of a foreign investor in respect to the implementation of any potential market seeking, resource/asset seeking, or efficiency seeking motives (see, for instance, Dunning, 1993; UNCTAD 1998).

In order to assess the relevance of **different economic motives for investment** in the Azerbaijani context it is necessary to first take a look at the dynamics and sources for investment over the recent years. Azerbaijan achieved considerable rates of investment in the domestic economy since the beginning of the century. In 2000 total investment stood at 27 per cent of GDP, peaked at 68 per cent in 2005 and stood at 40 per cent in 2007 (see Table 1).

Table 1 – Total investment as per cent of GDP 2002 – 2007

	2000	2002	2003	2004	2005	2006	2007
<b>Total Investment</b>							
<b>in % of GDP</b>	27.34	n. a.	44.85	59.46	68.23	53.77	39.56

Source: State Statistical Committee of the Republic of Azerbaijan 2008.

The absolute amount of investment increased throughout this time about eight times from about 1.4 bn US\$ in 2000 to 11.5 bn US\$ in 2007 (see Table 2). Consequently, the rate of investment in terms of GDP only decreased from 2005 onwards due to a rapid output expansion.

Table 2 – Total investment in Azerbaijan 2000 – 2007

	2000	2002	2003	2004	2005	2006	2007
<b>Total Investment</b>							
<b>mio US\$</b>	1441.4	2796.6	4326.4	5922.7	7118.5	8300.4	11540.3
<b>Foreign investment (direct and portfolio investment)</b>							
<b>mio US\$</b>	927	2234.9	3371	4575.5	4893.2	5052.8	6760.3
<b>in %</b>	64.31	79.91	77.92	77.25	68.74	60.87	58.58
<b>Internal Investment</b>							
<b>mio US\$</b>	514,4	561,7	955,4	1347,2	2225,3	3247,6	4780
<b>in %</b>	35.7	20.1	22.1	22.7	31.3	39.1	41.4

Source: State Statistical Committee of the Republic of Azerbaijan 2008.

If we look at the sources of investment in Azerbaijan between 2000 and 2007, we realize that in the beginning of this period the majority of investment funds came from foreign sources (see Table 2). Investment in Azerbaijan really took off in 2002. At this point of time about 80 per cent of investment funds came from abroad. Yet, substantial GDP growth rates after 2000 facilitated a steady increase in the share of domestic investment which stood in 2007 already at 41 per cent. Thus, Azerbaijan reduced its dependency on foreign sources for general investment, yet the majority of funds still stems from foreign sources.

Similarly, we need to accept that the majority of total foreign investment goes into the oil industry of Azerbaijan. The corresponding share peaked in 2004 at 89 per cent and stood still in 2007 at about 62 per cent (Table 3). Leaving foreign sourced portfolio investment, financial credits, and other investment aside the share of foreign direct investment into the non-oil-sector in total foreign investment is very low and even declined from 12.7 per cent in 2000 to 5.6 per cent in 2007.

Table 3 – Foreign investment in oil industry and share of total foreign investment in Azerbaijan 2000 – 2007

	2000	2002	2003	2004	2005	2006	2007
<b>Foreign investment in oil industry (direct and portfolio investment)</b>							
<b>mio US\$</b>	546.1	1693.0	2972.4	4088.1	3799.9	3422.3	4176.3
<b>in % of total</b>	58.9	75.8	88.2	89.3	77.7	67.7	61.8
<b>Foreign direct investment in non-oil-sector</b>							
<b>mio US\$</b>	118.0	318.9	45.4	104.2	230.5	368.4	376.0
<b>in % of total</b>	12.7	14.3	1.3	2.3	4.7	7.3	5.6

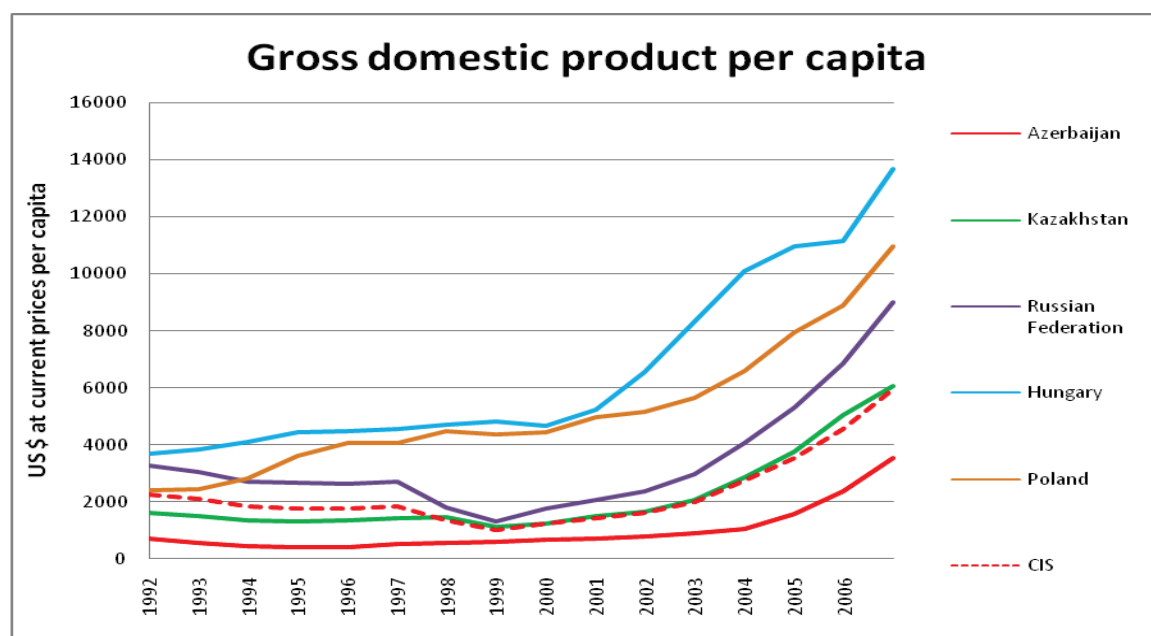
Source: State Statistical Committee of the Republic of Azerbaijan 2008.

This situation clearly indicates that foreign investment into Azerbaijan has been a major drive of economic growth, facilitated export receipts, and a rising share of domestic investment.

Yet, foreign investment flows are almost exclusively directed at the oil sector. Thus the prime foreign investment motive in Azerbaijan is resource seeking. This is in contrast to many other transition countries in CEE, where the majority of foreign direct investment has been of market and efficiency seeking nature (Bevin and Estrin 2004). Similarly, recent evidence for CIS countries shows a growing importance of market seeking motives (Johnson 2006, Kudina and Jakubiak 2008).

So what fundamental factors could explain the absence of market seeking? First of all the market size in terms of GDP is relatively small compared to many other countries in CEE and the CIS. Yet, maybe more important could be the fact that the level of income per capita is still comparatively low in Azerbaijan. In 2007 it stood at 3.550 US\$ per capita which constitutes only about 60 per cent of the CIS average.

Chart 1 – GDP per capita of selected transition economies (in US\$ in current prices)



Source: UNCTAD - Handbook of Statistics 2008.

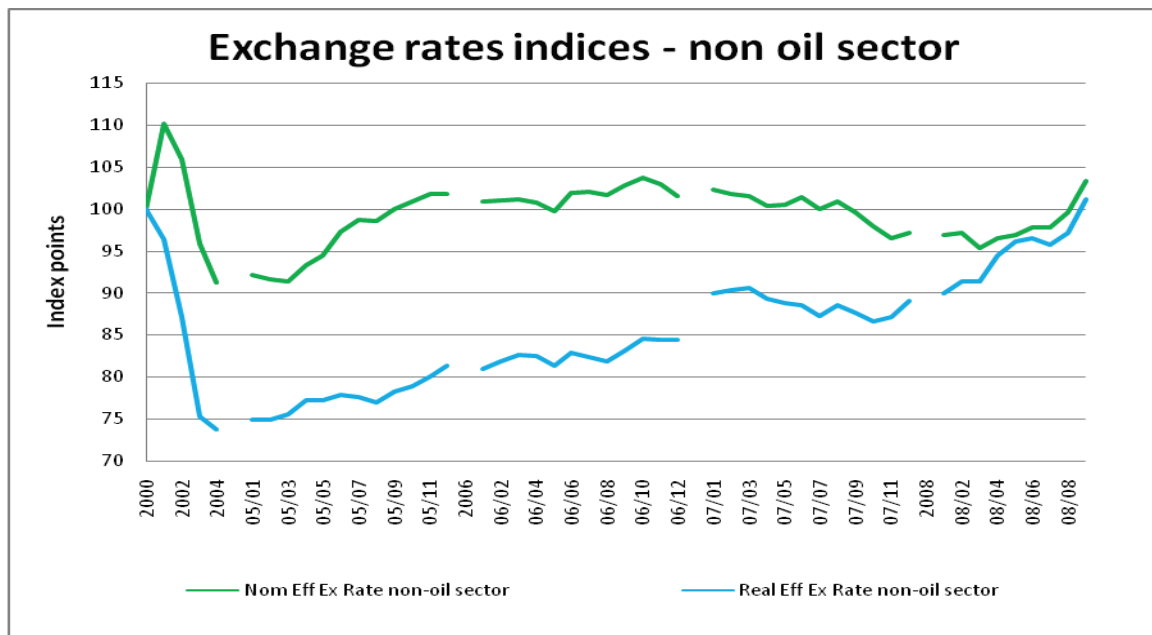
However, since 1996 Azerbaijan had annual average growth rates in GDP per capita that by far outperform Russia and the CIS average. During the period from 1995 to 2000 Azerbaijan had an average growth rate of 6.36 per cent, from 2000 to 2005 even 9.21 per cent compared to 1.42 and 4.28 per cent for the CIS respectively. As a result, the gap in per capita income between Azerbaijan and the CIS could be halved between 1992 and 1997. According to the IMF World Economic outlook (2008) this impressive **output recovery** is going to continue even stronger in the period between 2007 and 2013. Rising income levels certainly provide a future stimulus for market seeking FDI in Azerbaijan. The poverty in Azerbaijan and in particular in Baku declines rapidly due to increasing wages and salaries as well as a surge in transfer income to poor households (World Bank 2006). Given that this trend continues,



consumer goods industries such as food and beverages, textile and clothing, but also electronics could develop a strong domestic demand. This demand would to a large extent be catered by increased imports, yet in selected areas there might be also a stimulus for FDI such as in food and beverages, where transportation costs are high and direct access to the domestic production and distribution networks are important. Similarly attractive is the telecommunication market, where investment is related to a fixed network infrastructure. Both sectors might provide an excellent opportunity for Azerbaijan to attract market seeking FDI. At this stage, FDI could be linked to privatisation or acquisition of key Azerbaijani firms. This opens up the possibility for joint ownership. Yet, any investor into such markets is attracted by possible monopoly rents. Therefore, privatisation in such strategic markets must be accompanied by thoughtful national competition policy in order to reap the benefits.

However, to which extent could Azerbaijan attract efficiency seeking FDI? Arguably relatively low unit labour costs and proximity to the EU markets were major drives for efficiency seeking FDI into CEE mainly from neighbouring EU-15 countries. Many EU firms were attracted by relatively lower labour costs, perceived low transaction costs in managing production facilities over a short distance, and consequently increased overall efficiency in production. Yet, this trend must be considered in the context of EU accession, corresponding trade agreements, and finally EU membership. In addition, many CEE countries used a combination of exchange rate policy and moderate wage policy in order to promote export competitiveness. Azerbaijan has Turkey, Russia, and Iran as very large and growing neighbouring markets, which already are amongst the top 5 export destinations. Yet, these countries are not member of one regional trade bloc and follow rather divergent trade integration strategies. However, Azerbaijan increased its exports to the CIS from about 13 per cent in 2003 to 18 per cent in 2007, whereas imports from the CIS to Azerbaijan increased from 32 to 33 per cent over the same period of time (*State Statistical Committee of the Republic of Azerbaijan*). Thus **regional trade integration with the CIS** could improve the condition for efficiency and export oriented FDI to Azerbaijan.

Chart 2 – Indices of effective exchange rates 2000 to 2008 in the non-oil-sector (2000 = 100)

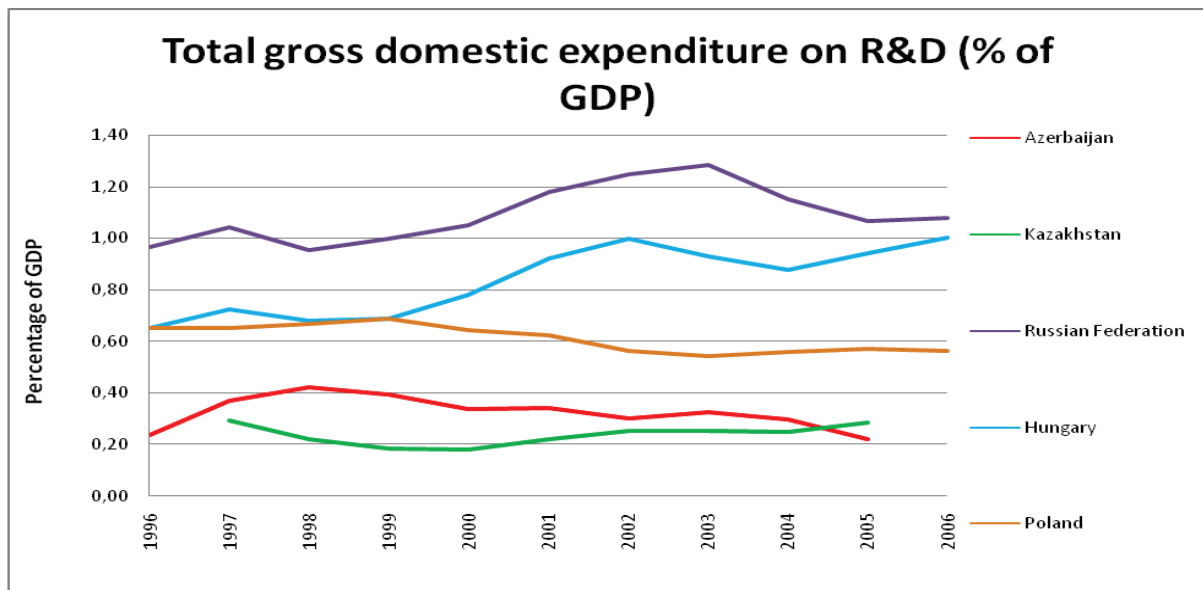


Source: National Bank of Azerbaijan 2008.

The steady **real exchange rate appreciation** is another potentially hampering factor for export oriented FDI in the non-oil-sector of the economy (see Chart 2). If this real exchange rate appreciation continues at such a pace, it is bound to have a negative impact on the export competitiveness of services and manufacture in the non-oil-sector of the economy. This would be an classical example of the so called ‘Dutch Disease’ and might constitute an obstacle for future FDI into services and manufacturing that aims at building a regional/global export platform in Azerbaijan.

Finally, long term export competitiveness is driven not by relative advantages in unit labour cost but technological leadership. Yet, if we take a look at the development of R&D expenditures as a share of GDP, we realize that the performance of Azerbaijan in comparison to other CIS or transition countries is in fact disappointing (see Chart 3).

Chart 3 – Total Gross Domestic expenditures on R&D (in % of GDP) 1996 to 2006



Source: UNESCO 2008.

Although, **R&D expenditures** are heavily influenced by the sectoral composition of countries and in fact natural resource abundant countries tend to have relatively low level of R&D expenditures to GDP, we observe for Azerbaijan even a falling trend between 1998 and 2005. Here seems to be serious need for government intervention by increasing public and private R&D expenditures at least in line with GDP growth. That would incrementally improve the build up of technological capabilities in the economy, which creates better conditions for attracting export oriented FDI as well as strategic asset seeking FDI.

In sum, we would argue with considerable potential for market seeking FDI, but fairly limited prospects for efficiency seeking FDI, foreign direct investment related to the oil sector is going to remain most important for Azerbaijan's future economic development. Therefore, another promising route could be to promote **investment in up-stream and down-stream sectors** related to the oil-exploration.

Table 4 – Structure of Imports and Exports (SITC) and Balance 2007

<b>Trade structure and balance 2007</b>			
<b>Commodities</b>	<b>Imports</b>	<b>Exports</b>	<b>Balance</b>
<i>Standard International Trade Classification</i>	in %	in %	in th. US \$
Food and live animals	11,5	6,7	-248.054
Beverages and tobacco	3,5	0,5	-170.633
Crude materials, inedible, except fuels	2,6	1,8	-43.689
Mineral fuels, lubricants and related materials	2,5	81,4	4.788.302
Animal and vegetable oils, fats and waxes	0,8	1,1	21.591
Chemicals and related products,	7,4	1,6	-326.920
Manufactured goods classified chiefly by material	18,9	3,6	-857.211
Machinery and transport equipment	45,7	2,4	-2.462.763
Miscellaneous manufactured articles	7,1	0,8	-354.231
<b>Total</b>	<b>100</b>	<b>100</b>	<b>346.229</b>

Source: State Statistical Committee of the Republic of Azerbaijan 2008.

To take an example, in the year 2007 about 80 per cent of imports to Azerbaijan were accounted for by machinery, equipment and manufactured goods including chemicals.

A considerable share of these imports is related to the demand from oil extraction, transport, and refinement industries. Often foreign investors find supply bottlenecks in the host economy that inhibit their operations. In such a situation imports can serve as a substitute to assure supplies. However, this might involve high transaction cost in the medium term, so that a situation might be preferable were foreign suppliers follow the oil company in order to produce in the host economy. This includes also the supply of business related services such as banking. In turn, large scale and capital-intensive downstream investment might also be feasible, when foreign entry for example in oil refining or the petrochemical industry can build upon existing local capabilities.

However, if upstream and downstream investment creates inefficiencies for the investing firms, the government might need to compensate for these on the grounds of externalities created from subsequent investment. To promote efficient and sustainable linkages to the oil industry, governments should pay attention to **strengthening domestic productive capabilities** and to providing an environment conducive to investment by both local and foreign firms (UNCTAD 2007). The **government** should engage into a **consultation process** with oil industry and related non-oil industries about feasible upstream/downstream investment projects. The major advantage of this strategy is that it starts with existing demand and latent capabilities of Azerbaijan. A coordinated approach to promoting investment would not only involve the provision of fiscal incentives, business facilitation services, and infrastructure to domestic and foreign investors, but also in-house and external training incentives as well as specific education and research programmes.

In addition, such a strategy could be complemented by a pro-active government approach in terms of acquiring large foreign direct investment in up- and downstream industries to the oil sector. One way to do this is to approach target firms directly using the investment promotion agency and to open negotiations. Alternatively, Azerbaijan could also use a **sovereign wealth fund (SWF) or Azerbaijan Investment Company (AIC)** to stimulate FDI by key global firms in the respective industries. Azerbaijan would indirectly hold foreign assets or equity in local joint venture projects and could exercise foreign companies' investment decision. Such an approach should build on mutual interests between the fund and the firm. The SWF or investment company offers an investment opportunity and fresh capital to the foreign company. The fresh capital supplied to the foreign company and/or shared ownership is able to compensate for any excessive risk associated with FDI in Azerbaijan. In exchange, the government would attract a major FDI project able to promote direct technology transfer, spillovers to domestic firms, and local value chain extension. Such a pro-active approach needs careful design in order not to be in conflict with security provisions of bi-lateral investment treaties that try to protect strategic firms and markets, and to limit the extent of state intervention. However, the current shortage of credit at international markets might also be a window of opportunity to enter such arrangements.

#### **Recommendations (II): Economic motives for investment**

**Any design of investment policy should follow the logic of economic motives as primary determinants** and should consider the regulatory and policy framework for investment in general and FDI in particular as important but secondary factors.

From this point of view, resources seeking investment in the oil-sector is going to remain the most important source for investment in Azerbaijan for the foreseeable future.

Building on this, we recommend **the promotion of investment in related upstream and downstream non-oil-sectors** (manufacturing as well as services). Such investment promotion aims at extending local value adding, relies on existing demand, and potentially upgrades host country specific capabilities. A **pro-active approach of the government** could be to use the investment promotion agency, a sovereign wealth fund, or investment company as vehicle to stimulate FDI by key players in upstream and downstream industries.

Given the considerable catch-up growth and poverty reduction, Azerbaijan becomes increasingly attractive as **a location for market seeking FDI in the non-oil-sector**. The consumer goods industry and strategic sectors such as telecommunication and banking might offer excellent investment opportunities. However, foreign entry in such markets needs a working competition policy framework.

The prospect for **efficiency seeking investment i.e. export oriented and technological asset seeking FDI is still limited**. However, continued government efforts targeted at trade integration, real exchange rate appreciation, and public and private R&D could improve the economic conditions for such investment in the future.

## 4. The Investment climate of Azerbaijan

### 4.1 General business climate

The World Bank came to its most recent Doing Business (2009) report to the conclusion that Azerbaijan is the top reformer for 2007/08. Reforms included the introduction of a one-stop shop for business start-up that began operating in 2008, halving the time, cost and number of procedures to start a business. Business registrations increased by 40 per cent in the first six months. Amendments to the labour code made employment regulation more flexible by allowing the use of fixed-term contracts for permanent tasks, easing restrictions on working hours and eliminating the need for reassignment in case of redundancy dismissals. And property transfers can now be completed in 11 days - down from 61 before - thanks to a unified property registry for land and real estate transactions. Azerbaijan also eliminated the minimum loan cut of \$1,100 at the credit registry more than doubling the number of borrowers covered. Minority shareholders enjoy greater protection, thanks to amendments to the civil code and a new regulation on related-party transactions. Such transactions are now subject to stricter requirements for disclosure to the supervisory board and in annual reports. Moreover, interested parties involved in a related-party transaction harmful to the company must cover the damages and pay back personal profits. Taxpayers in Azerbaijan now take advantage of online filing and payment of taxes, saving more than 500 hours a year on average in dealing with paper-work. And a new economic court in Baku helped speed contract enforcement. With the number of judges looking at commercial cases increasing from 5 to 9, the average time to resolve a case declined by 30 days (ibid).

Table 5 – Business climate indicators Azerbaijan 2008/2009

Doing business indicators	Rank of Azerbaijan 2008 (out of 178)	Rank of Azerbaijan 2009
Starting a Business	63	13
Dealing with Licenses	159	n. a.
Employing Workers	67	15
Registering Property	63	9
Getting Credit	25	12
Protecting Investors	110	18
Paying Taxes	143	102
Trading Across Borders	176	174
Enforcing Contracts	27	26
Closing a Business	78	81

Source: World Bank (2009) Doing Business – Overview.

These reforms improved the international position of Azerbaijan substantially on 8 out of ten indicators including the ease of starting a business, employing workers, registering property,

accessing credit, paying taxes, enforcing contracts, and protecting investors (see Table 5). Whereas Azerbaijan was ranked close to countries such as Turkey, Armenia, Bulgaria, and Romania in earlier years, the reforms propelled Azerbaijan now very often in proximity of high-income or OECD countries. The overall rank of the ease of doing business moved from rank 96 (2008) to 33 (2009) for Azerbaijan. For comparison France was ranked 31 and Germany 25 in 2009. This positive development demonstrates the political commitment to improve the general business and investment climate. This message will also be of importance to international investors and should be an integral part of the communication strategy of the investment promotion agency.

The position of Azerbaijan also considerably improved in terms of the perceived extent of corruption (see table 6). According to Transparency International's perceived corruption index Azerbaijan seems to have reduced the perceived corruption in 2008 to about a quarter of what it used to be in 1999 relative to all other countries part of the ranking.

Table 6 – Transparency International Corruption Perceptions Index for Azerbaijan 1999 to 2008

Year	Rank out of total	Ranks to the bottom of list	Ratio of relative position*
2008	158/180	22	7.2
2007	150/174	24	6.3
2006	130/163	33	3.9
2005	137/158	21	6.5
2004	140/145	5	28.0
2003	124/133	9	13.7
2002	95/102	7	13.6
2001	84/91	7	12.0
2000	87/90	3	29.0
1999	96/99	3	32.0

\*Ratio of ranks to the bottom to ranks to top, Source: IWH calculations.

Source: Transparency International (2008).

The Azerbaijani government has passed a comprehensive State Programme on Combating Corruption that was developed in cooperation with civil society and international organisations. Furthermore, it has undertaken several initiatives such as strengthening anticorruption institutions, and creating an anticorruption office in the Prosecutor General's Office and an anticorruption department in the Ministry of Interior. These developments have been endorsed by the Group of States against Corruption (GRECO) and the Anti-Corruption Network (ACN) for Eastern Europe and Central Asia at the OECD. Yet, despite considerable improvements, Azerbaijan still ranks very low in Transparency International's Corruption Perceptions Index. Weak governance is widely perceived as an obstacle to doing business. Firms in Azerbaijan reported corruption to be much more of a problem in 2005 than in 2002

and more than one quarter of firms reported that there was a frequency of unofficial payments. Corruption seems highest in tax administration (IBRD/World Bank 2006). Thus, corruption remains a serious problem in Azerbaijan (World Bank 2006).

## 4.2 Legal and institutional investment regime

### National legislation to protect investment

- *Law on the Protection of Foreign Investments (1992):*
  - includes a number of safeguards for foreign investors and allows the acquisition of exploration and development rights
  - Revisions to this Law are planned
- Law about investment activity :

establishes general social, economic and legal conditions of investment activity (capital investment) on the territory of the Azerbaijan Republic is directed to the intensive attraction of investments into the economy of the Azerbaijan Republic, efficient use of economy for the development of country economic base, as well as international economic cooperation and integration and will ensure protection of rights of all investors, independent of their property form
- Edict on extra actions upon promotion of investment activity (2006):

for a purpose of promotion of making investment in development of non-oil fields of economy, innovation of material and technologic base of enterprises in these fields
- NEW: Draft on investment law in Azerbaijan

The new investment law offers some favorable framework conditions for strengthening (foreign direct) investment in Azerbaijan. Like the existing law, it takes a liberal FDI approach in the sense that it does not discriminate between domestic and foreign investors, i.e. it treats both sides equal. Furthermore, it provides a good basis for the implementation of particular investment incentives since the idea of investment incentives is already included in the law, see e.g. 1.1.12 to 1.1.14 (these paragraphs mention special economic zones and/or direct state funding for investment projects).

### International legislation to protect investment

Part of the effort to attract international investment involves the adoption of **bilateral treaties (BITs)** for the promotion and protection of foreign investment. Bilateral investment treaties



are playing an increasingly important role in international investment relations worldwide, including in CEE transition economies which experienced a sharp increase in the number of treaties throughout the 1990s (UNCTAD 2000). Initially, BITs were concluded between a developed and a developing country, usually at the initiative of the developed country. The developed country — typically a capital exporting country — entered into a BIT with a developing country — typically a capital importing country — in order to secure additional and higher standards of legal protection and guarantees for the investments of its firms than those offered under national laws. The developing country, on the other hand, would sign a BIT as one of the elements of a favourable climate to attract foreign investors. This pattern has changed since the late 1980s and especially in the 1990s, as developing countries and economies in transition began to sign BITs between themselves in great numbers. As a result, the dividing line for BIT partners between capital exporting and capital importing countries no longer holds true and, in many instances, countries approach BITs with the dual purpose of protecting their outward investments to, while attracting inward investment from, the other BIT partner. Of course, the degree of emphasis that countries place on each of these objectives varies considerably from BIT to BIT (ibid). Thus, BITs have become one of the most widely spread types of international agreement for protecting and influencing FDI. There seems also to be evidence that the grand bargain in terms of investment protection in return for investment promotion seems to work, although the effect seems to realize only slowly after signing the BIT (Salacuse and Sullivan 2005). This might have to increase countries willingness to sign further BITs (ibid).

Also Azerbaijan started to sign BITs with a number of countries during the 1990s. Until 1999, Azerbaijan had signed 17 BITs with countries including Azerbaijan's major trading partners, neighbouring countries but also selected OECD countries such as the US, Germany, Italy, and France. Until today another 12 BITs have been signed mainly with EU-member states but also Egypt, Qatar and Israel.

Table 7 – Bilateral Investment Treaties concluded by 1. June 2008

Country	Date of signature	Date of entry into force
Austria	4-Jul-00	28-May-01
Belgium and Luxembourg	18-May-04	----
Bulgaria	7-Oct-04	----
China	8-Mar-94	1-Apr-95
Egypt	24-Oct-02	----
Finland	26-Feb-03	10-Dec-04
France	1-Sep-98	24-Aug-00
Georgia	8-Mar-96	10-Jul-96
Germany	22-Dec-95	29-Jul-98
Greece	21-Jun-04	3-Sep-06
Iran, Islamic Republic of	28-Oct-96	20-Jun-02
Israel	20-Feb-07	----
Italy	25-Sep-96	4-Feb-00
Kazakhstan	16-Sep-96	----
Kyrgyzstan	28-Aug-97	28-Aug-97
Latvia	3-Oct-05	10-May-06
Lebanon	11-Feb-98	----
Lithuania	8-Jun-06	----
Moldova, Republic of	27-Nov-97	28-Jan-99
Pakistan	9-Oct-95	----
Poland	26-Aug-97	10-Feb-99
Qatar	28-Aug-07	----
Romania	11-Oct-06	----
Switzerland	23-Feb-06	----
Turkey	9-Feb-94	8-Sep-97
Ukraine	21-Mar-97	9-Dec-97
United Kingdom	4-Jan-96	11-Dec-96
United States	1-Aug-97	2-Aug-01
Uzbekistan	27-May-96	2-Nov-96

Source: UNCTAD 2008.

Traditional BIT practice does not, in general, expressly deal with development matters beyond the inherent objective of BITs of investment protection.

In general, **BITs do not include explicit provisions on investment promotion**. According to UNCTAD (2008) this situation may severely limit the expected promotional effect of BITs since most of these treaties do not give foreign investors any assurance of what kind of investment promotion activities and measures they can expect when making an investment in the host country. There are many options for enhancing investment promotion in international investment rulemaking, including through measures by the host country, the home country and joint activities. Investment promotion agencies (IPAs) in particular could raise the awareness of the contracting parties on the need of investment promotion provisions in IIAs.

IPAs could also be involved in identifying countries with which IIAs are desirable in light of medium- and long-term national investment promotion strategies. Likewise, IPAs might wish to use IIAs more actively as a promotional tool. However, investment promotion provisions in BITs may increase the likelihood of host countries receiving foreign investment, but they may likewise reduce the contracting parties' discretion in the design and operation of their domestic investment promotion schemes.

In 1981, the members of the Organization of the Islamic Conference<sup>1</sup>, in implementation of their Agreement on Economic, Technical and Commercial Cooperation, signed the Agreement on Promotion, Protection and Guarantee of Investments, which contains investment protection provisions.

#### International trade agreements

It is important to underline that international investment is strongly linked with international trade regulations. Multinational companies in general account for a growing share of international trade. Therefore, any trade integration goes hand in hand with FDI. Several efforts have been undertaken in Azerbaijan so far, among them:

Partnership and Cooperation Agreement between the European Community and Their Members States and the Republic of Azerbaijan (1996);

Economic Cooperation Organization Trade Agreement (2003) Members of ECO are: Afghanistan, Azerbaijan, the Islamic Republic of Iran, Kazakhstan, Kyrgyzstan, Pakistan, Tajikistan, Turkey, Turkmenistan, and Uzbekistan.

Furthermore, accession negotiations between WTO and Azerbaijan are in an advanced stage and will be completed in the near future. National law in Azerbaijan has been largely modified in line with WTO requirements. In principal, this is a positive sign for international investment.

#### Other agreements with international organisations

##### *EU-Azerbaijan action plan*

In line with the EU neighborhood policy, Azerbaijan has signed the EU-Azerbaijan Action Plan which is a political document laying out the strategic objectives of the cooperation between the EU and Azerbaijan. The document lists a number of priority areas, among them “Further convergence of economic legislation and administrative practices”, where “reforms

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<sup>1</sup> As of 1995, the members of the Organization of the Islamic Conference were Afghanistan, Albania, Algeria, Azerbaijan, Bahrain, Bangladesh, Benin, Brunei, Darussalam, Guinea-Bissau, Indonesia, the Islamic Republic of Iran, Iraq, Jordan, Kuwait, Kyrgyzstan, Lebanon, the Libyan Arab Jamahiriya, Maldives, Malaysia, Mali, Mauritania, Morocco, Mozambique, Niger, Nigeria, Oman, Pakistan, Palestine, Qatar, Saudi Arabia, Senegal, Sierra Leone, Somalia, Sudan, the Syrian Arab Republic, Tajikistan, Tunisia, Turkey, Turkmenistan, Uganda, United Arab Emirates, the United Republic of Tanzania and Yemen.

in the field of public investment policy” is mentioned as one specific action. The relevance of it is demonstrated through the ongoing efforts of the government of Azerbaijan to further develop investment policy.

#### *EBRD in Azerbaijan*

European Bank for Reconstruction and Development is present in Azerbaijan and partner in some, mainly large investment projects. The EBRD is an important player with an important signaling function for private investment. In general, EBRD participation has the intention to support and enable promising investment projects.

To sum up, the legal framework and institutions have (long) been established in Azerbaijan; an Investment Promotion Agency as well as the Azerbaijan Investment Company (AIC) exists. Overall, a liberal FDI policy framework exists and agreements with as well as presence of international organisations are a positive signal for international investment, but all these efforts are **not yet enough as an investment policy**.

### **Recommendations (III): Investment climate**

#### *General business climate*

Azerbaijan made considerable progress in terms of various indicators for the ease of doing business. This positive development demonstrates the political commitment to improve the general business and investment climate. This message will also be of importance to (international) investors and **should be an integral part of the activities of the investment promotion agency**.

Yet, despite considerable efforts to improve governance and institutions over the last ten years, Azerbaijan still performs relatively weak by international standards **in terms of corruption**. This forms a **major obstacle to investment in general and for foreign investment in particular**. Corruption increases the risk of failure and has negative consequences in terms of enforcing contracts and property rights as well as accessing external finance.

#### *Legal and institutional investment regime*

It is highly recommendable to adopt the **new law on investment activity** as soon as possible. We also recommend designing the practical details of the investment incentive programs which are already mentioned in the draft law (1.1.12 to 1.1.14).

#### *International agreements on investment and trade*

Since the early 1990s Azerbaijan has successfully signed a number of bilateral investment treaties (BITs). These **BITs should be extended** in order to attract FDI from a large number of countries. The government should think about introducing investment promotion into BITs.

International investment is strongly linked with international trade integration, regional as well as global. The **governments’ efforts to facilitate regional and international trade need to be continued and intensified**. Otherwise the scope for market seeking (foreign) investment remains very limited.

Moreover, it is appropriate to **deepen the co-operation with international organisations** (EU, EBRD etc.) which has an important signalling function for (foreign) investors.

## 5. Investment Policy in Azerbaijan – Learning from CEE

For a number of CEE transition economies the attraction of foreign direct investment (FDI) became a priority in economic development policy of the 1990s. Governments used a mix of privatisation, corporate taxation measures, incentives schemes, as well as investment promotion as FDI policy instruments.

### 5.1 Corporate income taxation and investment incentives in CEE transition economies

Investment incentives cannot be evaluated in isolation from taxation. The corporate income tax (CIT) has received the strongest attention so far, since it most directly affects the amount of profit that is available for distribution. The most successful countries in attracting FDI tend to have low to moderate rates of CIT, with reasonable provisions governing deductions, depreciation, and loss relief (OECD, 2002a). Also CEE governments used CIT and incentives as tools to stimulate investment and in particular to attract foreign firms. The CIT rates have declined significantly in CEE economies since the mid-1990s. While the OECD average fell from 37.6 per cent to 31.4 per cent between 1996 and 2002, the average in CEE countries fell sharply from 31.2% to 23.6%. This drop happened against a background of increasing average levels of investment incentives since the mid-1990s, peaking in the period from 1997 to 2002, and stabilising or falling with EU accession in 2004/2007 (Cass, 2007).

Investment incentives in the narrow sense include fiscal, financial and other incentives (see Table 8). The fiscal incentives reduce the tax burden, financial incentives provide direct cash assistance, and other incentives reduce investment cost through non-financial means. In principal, investment incentives should be non-discriminatory with respect to sector, region or firm ownership (domestic vs. foreign). Yet, incentive design often takes place with an eye on international competition for investment. Moreover, in line with government priorities authorities often link incentives to performance requirements and direct investment into strategic sectors, regions or activities.

Table 8 – Key FDI incentives

Type of incentive	Purpose	Elements
Fiscal	Reduction of tax burden on investor	Tax credit, tax relief, tax rebate, exemption from customs duty, reduction of tax base, VAT exemption, accelerated depreciation, reinvestment allowance, loss accrual
Financial	Provision of direct financial assistance for certain projects	Soft loans, cash grants, sovereign guarantee on investment credits, export guarantee, insurance and credit, subsidised funding
Other	Reduction of investment cost through non-financial means	Preferential government contracts; real estate and infrastructure provided below market price for example in special economic zones, industrial or technology parks

Source: adopted from Sass (2003).

Performance requirements may include: local added value requirement (local content requirements), export requirement, minimum investment requirement, the requirement of domestic participation, employment-related issues, or technology transfer and R&D activities. However, multilateral and regional conventions (GATT/WTO) impose substantial restriction of the applicability of performance requirements.

While most transition countries have offered investment incentives at some point, there are considerable differences in the extent to which they have done so and policies varied over time. The most common form of investment incentives in the earlier part of transition was fiscal in nature. This included in particular corporate tax holiday, investment tax credit, and custom free zones. To a lesser extent and only more recently countries offer increasingly financial incentives i.e. cash grants, subsidies, or guarantees (see for a discussion of advantages and disadvantages box 1). Incentives have largely been targeted at manufacturing, with varying degrees of discrimination between industries, while some countries have recently begun to offer special packages for investment in R&D and certain services.

#### **Box 1 – Fiscal vs. financial incentives**

**Fiscal incentives** or investment tax-advantages are a scheme that benefits every company that carries out investment in the national economy. This instrument reaches all investors independent of the sector, region, size or any other characteristics. It is particularly suitable in the early stage of (re-)industrialisation of an economy since the instrument of fiscal incentives encourages the formation of any fixed capital. In the course of time, when private investors have made their investment decisions (of course taking into account further site-related factors), not only fixed capital formation wins ground but also certain patterns of sectoral specialisations appear in the sense of comparative advantages. When this becomes visible, policy makers might want to support investments more specifically through a strategic combination of fiscal and financial incentives.

In general, the fiscal incentives reduce the corporate tax burden – depending on the investment sum. Once established, the handling of fiscal incentives is relatively easy since companies claim the support through the tax declaration.

**Financial incentives** or investment grant are a form of public government co-financing which the investor applies for – decision on a “case by case” procedure. This can be subject to certain requirements, such as jobs created, minimum investment sum, use of new technology, investment in a certain sector or a certain region. The idea behind is that policy makers can actively regulate industry or regional investment structures and structural change. Financial incentives bound to certain requirements are particularly suitable in a more advanced stage of (re-)industrialisation when certain patterns of sectoral specialisation and/or regional agglomeration become visible. In such stage, policy maker may want to foster certain promising industries and/or regions.

In CEE the evolution of tax rates and investment incentives can be separated in four periods (Cass 2007, OECD 2003, Sass 2003, UNCTAD 2002). In the first phase, in the early years of transition, some countries, for example Hungary, Poland and the Czech Republic, introduced

fiscal incentives. In 1989, Hungary was the first country to open up its economy to FDI and benefited from a first mover advantage. Both, Hungary and Poland offered considerable incentives to foreign investors. Although, in Poland incentives could for a long time not offset a negative investment environment due to a protracted transition recession. Hungary was also the first to involve foreigners in the privatisation process.

In the second phase, in the first half of the 1990s a number of countries (Czech Republic 1993, Estonia 1994, Lithuania 1996, Poland 1993, Slovenia 1994) eliminated or restructured incentives, in conjunction with reform of the tax system and, in some cases, reduction of tax rates. As a result after a brief period in the early nineties, the Czech Republic and Slovakia did not offer any investment incentives, and their mass privatisation practically excluded foreign investors.

In the third period, in the second half of the 1990s corporate tax rates continued to fall and a 'tax competition' developed mainly between the Czech Republic, Hungary, Poland and Slovakia. Hungary was the leader of the process with relatively low corporate tax rates from an early stage and generous fiscal incentives. In Hungary 'industrial custom free zones' also played a major role in attracting FDI in particular export oriented Greenfield projects. Poland's response gathered momentum from 1995, with a network of 'special economic zones' in which ten year tax holidays were available, and with incentives for investment in certain industries and regions. These measures triggered a similar response in the Czech Republic starting in 1997. This approach involved incentives including: tax holidays up to ten years for large new enterprises; tax exemptions for expansion of existing businesses; and job creation and training grants. In 1998, Slovakia was the last to enter the 'competition' introducing new and more generous tax holidays and further relaxing the qualifying rules for tax incentives in 1999 and in 2001. After 2000 the Czech Republic and Slovak Republic developed industrial and technology parks but their role has been rather limited. In the same period, Romania and Bulgaria introduced and repealed a series of incentives which created a rather inconsistent approach. The three Baltic States tended to rely more on low rates of corporate income tax than on investment incentives. Yet, Lithuania offered significant profit tax reductions for investments in duty free zones and Latvia also established special economic zones offering tax reductions.

In the fourth phase – the period since 2001 until EU accession – the level of incentives offered showed signs of stabilization and started to decline, however, this process was accompanied by rapidly falling corporate income tax rates. Investment incentives offered by countries joining the EU are required to comply with EU competition rules. For the four CEE countries but also Bulgaria and Romania, this has meant the curtailment of fiscal incentives, greater emphasis on financial incentives and other instruments improving the investment climate – all subject to overall limits on the total value of incentives offered. EU membership

may also have stimulated some levelling up in countries where incentives were relatively low: for example in Latvia. Thus, EU membership has restricted the incentives that some transition countries are able to offer. A recent further fall in corporate tax rates may herald a new phase in which fiscal and financial incentives may play a lesser role in FDI attraction in the region.

Table 9 – Overview of key corporate income tax, FDI incentives, and minimum investment size in selected transition economies

Type of incentive	Poland	Hungary	Czech Republic
Corporate income tax (CIT)*	19 per cent	16 per cent	24 per cent
Minimum investment size**	100.000 EUR	approx. EUR 20 million (or approx 12 million EUR in less developed regions)	approx. 7 Mio EUR, (or 5 million in less developed regions)
Regional incentives***	14 Special Economic Zones: - Reduction in income tax (50% of investment); - Exemption from real estate and transport tax and custom duty; - Financial grants for new investment (50%), employment, training	Higher tax benefits in less favoured regions, four different regions, (maximum intensity ration acc. to EU); Free trade zones offer exemption from custom duty	Higher tax benefits in less favoured regions in terms of regional unemployment
Sectoral incentives***	Allowances of up 25 % for firms with exports or new technologies;	Incentive package for manufacturing, R&D, and regional service centres, and tourism (min. 10 Mio EUR): Financial incentives (Direct aid, training subsidies) and development tax allowance	Specific manufacturing industry, Technology and business support centres (see below)
Industrial and technology parks***	Provision of real estate, technology, infrastructure (since 1995)	Provision of infrastructure, business services, assistance in supplier network	Financial grant (50% of investment or 2-year labour costs; up to 60% of training costs)
Linkages programmes***	n.a.	Subcontractor target programme since 1998/2001	Supplier development programme (1999)
IPA since	1993	1993	1992

\*as of 2005; \*\* as of 2003; \*\*\* as of 2007.

Source: compiled by authors.

If we take a look at the current situation in Poland, Hungary, and the Czech Republic we realise that all three countries offer very competitive corporate income taxes between 16 and



24 per cent (see Table 9). The minimum investment requirement is most restrictive in Hungary (20 Mio Euro) and least in Poland (100 000 Euro). All three countries offer a mixture of fiscal and financial incentives, differentiate incentives regionally and sectoral. Often less developed regions are able to offer higher benefits. There is also a sectoral preference including cross-cutting activities related to export, new technology, and R&D. All three countries offer industrial and technology parks as entry gates for investors.

## **5.2 Taxation and investment incentives in Azerbaijan**

The experience from CEE shows that government incentives were of secondary importance for attracting foreign investors into the region. The primary considerations were economic and institutional characteristics of the respective host countries (OECD 1995). However, if two or more locations are ranked equally in terms of economic and institutional aspects, government incentives may tip the balance (Sass 2003). Therefore, competition between countries for FDI increased also the pressure to offer competitive government incentives. However, we should keep in mind that from an economic point of view, FDI-incentives are only justified as long as their costs do not exceed the difference between social and private returns to investment (OECD 2005). Otherwise, firms engage into a ‘beggar-thy-neighbour’ policy, which makes all countries worse off. However, careful targeting of investment incentives can increase effectiveness and reduce inefficiency of government incentives.

### **5.2.1 Taxation**

Tax policy is of high relevance for FDI. Here, one has to distinguish between general differences in corporate tax rates among countries and preferential tax treatment of MNEs. It has been a central policy question in current international tax relations whether discriminatory tax reductions in favour of mobile MNEs are collectively desirable or self-defeating in a world where countries remain free to set capital tax rates and growing share of trade is carried out by MNEs. The current consensus in both the OECD and the EU seems to be that **tax discrimination in favour of mobile firms is both ‘unfair’ and ‘harmful’**. The EU has adopted a Code of Conduct for business taxation under which member states have committed themselves to phase out existing tax preferences that either discriminate in favour of non-residents, or are extended to firms with no real economic activity in the country (European Communities, 1998). Moreover, one of the main motivations behind initiatives to tax MNEs under some form of formula allocation, rather than the current separate accounting system is to reduce profit shifting activities. However, from a theoretical perspective, it is not obvious, that discriminatory tax policies are harmful in a world where national jurisdictions are free to choose corporate tax rates independently.

Corporate tax rates have been cut and withholding taxes on dividends reduced at a global scale over the last decades. Official statutory tax rates in the EU show a decreasing trend over the last 25 years and, in particular, over the past ten years. Effective tax rates have decreased

or remained stable depending on the measure used (forward-looking hypothetical investment or tax burden measures). In Europe a ‘core-periphery’ pattern has emerged with high official tax rates in the countries in the geographical centre of the EU-25 and low tax rates in the more peripheral countries. It seems that the core region is still charging a ‘tax premium’ of about 15% points (European Commission, 2006a).

Table 10 – Overview of CIT rates and investment incentives in CIS countries by 2005

Country	CIT in %	Tax holiday	Tax credits	Financial Grants	Subsidized location	Free Zones with tax reductions
<i>Azerbaijan</i>	<i>24*</i>					
Armenia	20	X				
Belarus	24**	X***				X
Georgia	20					
Kazakhstan	30	X	X		X	X
Kirgizstan	20					
Moldova	18	X				X
Russia	24		X			X
Tajikistan	30	X				X
Turkmenistan	20	X				X
Ukraine	25					X
Uzbekistan	15	X	X			X

\*Different rate applies in oil sector; \*\*Different rate applies for banks; \*\*\*only firms established before 2005.

Source: Cass (2007).

In 2002, the average corporate income tax in the OECD stood at 31.4 per cent in comparison to 23.6 per cent across transition economies in CEE countries. In 2005 the average corporate income tax across the CIS stood at 22.5 per cent. Azerbaijan stands with 24 per cent CIT above the CEE (2002) and CIS (2005) average. However, this rate is already reduced from the 30 per cent which apply to the oil-sector. In 2007, Azerbaijan lowered the CIT to **22 per cent in the non-oil-sector**. This decrease improved Azerbaijan’s competitiveness, however, it remains merely average in comparison to other transition economies. Given that the government budget is balanced and revenues linked to the oil-sector generate considerable future government income a further substantial cut of the CIT below 20 per cent should be recommended. This would send a strong signal to domestic and foreign investors alike with regard to investment opportunities in the non-oil-sector. There seems prima face no reason to reduce CIT in the oil-sector.

Although the CIT is widely recognized as the most important tax, from the point of view of prospective foreign investors, it is far from being the only tax consideration. Also withholding taxes on dividends, interest and royalties are an important factor for a substantial proportion of investors. Among other taxes, individual income tax and social security contributions are normally a minor consideration, except to the extent that they have an unusually large impact on labour costs. In contrast, import taxes and customs duties are often

important: high duties and taxes on the import of machinery and other capital goods increase the initial cost of investment and may constitute a disincentive to FDI.

UNCTAD (2005) recommends to countries wishing to promote the importation of technology via FDI to review their tax laws to see whether there are provisions that present special obstacles and that could be removed or at least reduced. They might also consider whether any of the regular provisions can be modified in order to provide special incentives to promote TOT. Special obstacles might take any of the following forms: excessive import duties, taxation of capital contributions, restrictions on deductions, high withholding taxes, excessive taxation of expatriate employees, and the absence of tax treaties.

### 5.3.2 Investment incentives

**Currently, Azerbaijan does not offer any type of investment incentive. This does not compare favourably with other CIS states** (see Table 10 above). This is particularly true given that the corporate income tax rate is not particularly attractive either. From a purely fiscal perspective, international investors would not prefer Azerbaijan over other location with equal economic and institutional parameters. In turn, if the government would like to stimulate domestic investment in order to achieve development in the non-oil-sector incentives seems advisable in order to reduce or compensate associated risk, insecurity, and coordination failures. Consequently, there is a need to develop a comprehensive strategy with regard to investment incentives in Azerbaijan.

In creating the investment incentives policy, the Azerbaijani policy makers need to tackle decisions about a number of issues including the type and level of incentives, conditions and performance requirements, and delivery of incentives. **Government should take a medium-term perspective on the development of incentive schemes.** During the first phase, Azerbaijan could start to offer mainly fiscal incentives including tax breaks, and tax credit. These are more easily administered and facilitate bold marketing through the investment promotion agency. At this stage Azerbaijan would offer an incentive regime that is comparable to most members in the CIS. In a second phase, Azerbaijan could develop more sophisticated instruments and move towards international best practice once administrative capacity has built up and the structure of FDI inflows becomes visible (regions, industries). At this stage simple fiscal incentives develop into behavioural instruments including a higher share of financial incentives, as well as industrial and technology parks. The government implements monitoring of grants and incentives with regard to delivery. In the absence of administrative capacity and transparency such sophisticated instruments could generate lengthy and bureaucratic procedures that deter domestic and foreign investment.

**During the first phase,** Azerbaijan would introduce fiscal incentives including tax breaks and tax credits. At this stage investment incentives are available on equal terms to all investors irrespective of industry and nationality of investor, rather than based on discretionary decisions. The motive for supporting foreign investors – including existing investors that may consider expanding their activities – is to equalise social and private returns to investment. The reason for subsidizing local firms is to strengthen their capacity to absorb foreign technology and skills. Thus, investment incentives are part of a broader development strategy and should not be determined only or predominantly with FDI related considerations. Foreign investors and foreign-owned firms enjoy the national treatment in respect to incentives. However, within the existing non-discriminatory schemes there is room for the introduction of incentives which might be particularly relevant to foreign investors including fiscal incentives related to technology transfer, innovation, and regional headquarters, etc..

**During the second phase,** Azerbaijan would change the scope and performance requirements of existing instruments as well as introduce new in particular financial incentives. At this stage incentives should not be anymore granted prior to the investment, but instead they should promote activities that create a potential for spillovers. In particular, these include education, training, R&D activities, new technology, exporting, and linkages between foreign and domestic firms. Thus, incentives would become increasingly linked to specific purposes and performance requirements. This would imply that incentives would be now allocated in a selective rather than automatic way. Within financial incentives the share of grants and subsidies should be reduced in favour of various repayable types of financial incentives. Government would also move towards developing technology and industrial parks that provide investor with particular public goods. Finally, the efficiency of incentives would need strict and frequent project-related monitoring and sanctions in the case of not fulfilling the expected results. An advantage of such behavioural, performance based incentives is that they may affect the entire stock of investments, rather than just the flow of new investment. Given their broad scope, the investment incentives in question should be considered part of the economy's innovation and growth policies rather than a policy area that is only of relevance for foreign investors. Thus, in addition to investment incentives, the Azerbaijani government should also continue efforts to modernise infrastructure, raise the level of education and labour skills, and improve the overall business climate as parts of their investment promotion policy.

## Recommendations (IV): Corporate taxation and investment incentives

It is important to remember that any **government incentive is only of secondary importance to (foreign) investors**. However, given that two or more countries do not differ in terms of economic and institutional aspects, government incentives may tip the balance. From this point of view, it seems **appropriate to compare the portfolio of taxation and investment incentives of Azerbaijan to other resource rich CIS economies**. In terms of investment **in the non-oil-sector other transition economies** can serve as reference, too.

### Corporate taxation

From this perspective, the **competitiveness of the Azerbaijani corporate income tax rate in the non-oil-sector is only average**. This is particularly true against the background that Azerbaijan does not offer any fiscal or financial incentives for investment in the non-oil-sector. Therefore, we recommend a further rate cut in the **corporate income tax below the 20 per cent threshold**. This would provide a bold signal to domestic and foreign investors alike.

### Investment Incentives

Currently, Azerbaijan does not offer any type of investment incentive. This does not compare favourably with other CIS states – let alone transition economies in CEE. This is particularly true given that the current corporate income tax regime is not especially attractive either. Therefore, we strongly recommend developing a **comprehensive approach to the introduction and design of investment incentives**.

We recommend a **two stage introduction of the investment incentives** in the non-oil-sector. During the **first stage**, the focus would be on fiscal incentives that can be easily administered and communicated, such as tax holidays, including tax breaks, and tax credits. The emphasis would be incentives of an ex ante type granted prior to the investment. In the **second stage**, one should introduce performance requirements to existing fiscal instruments and would move towards a higher share of financial incentives. Fiscal and financial incentives alike would be increasingly allocated in a selective rather than automatic way. Performance requirements should promote activities that create a potential for spillovers such as training, R&D, exporting, or linkages.

The design of investment incentives should follow a number of principles: First, investment incentives should not be determined only or predominantly with FDI related considerations. Second, Azerbaijan should uphold the principle of non-discrimination between foreign and domestic investors. Thus, incentives should be available on equal terms to all investors rather than based on discretionary decisions.

Finally, the government should keep in mind that incentives only work in combination with **efforts to modernise the infrastructure**, to raise the level of **education**, to upgrade skills and competences, and to improve the overall **business and institutional climate**.

## 5.4 Investment Promotion Agencies – Learning from CEE

### 5.4.1 Investment Promotion Agencies in CEE

The number of investment promotion agencies (IPAs) across CEE but also the CIS has grown steadily since the early 1990s. Most agencies undertake the main promotional tasks into which IPA activities are conventionally classified: investor services, image building, and investment generation. In particular, the Czech, Polish, Hungarian, and IPAs show relatively strong performance across all three functions (Cass 2007). **International best practice** suggests that there is a further strategic dimension to IPA activity with a clear strategy, sharply defined sectoral priorities and an active involvement in the negotiation of incentives with individual investors. However, only a few IPAs in transition economies indicate that the country has investment priority areas and only the Czech IPA actively shapes the process of priority development (see box 2).

#### Box 2 – The creation of CzechInvest

In November 1992, CzechInvest was founded on pressure from the Department of Trade and Industry. European Union financial support was vital for the agency's budget throughout the 1990s. Facing a hostile environment both within the government and among the general public the agency focused on changing the public's perception of FDI and winning government's trust and support. In order to create alliances CzechInvest used its steering committee that included representatives of other government institutions, the private sector, and banks appointed by the Minister for Trade and Industry. CzechInvest presented positive experiences from other countries and needed to demonstrate quick results. Thus, it focused on attracting Greenfield projects with high job creation potential mainly in automotive, electronics, and precision engineering, which were sectors perceived to be a traditional Czech strength.

In 1996, CzechInvest established the association of Foreign Investors (AFI) as an official representative body that linked to government as well as local service providers. AFI and CzechInvest initiated working groups on a number of issues including labour law, tax accounting, residency, real estate development. However, the efforts of CzechInvest had only limited success as the government refused to provide preferential treatment to foreign investors.

The turning point came in 1997 with mounting economic crisis, failing of many privatised domestic enterprises, and falling behind in terms of FDI inflows in comparison to other CEE countries in particular Hungary. The government reversed its position moving from 'national capitalism' with limited FDI inflows to 'foreign led economic development'. Consequently, government drafted a law that created competitive investment incentives in 1998. CzechInvest has been granted considerable independence and operates as a one-stop-shop.

The agency arranges and efficiently implements practically all the tasks relating to the investment, often pro-actively approaching investors, and their experiences appear to be utilised when rules are amended. Czechinvest has had also a major role in the introduction of two new incentive schemes in June 2002 focusing on framework programmes to promote strategic services and the foundation and expansion of technology centres.

Source: Sass (2003) and Drahokoupil (2009).

The promotion of linkages between MNEs and local firms is becoming integrated into the overall efforts of IPAs to attract FDI, as more attention is now being paid to ensure that sustainable development gains result from FDI. An effective business linkages programme is believed to be one of the fastest and most effective ways of upgrading domestic enterprises; facilitating the transfer of technology, knowledge and skills; improving business and management practices; and facilitating access to finance and markets. IPAs are ideally positioned to facilitate matchmaking between foreign affiliates and local SMEs, provided their mandate permits them to engage in this activity. The most common activity undertaken by IPAs in matchmaking is the organization of meetings, forums, workshops and plant visits.

### **Box 3 – Case study: IPA Support to Diamond Electric’s Linkages in Hungary**

Diamond Electric Hungary Kft. (DE Hungary) is a 100 per cent owned affiliate of Diamond Electric K.K. of Japan, a global manufacturer of electronic parts for the automotive industry. Its main product lines are ignition coils, transmission switches and variable reluctance sensors. In September 2000, DE Japan opened its first European factory in Esztergom Industrial Park, Hungary, and requested the Hungarian Investment and Trade Development Agency (ITDH) to assist in identifying suitable local SME suppliers.

Based on its knowledge of competitive local firms, ITDH staff helped to locate a number of local SMEs as potential partners of DE Hungary. In the end, 10 out of 119 local SMEs were selected to provide inputs to DE Hungary’s manufacturing operations. Using local suppliers resulted in a net cost reduction of 15 per cent compared to the products previously imported from Japan.

The efforts of DE Hungary to reach out to local partners may be influenced, at least in part, by the policies of the automobile manufacturer it supplies. DE Hungary is currently supplying electronic parts to Suzuki’s plant in Hungary, which actively encourages the use of parts and components from local primary and secondary suppliers. DE Hungary plans in the near future to supply Daimler-Benz and other car factories in Europe.

Source: UNCTAD 2006 based on information provided by ITDH Hungary.

An important component of any effective IPA business linkages programme is the ability to collect and provide accurate information on linkage opportunities to investors. The provision of resources and advice to local SMEs to help them upgrade their capabilities and become effective partners of foreign affiliates, forms the third pillar of IPA activities in supporting the formation of business linkages.

#### **Box 4 – The supplier development programme at Czech Invest**

In 1999, the supplier development programme of CzechInvest was launched. Like many IPA business linkages programmes, it aims at increasing the number of domestic subcontractors for foreign-affiliate manufacturers and other direct investors.

Within the framework of this EU funded programme, a database of over 900 potential Czech subcontractors has been put on the Internet. CzechInvest also mediates contacts between foreign investors and Czech suppliers, and selected subcontractors are provided with active counseling aimed at increasing production quality. As part of this programme, Czech manufacturing companies are offered as potential partners for the creation of joint ventures with foreign manufacturers.

The programme has been able to establish linkages between local suppliers and foreign-affiliate manufacturers in the Czech Republic, building a relationship with existing inward investors, especially major transnational corporations. Participating MNEs include: ABB, Aisin, Bosch, Daikin, Denso, Evo-Bus, Ford, Matsushita Pardubice, Mitsubishi, Sanden, Schneider Electric, Siemens, Toyota, TRW Autoelektronika.

Source: UNCTAD 2006 based on information provided by CzechInvest.

The majority of IPAs across transition countries also engage in ‘policy advocacy’ i.e. activities to improve the general investment climate. A number of IPAs in CEE and the CIS have tasks other than investment promotion, including export promotion and local business development. Many of these responsibilities evolved from mergers between IPAs and other agencies. Whether they contribute to the effectiveness of the agencies’ investment promotion role is open to question. The wide divergence in the role and effectiveness of IPAs has policy implications, including whether limited resources are being spread over a wider range of tasks; whether it is desirable to undertake tasks additionally to investment promotion; and whether some agencies are positioned in such a way as to make an appropriate and effective input to official policy in relation to FDI.



#### 5.4.2 Investment promotion in Azerbaijan

Most agencies undertake the main promotional tasks into which IPA activities are conventionally classified: investment generation, investor services and image building. Let us discuss each of the respective areas in turn below:

##### *Investment generation*

Investment generation constitutes the core business of the Azerbaijan IPA (AzPromo). In order to think strategically about investment promotion AzPromo should continue its efforts to structure its activities along sectoral priorities in line with Azerbaijan's competitive advantages. From this point of view, resources seeking investment in the oil-sector is going to remain the most important source for investment in Azerbaijan for the foreseeable future. However, building on this the **promotion of investment in related upstream and downstream non-oil-sectors** is absolutely promising. The IPA should engage into a **consultation process with the oil-industry** in order to identify (i) possible industries in manufacturing and services where such activity seems feasible; (ii) potential foreign investors in respective areas; and (iii) various host country requirements for such investment to happen. At the same time, government, AzPromo and AIC should themselves identify industries related to oil where Azerbaijan could potentially offer existing capabilities.

Given the considerable catch-up growth and poverty reduction, Azerbaijan becomes increasingly attractive as a location for market seeking FDI in the non-oil-sector. Again, the **AIC should identify possible growing domestic markets** (such as food and beverages, electronics, white goods etc.) that could be attractive to foreign investors. In addition, strategic sectors such as telecommunication, banking, infrastructure, and energy might offer excellent investment opportunities. However, here the AIC should form an **alliance with the government in order to create a suitable competition policy framework** that regulates foreign entry in such strategic markets that promise monopoly rents.

The prospect for efficiency seeking investment i.e. export oriented and technological asset seeking FDI is limited due to the currency appreciation and fairly low R&D expenditures. However, once investment in upstream/downstream industries to the oil-sector as well as in domestic industries with growing demand have materialised, it might actually be feasible to stimulate exporting, which might in some instances even give rise to selected regional headquarters.

The majority of IPAs across transition countries also engage in '**policy advocacy**' i.e. activities to improve the general investment climate. This might in the case of Azerbaijan also require **changing the public's perception of FDI and winning government's trust and support** with respect to foreign participation in the economic development of the non-oil-sector. Following the case of CzechInvest, one could therefore create a **steering**

**committee** of the IPA that includes representatives of other government institutions, the private sector, banks, as well as international institutions. Similarly, it might be worthwhile to think about establishing an **association of foreign investors** that serves as an official representative body linking government as well as local service providers on issue such as labour law, tax accounting, residency, real estate development. Certainly high **up on the agenda should be the design of corporate taxation and investment incentives**, which need to be put in place. Finally, the AIC should present positive experiences from other transition countries and should focus on attracting some key investment projects with high impact potential.

#### Investor services

**One-stop-shop** has been successfully introduced to minimize the bureaucratic procedures for private investors. Efforts should be continued, for example by offering a **business linkage programme**. Given that resources seeking investment in the oil-sector is going to remain the most important source for investment in Azerbaijan for the foreseeable future, there is a potential for investment promotion in related upstream and downstream non-oil-sectors (manufacturing as well as services). Part of such an investment strategy could be the **development of a business linkages programme to foster linkages between foreign investors in the oil-industry and domestic firms in upstream/downstream non-oil industries**. AIC would need a mandate to develop a strategy with at least three components: **matchmaking and networking; provision of information to both foreign and domestic firms; technological partnership and SME upgrading support**. IPAs often do not have enough resources to sustain an effective business linkages programme alone. Therefore, the implementation of the linkage programme would require involvement of partner institutions, including other government agencies; local development agencies, private institutions such as chambers of commerce, business associations, non-governmental organizations (NGOs), media institutions, universities, technological institutes, research and development centres, etc. It is also important to **assess the contribution of business linkages** to the process of economic development in Azerbaijan. In particular, employment gains, human capital and know-how spillovers, SME turnover, technology transfer, access to finance and access to new markets are important criteria of such an assessment of the efficiency of the business linkages programme. Once the programme is up and running it is possible to extent the business linkage programme to other industries in the non-oil-sectors with FDI penetration.

#### Image building and marketing

Public investment in **professional marketing of Azerbaijan as a place for industrial investment is very important**. The image of the country as a serious place for foreign direct investment outside the oil-sector needs to be further developed. Professional marketing is urgently needed – “selling” Azerbaijan as a location for industrial investment – first mover

advantages in a region with growing purchasing power. The marketing strategy should build on the competitive advantages of Azerbaijan that have been identified as potentially attractive to foreign investors. There should be reference to resource, market, and efficiency seeking motives foreign investors. Furthermore, there should be reference to recent progress in improving the business climate and a transparent treatment of the corruption issue. Once corporate taxation has been reformed and investment incentives been introduced, they should become an integral part of the marketing strategy of the IPA.

The full set of professional marketing tools must be exploited in order to implement a coordinated communication strategy. Instruments for implementing the communication strategy could include the AIC participation in international fairs; targeting foreign business associations; close ties with major international consultancies; organising local business journeys for potential investors; fully fledged modern web presentation of AIC, its services, and investment opportunities as well as endorsements of existing investors in favour of the location; and a regular newsletter with electronic newsletter for potential investors.

#### **Recommendation (IV): Activities by the Investment Promotion Agency**

##### Investment generation

In order to promote investment in upstream and downstream industries to the oil sectors the AIC should engage in a **consultation process with the oil-industry and other stakeholders** in order to identify possible industries, potential foreign investors, and various host country requirements.

With regard to market seeking FDI **AzPromo/AIC should identify possible growing domestic target markets and strategic sectors** that offer investment opportunities. With regard to the latter, the AIC should form an alliance with the government in order to create a suitable competition policy framework that regulates foreign entry.

The creation of an **AzPromo/AIC advisory board** as well as an **association of (foreign) investors** could leverage support by forming an alliance of stakeholders. This might prove to be a useful tool to change the public's perception of FDI and winning government's trust and support with respect to foreign participation in the economic development of the non-oil-sector.

In terms of **policy advocacy of AzPromo/AIC**, corporate taxation as well as the design and introduction of investment incentives should be high up on the agenda.

##### Investor services

One aspect in support of development of investment in the non-oil-sector would be the development of a **business linkages programme** to foster linkages between foreign investors in the oil-industry and domestic firms in upstream/downstream non-oil-industries. Matchmaking and networking provision of information; technological partnership and SME upgrading support would form an integral part of AIC mandate.

##### Image building and marketing

In terms of **image building and marketing** AIC should develop an overarching communication and marketing strategy building on the country's competitive advantages, economic motives for investment, legal and institutional factors, as well as taxation and investment incentives.

## 6. A comprehensive approach to investment policy in Azerbaijan

So far, we have dealt with several pieces of an investment policy for Azerbaijan, i.e. analysis of possible investment motives against the background of the macroeconomic situation in Azerbaijan; business climate in Azerbaijan; current legal and institutional investment regime; possible incentive schemes for Azerbaijan against the experiences in Central and East European countries; and also investment promotion (marketing) aspects. This final chapter will summarize and provide recommendations for a comprehensive investment policy.

Azerbaijan and how it can constantly be further developed (e.g. through regular meetings of “advisory council”).

### Recommendation (V): Investment Policy

#### General

In order to reduce the dependence of Azerbaijan from the oil-sector and oil-price fluctuations, there is a strong need to diversify the economy through investments in the **non-oil-sector** in a mid- and long-term perspective.

The (re-)industrialization of the non-oil-sector requires a comprehensive **investment policy** considering domestic as well as foreign capital.

One strategically important piece of the investment policy should be the exploitation of advantages coming along with **foreign direct investment**, esp. technology transfer and integration into the world economy.

An investment policy should be seen as **support for investment**. One should make clear that it cannot outweigh fundamentally given site-related factors, such as market size, socio-cultural aspects, geo-political location etc. At the end, single means of an investment policy, such as incentives, corporate tax level, investor services etc. are of secondary importance.

#### Legal and institutional setting

Progress and improvements in **business climate** should be actively utilized as an argument for (foreign) investment in Azerbaijan. Yet, the reduction of corruption remains an important task.

The new **investment law** (draft) – addressing domestic and foreign investors equally and preparing the ground for incentive schemes – should be quickly passed.

Bi- and multi-lateral **investment treaties** as well as **co-operation with international organisations** should be continued as an integral part of investment policy including a signalling function for (foreign) investors.

Legal framework conditions for **regional and international trade** should be further developed. Otherwise, the scope for market seeking (foreign) investment is extremely limited. WTO accession will be an important step forward.

#### Incentive schemes

In the global and highly competitive **race for international investment**, and in the face of what other countries in the region offer to (foreign) investors, Azerbaijan cannot expect substantial investment in the non-oil-sector without incentive schemes.

General corporate taxation as well as fiscal and financial incentives – for domestic as well as foreign investors – should be paid attention in the design of an investment policy:

So far, **corporate income tax** (CIT) in Azerbaijan is only average as compared to other countries in the region. In order to increase the attractiveness of Azerbaijan, we recommend a further cut of CIT below the 20% threshold.

Furthermore, in a first stage, we recommend the introduction of **fiscal incentives** for any investor in the non-oil-sector. This can be temporary tax holidays or tax reduction depending on the investment sum (via tax declaration). This instrument is intended to facilitate overall (re-)industrialization. In a second stage, esp. when sectoral specialization appears, direct **financial incentives** should be introduced, bound to selected requirements, such as sector or region.

#### Investment promotion

Professional **investment promotion** including an active commercialisation and image building in favour of the Azerbaijan economy should be continued and intensified building on the country's competitive advantages, economic motives for investment, legal and institutional factors, as well as taxation and investment incentives.

Existing international investors should be used and demonstrated as **reference projects**.

At a certain stage of development in the non-oil-sector, investor services should also include **a business linkage** program in order to foster technological spillovers between foreign and domestic firms.

#### Complementary activities – beyond investment policy

The final design and practical details of the investment policy could strongly benefit from **periodic consultations** between the different parties involved, such as policy makers, industry representatives, IPA etc. – this “**advisory board**” could be co-ordinated at the president's office. Such an institution also plays an important role for the constant development of an investment policy (e.g. shift from fiscal to financial incentives).

Finally, the government should keep in mind that incentives only work in combination with **efforts to modernise the infrastructure**, to raise the level of **education** in order to upgrade skills and competences, and to provide a functioning **competition policy**.

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