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INVESTMENT PROMOTION POLICY: HOW TO IMPROVE IT?

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ANNOTATION

This policy paper has analysed the investment processes in the economy of Azerbaijan until 2014 and investment policy of the government. Moreover, the paper also evaluates the decisions of and the implemented measures on the transition to investment based growth model by the government in the context of declining oil-gas revenue since 2015 and provides recommendations on improving government policy in promoting private investment.

ABBREVATIONS

SOFAZ –	State Oil Fund of Azerbaijan Republic
ACG –	Azeri-Chirag-Guneshli
CA –	Current Account
SIP –	State Investment Program
SCC –	State Customs Committee
SSC –	State Statistics Committee
PSA –	Production Sharing Agreement
FMSA –	Financial Markets Supervision Agency
GDP –	Gross Domestic Product
SOCAR –	State Oil Company of Azerbaijan Republic

CONTENTS

INTRODUCTION

In the first decade of independence, the main target of the government of Azerbaijan was the attraction of foreign investment at all costs in order to ensure economic revival through investment activity in the context of negative economic outlook characteristic to the period. The main challenge facing the government was this: *where to find this investment?* At the time, the main restriction on the ability to attract foreign investment was the threats to the independence of the country. Accordingly, the government focused on the sector of the economy that had the biggest appeal for foreign investors, namely the oil and gas sector, and succeeded to attract large-scale foreign investment in short time.

On the other hand, in the decade of "oil boom" (namely, the period of 2005-2014) the government of Azerbaijan did not experience "investment shortage". Massive budget revenues allowed the government to rapidly and significantly increase both the current and capital expenditures: the burden of investment activity was mainly born by the government. The main challenge of the government in this period was this: *where to direct investment?*

The reduction of dependence on resource revenues was adopted as one of the top policy priorities and the government announced the strategy of non-oil sector development, diversification of economy and exports. However, the backbone of these reform efforts was oil and gas revenues. The fall of country's oil and gas revenues beginning from 2015 has shaped a new conjecture in the economy related to the need for new sources of economic growth and sustaining investment activity: the model of economic growth driven by large-scale public resources has been exhausted and the center of gravity of economic activity should fall upon the private sector (private investment). It is necessary to attract investment from both domestic and foreign sources to attain sustainable economic growth. Main challenges of the government in this new stage of economic development are these: *how to enhance the investment potential of the economy? How to attract investment? How to use the existing resources more efficiently?*

The government should implement a completely new investment strategy for the promotion of domestic and foreign investment. The government have made a number of important policy decision since the end of 2015 related to improvement of business environment, development of non-oil sector and promotion of non-oil exports. This policy paper has evaluated the latest policy decisions and measures of the government in terms of their ability to attain private-based investment activity and to identify and promote new sources of sustainable economic growth, and we also designed a number of recommendations for improvement of the investment promotion strategy.

1. NECESSITY OF TRANSITION TO INVESTMENT-BASED GROWTH MODEL

Azerbaijani economy, which experienced a deep recession in the first years of independence and which began its way toward economic revival via economic reforms beginning in the mid-90s, has transformed into economic phase known as "economic growth through oil income boom" in the beginning of 2000s, due to increased oil production in the aftermath of "Azeri-Chirag-Guneshli" HPBS contract[1], the first oil contract of the country. Significant rise in the production and export of oil combined with favourable conjecture of global oil market (high oil prices) in 2005-2014 period has earned Azerbaijan massive oil income and resulted in rapid economic growth.

[1]Competitive regional clusters. OECD Reviews of Regional Innovation. http://artnet.unescap.org/tid/artnet/mtg/gmscb_regionalclusters.pdf

Rapid fall in oil prices in the second half of 2014 and throughout 2015[2] resulted in a dramatic reduction of oil and gas revenues of Azerbaijan: income of SOFAZ in 2014 was equal to USD 16.2 bln, while it decreased to USD 7.7 bln in 2015 (a decrease by 2.1 times) and further to USD 3.0 bln in 2016 (a decrease by 5.4 times relative to 2014)[3]. There were several negative consequences of such a rapid fall in oil prices: i) financial stability was disturbed and domestic currency (AZN) was devalued[4], currency reserves of the country fell dramatically[5]; ii) dollarization of the economy accelerated; iii) discount rate of the Central Bank and interest rates in the loan market rose significantly; iv) banking sector faced serious debt problems and several banks filed for bankruptcy[6]; v) public expenditures, especially public intertreatment were reduced[7] etc.

All of these factors led to a dramatic fall in the growth rate of the economy: for the first time since 2000, GDP growth fell below zero (-3.1%) in 2016 (see *figure 1*). Economic growth rates in Azerbaijan have always exceeded 10% in 2000-2009 period. In the years of large real growth (2005, 2006 and 2007) expansion was due to rapid oil sector growth. While the real GDP growth rates have fallen since 2010 with gradual decrease in the oil production.

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[2]The average annual export price of Azerbaijani oil ("Azeri-Light") was 111.1 USD p.b. in 2013, 100.9 USD p.b. in 2014, while it fell to 51.0 USD p.b. in 2015 and to 45.1 USD p.b. in 2016.

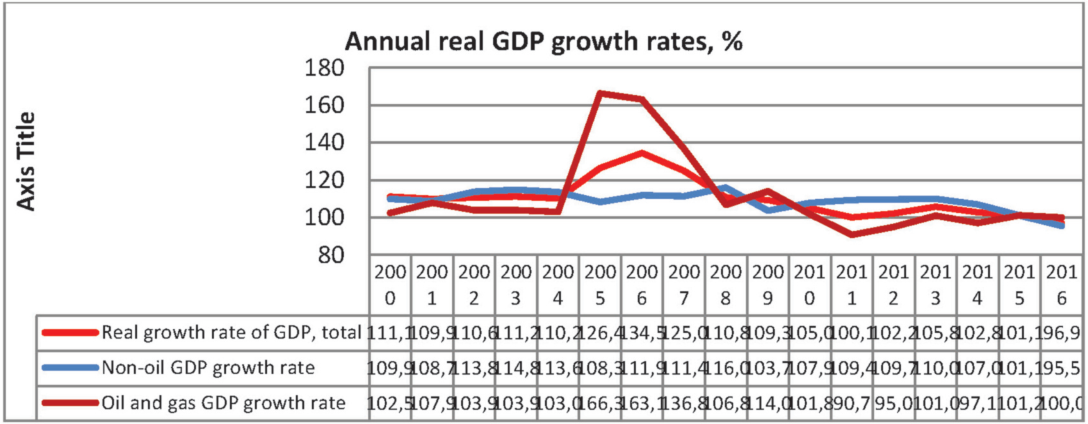
[3]http://oilfund.az/

[4]Central Bank was forced to devalue AZN twice in 2015 (once at the beginning and once at the end of the year) and AZN saw its value against USD to drop by nearly twice (from 0.78 to 1.55), while in 2016 it fell further to 1.80.

[5]Central Bank currency reserves were equal to USD 15.2 bln in July, 2014 which fell to USD 4.0 bln in 2016. Furthermore, SOFAZ reserves also decreased by USD 3.5 bln during 2015.

[6]The number of commerical banks in the country decreased from 45 in the first half of 2015 to 32 at the end of 2016.

[7]Investment expenditures in 2016 budget were equal to AZN 2.7 bln, which is 2.5 times lower than its 2013 level.



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Real growth rate of GDP, total	111,1	109,9	110,6	111,2	110,2	126,4	134,5	125,0	110,8	109,3	105,0	100,1	102,2	105,8	102,8	101,1	96,9
Non-oil GDP growth rate	109,9	108,7	113,8	114,8	113,6	108,3	111,9	111,4	116,0	103,7	107,9	109,4	109,7	110,0	107,0	101,1	95,5
Oil and gas GDP growth rate	102,5	107,9	103,9	103,9	103,0	166,3	163,1	136,8	106,8	114,0	101,8	90,7	95,0	101,0	97,1	101,2	100,[illegible]

Figure 1: Annual real GDP growth rates, % (Source: State Statistics Committee)

Unlike oil and gas sector, non-oil sector growth rate curve of 2000-2014 years is relatively stable (with the exception of 2008 and 2009, it is around 10%). Steady growth in the non-oil sector can be the result of public investment of oil income in the economy (this hypothesis is confirmed by our analysis in the second part of this paper). The fall in oil income (and associated fall in public spending) led to a fall in non-oil GDP growth rates, which fell below zero in 2016: -4.5%.

The sharp fall in oil and gas revenues made it inevitable for the government to abandon its growth policy based on resource revenues. "Strategic Roadmap for the National Economy of the Republic of Azerbaijan" signed on December the 6th, 2016 by the President of the Republic of Azerbaijan states that: "The fall in the energy prices in the global commodity markets since the end of 2014 was accompanied by sharp decline in foreign currency denominated income of Azerbaijan, which has restricted the ability to resume financing economic growth model of the last 10 years. Fall in oil prices further underlined the necessity of transformation to a new economic growth approach[8]".

Major structural sources of economic growth according to economic literature[9] are considered production factors (especially natural resources), investment and innovation. Current situation of innovation infrastructure in the country, education system and generally the development level of the "human capital" makes the transition to innovation-based growth model impossible in the short run[10]. Thus, the source of economic growth at the current stage of economic development can be private investment.

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[8]http://www.e-qanun.az/framework/34254

[9]For example: Портер М.Е. Международная конкуренция. Москва: «Дело», 1993

[10]See: Azerbaijan - Country economic memorandum : a new silk road - export-led diversification, World Bank, 2009 (Report No. 44365-AZ)

The government of Azerbaijan have long since announced the policy of economic and export diversification with an aim of reducing the dependence of the economy on oil sector[11]. This requires large amount of domestic and foreing investment to non-oil sector. Government have targeted to increase the share of foreign direct investment (FDI) to non-oil sector in GDP to 4% by 2025 (this indicator was equal to 2.6% in 2015) [12].

Large number of policy decisions have been approved and measures have been taken related to improvement of business and investment environment, promotion of investment, promotion of domestic production, protection of domestic markets, promotion of non-oil exports since 2015. The importance of such measures and decisions like easing of licensing conditions, temporary suspension of examinations of enterprises for two years, subsidization of a number of agricultural products, implementation of concessions promoting investment and exports should be mentioned here.

Implementation of "investment promotion document"[13] is worthy of mention when discussing the promotion of investment activities. Legal persons and entrepreneurs with investment promotion document receive exemptions on all kinds of taxes and import tariffs for 7 years from the date they obtain the document. The establishment of export promotion payments from the state budget to exporters of non-oil products is among the decisions promoting investment into non-oil sector[14]. Entrepreneurs receive payments equal to between 3 to 6% of customs value of their exports (exact amount is determined by the list of products eligible for the export promotion[15]).

[11]"Azerbaijan 2020: Look into the future" Development Concept (approved by Presidential decree No. 800, dated 29.12.2012)
[12]Strategic Roadmap on national economy of the Republic of Azerbaijan, pg. 54
[13]http://e-qanun.az/framework/31870
[14]http://www.president.az/articles/17948
[15]http://cabmin.gov.az/?/az/pressreliz/view/2071/

Strategic Roadmap for National Economy states that the establishment of the right incentive framework might help to attract investment to economy (especially, foreign investment). Nevertheless, it is also noted that "such instruments targeted at economic development are already being implemented in Azerbaijan. Incentives will be continuously reviewed and renewed".[16]

Thus, our main research questions are these:

I. Are policy decisions and measures of the last two years (2015 and 2016) sufficient to improve investment environment and to attract domestic (private) and foreign investment to non-oil sector?
II. What other policy changes should the government adopt to stimulate both domestic private and foreign investment to non-oil sector?

2. INVESTMENT ACTIVITY IN AZERBAIJAN: TENDENCIES AND CHALLENGES

According to SSC calculations, the amount of total investment to the economy of Azerbaijan in the period of 2000-2014 was equal to AZN 158.6 bln (approximately USD 193 bln), of which AZN 75.7 bln (approximately AZN 90.6 bln) or 39.2% was foreign investment, while AZN 82.9 bln (approximately USD 102.4 bln) or 60.8% was domestic investment (to compare: total investment in 2000-2016 period was equal to AZN 201.5 bln, 51.1% of which was foreign, 48.9% domestic investment)[17].

Both domestic and foreign investment to the economy grew every year in the period of 2000-2013 (with the exception of 2009) (figure 2).

[16] http://www.e-qanun.az/framework/34254
[17] http://www.stat.gov.az/source/finance/

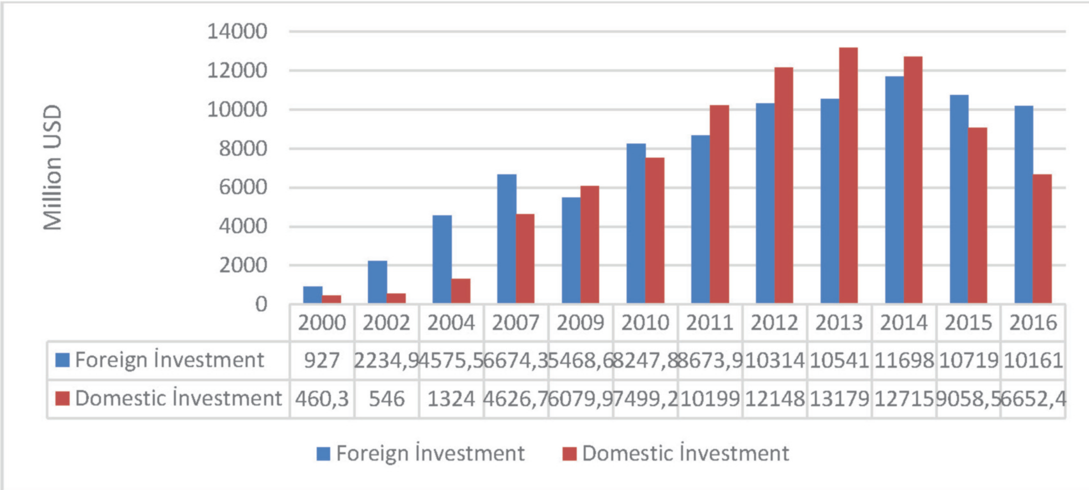

Figure 2. Dynamics of foreign (in USD) and domestic (in AZN) investment in Azerbaijan economy (source: SSC)

Both foreign and domestic investment have decreased in the period of 2014-2016. There has been a bigger decrease in the volume of domestic investment: domestic investment in 2016 have decreased by 50% compared to 2013.

Structure of capital investment based on economic activities. Calculations based on SSC data reveal that, AZN 167 bln (82.9%) out of total 201.5 bln investment in the period of 2000-2016 was capital investment[18]. Three main priorities of capital investment in the period were oil and gas industry, transportation and construction.

Capital investment to non-oil sector in the period of 2000-2014 have steadily increased: capital investment to this sector in 2003 was equal to AZN 1.0 bln, while in 2013 this figure was 12.8 bln, more than 12-fold increase (*figure 3*).

To compare: non-oil GDP has increased from AZN 4.4 bln to 30.5 bln in the same period, 6.9-fold increase.

Investment in non-oil sector[19] have continuously exceeded investment in oil and gas sector in the period of 2007-2014. The former exceeded the latter by 2-3 times between 2008 and 2014. Capital investment in the oil sector have continued to gradually rise in the past 3 years (2014-2016), while capital investment in the non-oil sector have fallen: 54.8% of all capital investment in 2016 were in the oil sector[20].

The share of non-oil sector investment in non-oil GDP was equal to 36.2% in 2010, 41.8% in 2013 and 25.6% in 2015.

Foreign investment. As was mentioned above, total foreign investment in our economy in the period of 2000-2016 was equal to USD 111.5 bln, which constituted 51.1% of total investment in this period. The large proportion of the foreign investment was in oil sector

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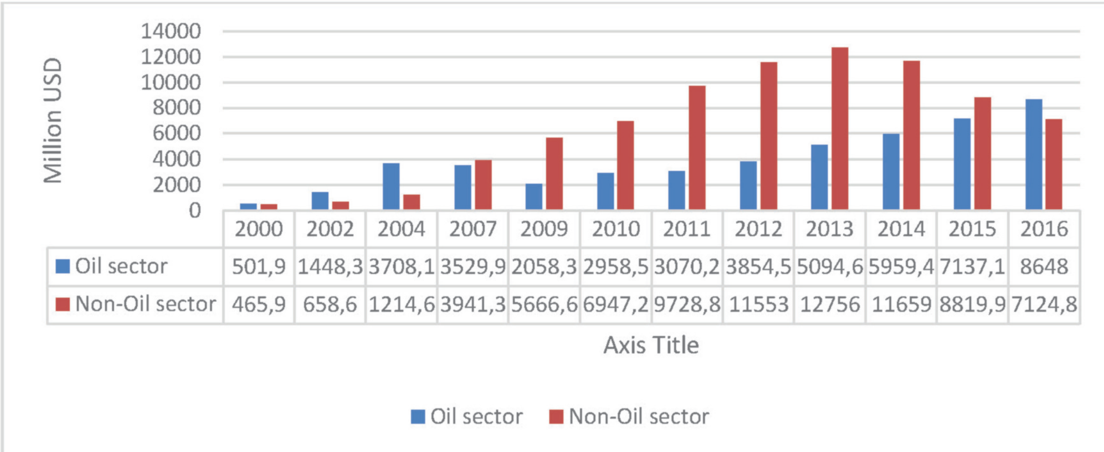
[18]Calculated based on SSC data (http://www.stat.gov.az/menu/13/?lang=en).

[19]We should note that, when differentiating the investment in non-oil and oil sectors, SSC and IMF use different methodologies: a number of activities that IMF lists in oil sector are considered part of non-oil sector at SSC.

[20]Note: here we should take into consideration the change in the USD/AZN exchange rate.r



	2000	2002	2004	2007	2009	2010	2011	2012	2013	2014	2015	2016
Oil sector	501,9	1448,3	3708,1	3529,9	2058,3	2958,5	3070,2	3854,5	5094,6	5959,4	7137,1	8648
Non-Oil sector	465,9	658,6	1214,6	3941,3	5666,6	6947,2	9728,8	11553	12756	11659	8819,9	7124,8

Figure 3. Dynamics of capital investment in oil-gas and non-oil sectors in Azerbaijan, mln AZN. (source: SSC)

(for example, 58.9% in 2000, 77.7% in 2005, 35.8% in 2010,

Another major direction of foreign investment in this period was financial sector (public borrowing from international financial institutions, foreign funds attracted by banks etc.): 262.9 mln in 2000 (28.4% of total foreign investment), 2.4 bln in 2010 (41.3%) and 1.9 bln in 2014 (16.1%).

The share of foreign investment in the economy in the form of investment in joint or foreign enterprises in total foreign investment was equal to 4.7% in 2005, 8.0% in 2010, 11.3% in 2014, 16.8% in 2016. The amount of such direct investment is on the rise in recent years: while it was USD 230.5 mln in 2005 and 659.6 mln in 2010, it reached 1.3 bln in 2014 and 1.7 bln in 2016. On the other hand, there is significant volatility in the amount of such investment: it decreased by 35% in 2015, but increased by nearly 100% in 2016.

Overall, USD 61.9 bln (or 55.5%) of total foreign investment in the economy in 2000-2016 period was in oil and gas sector. USD 27.4 bln, or 24.6% of foreign investment was financial loans, 10.1 bln, or 9.1% in joint or foreign enterprises, remaining 12 bln, or 10.8% in other directions (bonuses, portfolio investment etc.).

Structure of foreign investment based on economic activities. The largest part of foreign investment is directed to mining industry. Apart from that, transportation and electro energy sectors are among the priorities of foreign investors. There has been an increase in the investor interest toward construction sector since 2010: the share of construction in foreign investment was equal to 2.5% in 2010, 4.0% in 2013, 6.1% in 2014, 9.2% in 2015.

Manufacturing sector enterprises haven't been among priority investment directions of foreign investors: only AZN 319 mln of 86.7 bln foreign investment (or 0.4%) have been in manufacturing sector in the period of 2000-2015. 301 mln of this amount were invested before 2009. There has been almost no interest in manufacturing sector among foreign investors since 2010 (*figure 4*).

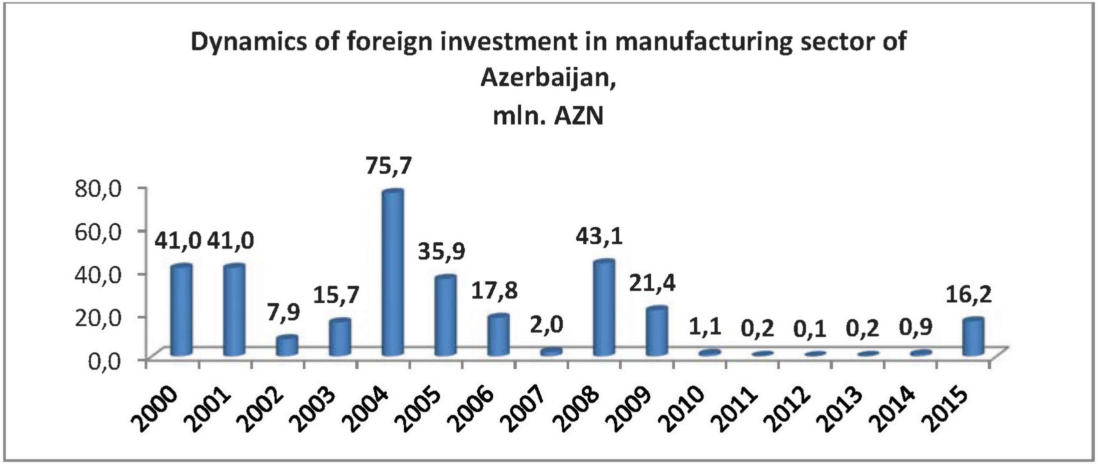


Figure 4. Dynamics of foreign investment in manufacturing sector of Azerbaijan, mln. AZN (source: SSC)

As we can see from the figure, investors have not been interested in the production of tradable goods in Azerbaijani economy.

Domestic investment. Domestic capital investment in the period of 2000-2015 was equal to AZN 91.9 bln, 63 bln (68.6%) of which was from public sources, while remaining 28.9 bln (31.4%) from non-public investors.

Between 2000 and 2003 both public and private investment was small in volume and roughly equal. Public investment started to increase sharply beginning from 2005: public investment has increased twice every year from 2005 to 2007, while in 2008 it rose by 60%. As a result, public investment in 2008 (AZN 5.7 bln) was 14 times higher than its 2004 level. Public investment constituted 70% of total domestic investment in the period of 2007-2013.

The highest amount of public investment in the reviewed period was recorded in 2013 – AZN 10 bln. The share of public investment in capital investment that year was 76.3%. Public investment was equal to 16.9% of GDP and 30.1% of non-oil GDP in 2013 (we should note that, the share of public investment in GDP is around 3-5% for European countries). Public investment has significantly decreased in the following years: public investment in 2015 was two times lower its 2013 level (AZN 5 bln).

Besides investment financed by the state budget, public investment also includes investment by off-budget state funds (for example, SOFAZ etc.) and state owned enterprises. However, major part of capital investment came from state budget and SOFAZ.

Projects that are to be funded by the state budget or SOFAZ are included in Public Investment Program (PIP) and are financed within this program framework. Design and implementation procedures of PIP are regulated by "Rules of design, implementation, monitoring and evaluation of Public Investment Program of the Republic of Azerbaijan", which was approved by Presidential Decree No 239, dated 17.03.2010. According to this decree, the Cabinet of Ministers was assigned to prepare and approve the guideline relating to evaluation and examination of public investment projects within 2 months[21]. However, no such guideline has yet been approved by the Cabinet of Ministers. Although Ministry of Economy has prepared the project of this guideline, this guideline doesn't include points relating to project evaluation[22]. Therefore, although public investment projects capture billions of manats every year, there is still no effective mechanism to evaluate those projects.

State-owned enterprises, especially State Oil Company (SOCAR) finance sizable portion of public capital investment.

Our research reveals that, huge sums from state budget have been allocated for all large state-owned enterprises (SOCAR, "Azerenerji" JSC, "Azerbaijan Airlines" CJSC, "Caspian Shipping" CJSC, "Azerbaijan Railroads" CJSC, "Azersu" JSC and others) to refund their capital, improve their material-technical base and organize their activities[23] (also these enterprises borrowed with state guarantee). Measures to improve the efficiency of their operations, to modernize their management, to implement corporate governance practices, to adopt international reporting standards have not been adequate. As a result, despite large state support used to improve their material-technical base, transfers from these state-owned enterprises to state budget in 2010-2014 period haven't increased substantially and, in case of some (for example, "Azerbaijan Airlines", "Caspian Shipping Company", "Azerbaijan Railroads" etc.), have actually decreased relative to previous period.

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[21] http://e-qanun.az/framework/19404

[22] Annual report of Chamber of Accounts for 2015. Baku, 2017. p.91 http://sai.gov.az

[23] Our analysis of state budget have revealed that the state have invested USD1.8 bln in SOCAR in the period of 2005-2015. We have calculated similar figures for other large state-owned enterprises as well. r

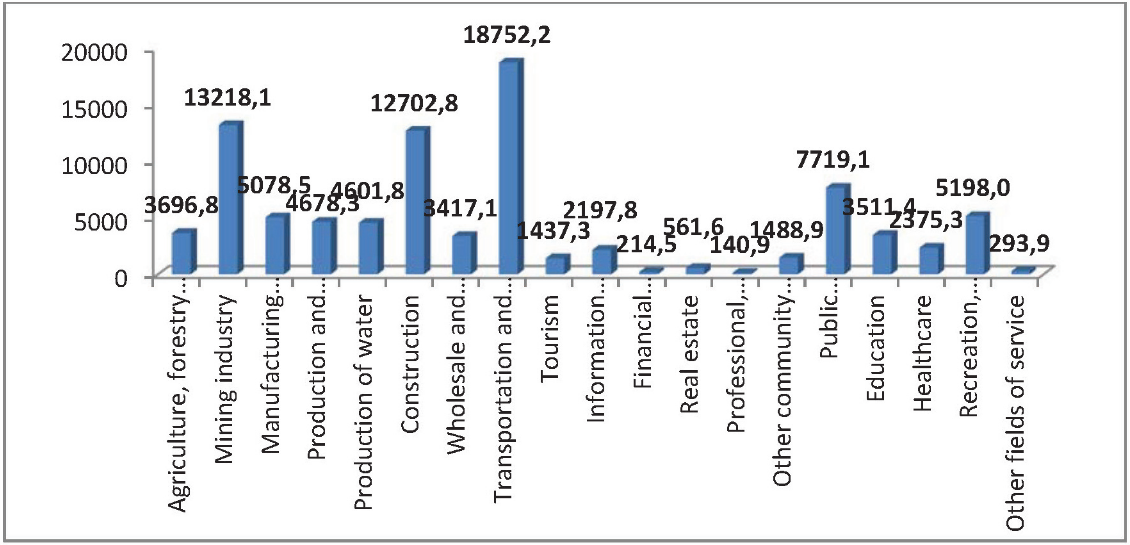

Figure 5. Total domestic capital investment destinations in the period of 2000-2015[24] (current prices, mln. AZN)

Capital investment from non-public sources have been gradually increasing between 2000 and 2014: such investment was equal to AZN 1.3 bln in 2005, 1.9 bln in 2010, 3.3 bln in 2012 and 4.1 bln in 2014-2015.

Structure of domestic capital investment based on economic activities. Our calculations based on SSC data revealed that, capital investment from domestic sources in the period of 2000-2015 was equal to AZN 91.9 bln. The top five destination sectors for domestic capital investment in Azerbaijan economy for 16-year period were as following (*figure 5*):

1) In transportation and storage industry: AZN 18.8 bln (20.5% of all capital investment);
2) In mining industry: AZN 13.2 bln (14.4%);
3) In construction: AZN 12.7 bln (13.8%);
4) In public governance, defence and social security: AZN 7.7 bln (8.4%);
5) In recreation, entertainment and culture: AZN 5.2 bln (5.7%).

Capital investment in manufacturing sector in the same period was only AZN 5.1 bln (5.5%) for manufacturing industry, 3.7 bln (4.0%) for agriculture and 1.4 bln (1.5%) for tourism.

Technological structure of capital investment. The share of investment in construction have been increasing alongside total capital investment in the reviewed period: the share of construction in capital investment rose from 33% in 2001 to 75.4% in 2014. On the other hand, the share of capital investment spent on machinery, equipment, tools and inventory have decreased from 31% in 2002-2003 to 11.7% in 2014[25]. The decrease in the share of this spending is especially noticeable since 2010.

[24]alculated based on SSC data (http://www.stat.gov.az/source/construction/)
[25]Source: State Statistical Committe

The evaluation of the effect of non-oil sector investment sector on non-oil GDP growth. In order to evaluate the effect of capital investment in non-oil sector on non-oil GDP growth we have calculated a correlation between these two variables (growth rate of non-oil capital investment and growth rate of non-oil GDP, see *figure 6*).

Even though capital investment in non-oil sector in 2001-2011 period was highly volatile (increases were followed by sharp drops), non-oil GDP growth rate was stable: changes in non-oil GDP growth rates in the years of large increase in investment were negligible. In some cases, growth rate has even decreased compared with previous year, despite a rise in investment. For example, capital investment in non-oil sector in 2005 increased by 36%, while growth rate was 13.8%, respective figures were 65.8% and 8.3% in 2005, 78.2% and 16.0% in 2008. Capital investment in 2005 increased by 45.2% relative to 2004, but non-oil GDP growth rate was 5.3 percentage points lower than the previous year.

The effect of large increase or decreases of capital investment on GDP growth rates of this sector are non-existent even after considering the investment lag factor. This can be explained by the fact that, large part of this investment was directed at infrastructure development: if this infrastructure projects are not actively utilized by enterprises, the effect of this investment on GDP is hugely diminished[26].

Structure of capital investment based on sources of financing. 51.2% of total capital investment (AZN 110.7 bln) in the period of 2005-2014 was funded by firms and enterprises, 40.0% by state budget and off-budget funds, 4.4% through bank loans, 3.2% through private funds of the population.

While the volume capital investment from state budget have in-

[26]Further research is needed to confirm this hypothesis.

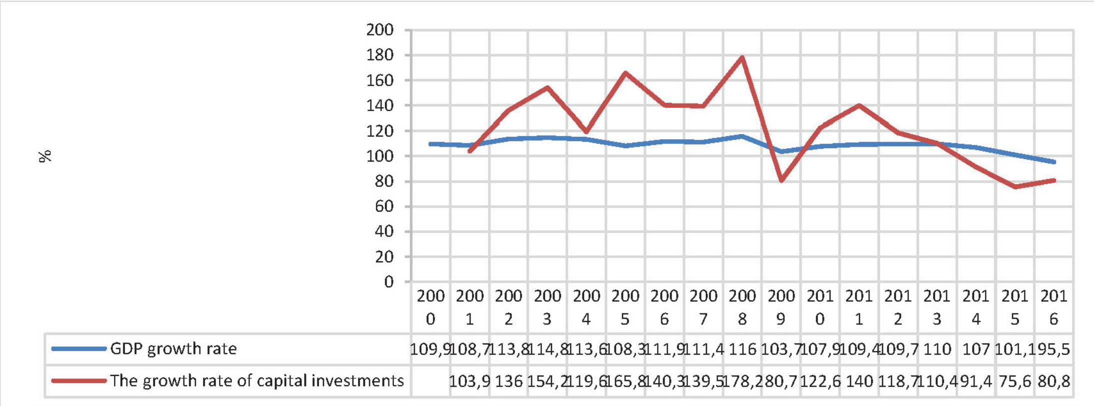

Figure 6. Correlation between growth rate of non-oil capital investment and growth rate of non-oil GDP, yearly growth rate, % (source: SSC)

creased by 41.7 times between 2005 and 2013, investment financed through bank loans increased by 2.3 times, investment financed from funds of firms and enterprises increased by 64.2%, investment from private funds of the population increased by 37.2%.

According to our approximate calculations, capital investment of ***private enterprises*** in 2013 was equal to AZN 300-350 mln[27]. This was equal to 0.6% of GDP, or 1% of non-oil GDP. We should note that, business investment is equal to 11-12% for European countries[28].

The share of capital investment financed through ***bank loans*** was 5.0% in 2003, 6.5% in 2010 and 4.8% in 2013. The volume of bank loans used for capital investment was AZN 372.1 mln, which was 25.8% of all bank loans for that year. These figures increased to AZN 643.8 mln and 7.0% for 2010, 859.0 mln and 5.6% for 2013 and later decreased to 6305 mln and 3.4% in 2014[29].

Although the volume of total bank loans to economy have increased by 6.4 times in 2010, 10.7 times in 2013 and 12.9 times in 2014 relative to 2005, volume of capital investment funded through bank loans increased only by 73.0%, 2.3 times and 69.4 times respectively. The volume of bank loans in the decade of 2005-2014 have increased by 12.9 times[30], but the capital investment in the same period increased only by 69.4%. As a result, the share of bank loans among the financing sources of capital investment fell from 22.5% in 2005 to 3.4% in 2014. It should also be noted that, large part of

27There are no data on the participation of domestic private sector in capital investment in SSC database.

28http://ec.europa.eu/eurostat/statistics-explained/index.php/National_accounts_and_GDP#Main_tables

29The reason for increase in the share of capital investment financed through bank loans in 2015 and 2016 is the devaluation of manat and expression of dollar credits in manat.

30The information on bank loans is obtained from statistical bulletin for the first quarter of 2016 published by Central Bank: https://www.cbar.az/pages/publications-researches/statistic-bulletin/.

capital investment funded through bank loans are the concessional loans provided from state budget (via National Fund for Entrepreneurship Support and other similar organizations) [31]. Which means that, participation of commercial banks in financing production activities was very low (for comparison: 35-40% of all bank loans in this period were consumption loans, while 15-20% were given to trade sector[32]). High interest rates (interest rates for business loans varied in the range of 15-30% among banks), low profitability and high risk of production sector can be listed among the reasons why such loans were not attractive neither for banks nor for entrepreneurs[33]. On the other hand, the lack of investment banks (currently, all of the banks operating in Azerbaijan are commercial banks) also contributed to this problem.

Private funds of population used in financing capital investment was equal to AZN 331.8 mln in 2005 (5.7% of total investment), 373.2 mln in 2010 (3.8%), 455.2 mln in 2013 (2.6%) and 699.8 mln in 2015 (4.4%). Thus, the amount private funds used for capital investment increased by 2.1 times from 2005 to 2015. The income of population in this period have increased by 5.5 times, while savings increased by 4.4 times, according to SSC. Saving of financial assets by population increased by 4.5 times, non-financial assets increased by 4.3 times, while deposits of population increased by 14.5 times[34]. In other words, even though population significantly increased its savings, they prefer to save in the form of bank deposits, financial or non-financial assets, rather than to invest in business.

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[31]There are more information below about these institutions and loans presented by them.
[32]https://www.cbar.az/pages/publications-researches/statistic-bulletin/
[33]It should be noted that, biggest bank in terms of loans for capital investment was International Bank of Azerbaijan, 50% share of which belongs to the state. It is already known that, the majority of IBA credits turned out to be toxic assets.
[34]Data on the deposits of population is the comparison of 2005 and 2014. http://www.stat.gov.az/menu/13/

Capital investment of households was equal to 1.2% of GDP (2.1% of non-oil GDP) in 2015.

Capital markets. Capital markets are institutions that promote investment activity and provide alternative sources of long-term financing for firms and enterprises.

The volume of investment securities market in Azerbaijan was equal to AZN 13.3 bln in 2014. 35.7% (4.7 bln) of securities market was in corporate securities (stocks and corporate bonds), 31.3% (4.2 bln) was in government securities (Ministry of Finance bonds, Central Bank notes and repo/counter-repo operations) and 33.0% (4.4 bln) was in derivative instruments (commodity-based and currency-based securities). 27% of corporate securities were stocks, the remaining 63% were bonds. The most active participants of stock market are stockholder-commercial banks. Stock market was only AZN 1.3 bln in 2014[35] (2% of GDP), which was due to expanded activity related to increased capital requirements for banks. Stock market shrank by a factor of 2 in 2015. Main reasons behind limited stock market are formality of majority of stock companies operating in the economy (especially state-owned stock companies), the lack of initiative in establishing corporate governance in these companies, insufficient demand for stocks as a financial asset from population due to the lack of dividends, financial literacy or trust.

The volume of insurance market is also quite low: in 2015, total capital of insurance companies was equal to AZN 529 mln (1% of GDP), total amount of insurance fees was 481.5 mln (0.9% of GDP), the total insurance payments was 184.1 mln (0.3% of GDP)[36]. Total amount of insurance capital has increased by 14.7 times, insurance

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[35]Annual report of Financial Markets Supervision Authority of the Republic of Azerbaijan for 2015.
[36]Statistical indicators of Azerbaijan, 2016. SSC http://www.stat.gov.az/menu/6/statistical_yearbooks/

fees by 5.8 times, insurance payments by 9.6 times since 2005 to 2015.

Although "The Law of the Republic of Azerbaijan on Investment Funds"[37] has been passed in 2010, no investment fund has been established since. Furthermore, the discussions on the issue of private pension funds went on for some time, there have been no progress on the issue yet.

Public institution for the promotion of investment. Institutions and authorities created by state for the promotion of investment have played a significant role in boosting investment activity around the world.

National Fund for Entrepreneurship Support of the Republic of Azerbaijan (NFES). Allocations to NFES from the state budget in the period of 2002-2016 were equal to AZN 1 bln, while total repayments to the Fund related to its loans (including interest payment and other revenue) were equal to 952.0 mln. Overall, the sum of concessive loans by the fund to enterprises between 2002 and 2016 were equal to AZN 1944.2 mln (999.9 mln of which was state budget funds and 944.3 was from repayments and interest)[38]. Of the loans provided in the 2002-2016 period, AZN 509.7 mln (26.2%) were for the production of industrial goods, 211.5 mln (10.9%) for manufacturing of agricultural products, 942.5 mln (48.5%) for production of agricultural products, 244.5 mln (12.6%) for the development of service industry (infrastructure), 34.3 mln (1.8%) for the financing of tourism projects[39].

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[37]http://e-qanun.az/framework/20760

[38]Comments of Chamber of Accounts on law "On the execution of state budget of the Republic of Azerbaijan for 2016" and on the yearly report on the execution of state budget, Baku 2017, p. 330-331.;
http://sai.gov.az/upload/files/ICRA-2016-SON_FINAL.pdf

[39]http://anfes.gov.az/az/show.page.php?guid=4e13c77b-280b-11e0-8e86-0022190362dd

Although the main purpose of NSEF was the support of small and medium enterprises, 80-85% of loans by fund since 2011 were received by medium-large projects (AZN 3-5 mln). 97% of all loans provided by the fund are small, but the share of these loans in the volume of NSEF loan portfolio is only 9%[40].

Similar funds in other countries mostly aim to support newly established enterprises and try to finance as many projects as possible (for example, KOSGEB[41] in Turkey), but NSEF tends to fund medium and large projects. The study of annual reports of NSEF and reports of organizations that have carried out projects with NSEF loans reveals that, most of the medium and large enterprises that receive loans from NSEF are parts of the largest holdings of the country, which would have little difficulty of finding loans from other sources[42].

"Azerbaijan Investment Company" JSC (AIC) – SOFAZ has allocated AZN 90 mln for capital of this company in 2006 and state budget has provided 70 mln manats as a part of "capital investment" expenditures to increase its capital in 2009.

According to Azerbaijan Chamber of Accounts, between 2007 and 2015, the Company have invested the total of AZN 88.6 mln in 11 stock companies in the form of stock and share purchases. The latest investment by the Company was on May 24, 2012[43]. AIC have been participating in establishment of industrial estates[44].

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[40]Strategic Road Map for the manufacture of small and medium entrepreneurship-level consumer goods in the Republic of Azerbaijan.
[41]http://www.kosgeb.gov.tr/
[42]More information on NFES and other investment promotion institutions is given in the appendix 2 of this paper.
[43]Annual report of Chamber of Accounts for 2016
http://sai.gov.az/upload/files/HP%202016%20fealiyyet.pdf
[44]https://www.aic.az/az/pages/id:59

Azerbaijan Export and Investment Promotion Foundation (AZPROMO) – is a joint public-private initiative, established by the Ministry of Economy of Azerbaijan in 2003. AZPROMO website is only in 2 languages and the presented information is very limited, the website lacks the extensive information even on investment legislation and investment concessions. The majority of the information on the website is about the projects organized by the Foundation. There are no special reports on its activity. The information on its activities are presented in the annual report of the Ministry of Economy, in 1-2 pages.

Website[45] of WAIPA (World Association of Investment Promotion Agencies), which AZPROMO is a member of, contains contact details of all of its members. Websites of these organizations, whose purpose is to attract foreign investors in their countries or to promote their products abroad, include their periodic reports and extensive information on investment opportunities in their countries, investment legislation, concessions for investors, potential sectors for investment and other relevant issues. Most of them provide this information not only in their native language and in English, but also in languages of countries that can potentially invest in their countries. For example, relevant institution in Turkey is Investment Support and Promotion Agency. The website of the Agency contains information in 12 languages[46]. The website also contains information on nearly all issues that can interest potential investors, including information on visa requirements, establishment of businesses, taxes, concessions, social security, financial issues and others. All opportunities and concessions presented to domestic and foreign investors, all procedures of opening a business, attractive opportunities for potential investors, regional opportunities and more

[45]http://www.waipa.org/
[46]http://www.invest.gov.tr/en-US/Pages/Home.aspx

are all explained in detail[47]. It is essential for AZPROMO to improve its operations in accordance with the experience of other, more advanced members of WAIPA.

State Service for the Management of Agricultural Projects and Loans under Ministry of Agriculture of the Republic of Azerbaijan. This institution has lent AZN 59.8 mln between 2007 and 2016. The volume of its loan portfolio was equal to 61.8 mln on January 1, 2017[48].

State Fund for the Development of Information Technologies under the Ministry of Communications and Information Technologies of the Republic of Azerbaijan. The Fund received AZN 5 mln from state budget in 2015 and 4 mln in 2016 for the loans to support the IT sector. However, the Fund itself provided only AZN 687.3 thousand in 2015 and 3.8 mln in 2016 as loans and the remaining amount was returned to the budget[49].

Establishment of industrial and technology parks. Yet another step toward increasing investment activity is the creation of industrial and technology parks, industrial estates and free economic zones. Sumgait Technologies Park is already in operation, Sumgait Chemical Industrial Park, Balakhani Industrial Park, Sumgait High Technologies Park, Mingachevir Industrial Park, Pirallahi Industrial Park, Garadagh Industrial Park are in the process of creation. It should be noted that, according to legislation, industrial park residents enjoy tax and customs concessions and exemptions and a number of other privileges for the first 7 years of parks' operations.

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[47]http://www.invest.gov.tr/tr-TR/investmentguide/investorsguide/Pages/Incentives.aspx
[48]Comments of Chamber of Accounts on law "On the execution of state budget of the Republic of Azerbaijan for 2016" and on the yearly report on the execution of state budget, Baku 2017, p. 336.
[49]http://sai.gov.az/upload/files/ICRA-2016-SON_FINAL.pdf, p. 338

Conclusions. So, analysis of the investment activity in the country up to 2014 has revealed the following tendencies and challenges.

- In the period leading to 2014, there have been a quite significant investment activity in the country (total investment was equal to around 30-35% of GDP): this activity was mainly due to foreign investment in oil and gas sector and public investment.

<u>In foreign investment:</u>

- most of the foreign investment in Azerbaijani economy is directed to the oil and gas sector, only recently has the share of financial loans in foreign investment increased;
- despite the relative increase in the foreign investment in the form of joint and foreign enterprises recently, the share of this type of investment has always been negligible;
- manufacturing and agricultural sectors of Azerbaijan were not attractive investment directions for foreign investors, investment in these sectors has ceased altogether since 2010;
- no leading world brands have established its production facilities in Azerbaijan;
- works to attract foreign investment in non-oil sector has proven to be insufficient, there is a dire need for improvement in this respect;

<u>In domestic investment:</u>

- main source of domestic investment in the national economy since 2005 was public funds: 70.6% of 80.5 bln total domestic investment was provided by the government in the 2005-2014 period;
- main priorities of the domestic investment were transportation, mining industry, construction, public governance and recreation/entertainment industries;

- the government, as the main domestic investor, prioritized infrastructure building (production, communal and social) in its investment: up to 70% of domestic investment was in construction;
- despite the increased activity of the government in the investment market, there is no effective mechanism for the evaluation of public investment projects: no evaluation of socio-economic efficiency of such projects is being carried out;
- despite the provision of huge sums to state-owned enterprises from the state budget for their capitalization and improvement of their material-technical base in the period of 2006-2014, no sufficient steps have been taken to increase the efficiency of their operations and to ensure the implementation of modern effective management practices;
- investment in manufacturing and agricultural sectors have always been small, moreover, major part of the investment in these sectors consisted of funds provided by the state budget, i.e. private initiative was replaced by the activity of the government: investment activity of domestic private enterprises in these sectors is considered to be only around 1% of non-oil GDP;
- although the creation of infrastructure capital via public investment was extensive in recent years, low rate of private domestic investment, especially in manufacturing and agricultural sectors, decreased the productivity of non-oil sector investment;
- participation of commercial banks in financing production activities was very low: high interest rates, low profitability and high risk of production sector can be listed among the reasons why such loans were not attractive neither for banks nor for entrepreneurs;
- no specialized investment bank has yet been created;

- even though population significantly increased its savings, they prefer to save in the form of bank deposits, financial or non-financial assets, rather than to invest in business;
- small volume of stock and capital markets in the country restricts the ability of the private sector to use them as sources of investment;
- no investment fund has yet been created in the country and neither private, nor public organizations have taken any steps in this direction;
- there are serious problems in ensuring effective and efficient operations of state institutions of investment promotion.

3. HOW SHOULD INVESTMENT PROMOTION STRATEGY BE DESIGNED?

According to economic theory and within the framework of free market relations, investment is regulated by "invisible hand" of the market. Special promotion strategy of the government is required only when the market is unable to independently manage the investment (restriction of competition, insufficient market stimulus – high costs and low profits, the lack of R&D etc.) or when the market allocation of investment is not socially efficient (i.e. such allocation doesn't ensure inclusive and sustainable development).

Formulation and implementation of efficient investment policy by the government involves, firstly, an accurate assessment of all (market and non-market) factors restricting investment activity, selection of policy tools and instruments necessary for solving these problems, proper implementation of the designed policy. It should also be considered that, the same policies can have different results in different countries or different sectors of economy. Also, the effect of policy tools and instruments change with time and with changing conditions.

It is known that, as all market processes, investment has two sides: supply and demand. Demand for investment in a country is determined by the level of development of its economy and its sectors, opportunities for creation and presentation of new ideas in the country, development stage of different sectors, competitiveness of the sector, market size (both domestic and foreign) for the sector's products, export conditions and opportunities for these products, the volume of import of these products into the country and other factors. Shortage or abundance of new ideas, in turn, depends on the education level of the population and the situation in entrepreneurial freedom.

The supply of investment depends on the level of development of private sector, entrepreneurial freedom and the condition of investment environment, the level of investment risks, attitude towards domestic and foreign investors, the size of public sector, income level of the population, development level of capital markets and banking sector, link with international capital markets, macroeconomic factors and a number of other factors.

Investment risk is considered to be the main indicator of economic institutions of the country: this risk entails the risk of expropriation risk, the ease of repatriation of profit and the probability of violation of contractual obligations.

The design of investment promotion strategy should include the detection of problems and limitations relating to both demand and supply factor (these can vary from sector to sector), evaluation of investment risks, determination of necessary steps to reduce and remove these risks and limitations. As was mentioned before, Azerbaijani government have adopted a number of policy decisions regarding investment promotion.

According to Harvard University Professor D. Rodrik, it is important not to confuse institutions with tools and measures used for the implementation of a policy. He states that, such measures as tariffs and tax regimes are the simple sides of the issue. More important aspect of the issue is *behavioural models within public sector and especially the change of attitude of government toward private sector.* The importance of the reform process lies not in the quantitative restrictions and the level of tariffs, *but in the new rules and expectations created by the reforms regarding the way the decisions are made and implemented thereafter.* This approach also permutates new philosophical approach regarding the way the strategy of sustainable development should be designed. Therefore, these reforms turn into institutional reforms of a massive scale[50].

If we review policy decisions of the government since 2015 in the context of the approach mentioned above, it is clear that the most of the decisions were quantitative in nature, i.e. provision of certain concessions (subsidies, customs and tax exemptions, concessional loans) and import restrictions. And these are the tools for policy implementation.

The reforms should aim to eradicate the behavioural stereotypes that can have an adverse effect on the investment decisions. D. Rodrik states that, institutional reforms should target not only policy parameters, but also behavioural stereotypes obstructing the development[51].

Stereotypes that have emerged from long-standing realities of Azerbaijan economy and that have been taken root in the public consciousness (such as "each business sector is under control of some public official", "all officials and public institutions are corrupt", "everything is solved through bribes or acquaintances", "all business-

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[50]D. Rodrik. Reform of trade policy as institutional reform
http://siteresources.worldbank.org/INTRANETTRADE/Resources/Pubs/Handbook_rs_Rodrik_ch1.pdf
[51]Ibid

men are tax evading thieves", "laws are only for the poor" etc.) have a decisive effect on the reception of investment policy decisions. The reforms cannot be successful unless these behavioural stereotypes are changed.

Actually, Azerbaijan already have an experience in eradicating certain stereotypes: for a long time, there was a stereotype that (and it still goes on to certain extent), corruption and lawlessness stem from our national mentality and it is impossible to eradicate them in a short period of time. However, the establishment of ASAN service and the operation of "BakuBUS" buses have demonstrated that, even our people obey the law and order within the framework of properly constructed rules (institutions), because it is beneficial to all parties involved.

Yet another stereotype that needs to be changed is that the policy decision that affect the profits and costs of the business sector (such as tax rate changes, the revoke of tax exemptions, changes of energy prices, prices of utilities, fees for communal and other services) are taken behind the "closed doors" and thus the businesses suffer huge losses. Businesses cannot plan their activities properly, since they don't get informed about this decision on time. It is very essential for businesses to have a predictable operational environment. Therefore, the government should abolish the practice of "secret decision-making" and put important laws and policy decisions that may affect the business sector up for public discussion. Also, there should be sufficient time period between the date of the decision and its date of implementation, so that the business sector can adapt its operations to consequences of the decision.

A number of developing country governments conducted reforms targeting economic growth in the 1980-2000 period. Part of them achieved sustainable growth (Singapore, Malaysia, Korea, China, Thailand, Taiwan, Indonesia, Vietnam, Egypt, Tunis etc.), while others were unsuccessful (Latin American countries etc.). A group economists[52] analysing reforms of 43 countries have concluded that, success of the governments targeting sustainable growth depends on the following factors:

1) *prioritizing the export of industry products* – almost all of the countries that achieved sustainable growth had greatly increased their exports of industrial product;
2) *avoiding the artificial appreciation of national currency* – successful countries were able to adjust the exchange rate of their currency to real income level of the country (real situation of balance of payments), while the unsuccessful ones experienced overvalued currency;
3) *the size of the public sector* – size of the government in successful countries was smaller than in unsuccessful ones and they kept the inflation under control by conducting more responsive fiscal policy;
4) *liberalization of foreign trade* – most of the countries that achieved sustainable growth did not liberalize their imports (there have been temporary restrictions on import of certain products), yet they adopted active export strategy and were more open to the global market in this respect;
5) *availability of economic opportunities* (for example, education level, access to financing etc.) – all of the successful countries achieved high quality education for whole population (including preschool, middle school, vocational education, and tertiary education);
6) and finally, *development of institutions* – institutions in the countries that achieved sustainable development were weak

[52] S. Johnson, J. D. Ostry, A. Subramanian. "Levers for Growth", Finance and Development, March, 2008.

in the beginning of the reform process (1980s), but the reforms in these countries took place alongside the process institutional development and they completed each other – this was the exact reason of success of these countries.

It is clear that, a reform is a very complex process. Every action has a reaction and the efficiency of an action is evaluated based on its reaction. Contribution of reforms to the welfare of the public is evaluated based on the suitability to economic growth of the environment this reform has created: what drives the economic growth and how sustainable is this mechanism. In other words, the criteria for assessment of reforms is its contribution to development of quality of institutional environment.

One of the essential components of industrialization strategy is selective industrial policy. Selective industrial policy involves selection and prioritization of industry sectors that have potential to boost economic growth and to provide privileges to the sector. The success of industrialization depends upon successful sector choice. It is known that, this strategy is being implemented in Azerbaijan: the government subsidizes producers of a number of agricultural products.

According to Luis A. Moreno, the president of Inter-American Development Bank, the failure of industrial policies of Latin American countries in 1950s and 1960s were a result of wrong industry choices. He believes that, governments then picked weak sectors without serious justification: the choice of industry was not based on the sector's competitiveness but was dictated by political pressures[53].

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[53]https://www.project-syndicate.org/commentary/latin-america-industrial-policy-failures-by-luis-a--moreno-2015-01?barrier=accessreg

According to Moreno, major determinant of success of industrial policy is the ability of the government to steer clear of political and special interests: special interests should not influence the formulation of industrial policy. Ireland, which is famous for its successful project choices accomplished this with the help of technical competency of Industry Development Agency: this authority ensured the efficiency and integrity of project selection process. Chile, despite having quite strong institutions, entrusted the selection of industry sectors to independent organization – Boston Consulting Group.

According to Moreno, to formulate a successful industrial policy, government firstly should seek answers to the following questions[54]:

i) are there any apparent "market failures" and is there any justification for state intervention?

ii) can the proposed measures eradicate market failures?

iii) are there institutions in the country that can conduct the industrial policy?

Harvard University Professors R. Haussmann, D. Rodric and A. Velasco have proposed that, hurdles to growth in each country consist of a number of constraints, but there are some among them that are "binding" (such binding constraints "bind" a number of other problems together, acting as a cause of several problems, thus seriously restricting economic growth). Their research suggests the importance of detection of such binding constraints (based on the current situation of economic and government system) and formulation of reform efforts around solving these constraints[55]. They argue that,

[54]Ibid

[55]Ricardo Hausmann, Dani Rodrik, and Andrés Velasco. "Getting the Diagnosis Right". Finance and Development , 43 (2006).
http://www.imf.org/external/pubs/ft/fandd/2006/03/hausmann.htm

when the number of necessary reforms is high, governments tend either to endeavour to address all of them at once, thus losing the control over situation (some of these reforms may obstruct the others), or they target more easily resolved constraints to create an illusion of change, which doesn't have a significant impact on the growth potential of the country.

These researchers propose the application of a decision tree methodology for detection of binding constraints[56]. This approach, in essence, is prioritization of reforms based on extent of influence. There is a simple principle behind the methodology: the government should prioritize the reforms that aim to eliminate binding constraints and, thus, those reforms that are more efficient (i.e. have a bigger impact on growth potential).

Based on the first two parts of our analysis, we can observe that, Azerbaijani economy currently faces the majority of the problems listed in the decision tree. International rankings (for example, Corruption Perception Index, Doing Business Report, Global Competetiveness Report, Economic Freedom Report, Gloval Innovations Report, Global Opportunities Report etc.), that rate countries based on such criterias as business environment, economic freedoms, competetiveness of the economy, economic situation and quality of government, confirm that there are serious problems in Azerbaijan with these issues. These international ratings are instrumental in determining the attractiveness of a country for investors and the evaluation of investment risks. They play an es-

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[56]Growth Diagnostics. Ricardo Hausmann, Dani Rodrik, Andrés Velasco. March, 2005
http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.446.2212&rep=rep1&type=pdf

sential role in decisions of foreign investors. Therefore, the order of the President of the Republic of Azerbaijan that further highlighted the importance of development of favourable business environment and approved the additional action plan on improvement of the rating of Azerbaijan in international rankings is an important step forward[57]. Nevertheless, recurring news reports about lawless behaviour of public officials and expropriation of private property of businessmen by high ranking officials, especially the facts revealed about the criminal cases related to the Ministry of National Security and to International Bank of Azerbaijan are the factors that enforce the distrust of governemnt among foreign and domestic investors.

During recent years, certain authorities have been established to restore and ensure macroeconomic stability (Macroeconomic Stability Committe[58]), to efficiently administer and develop financial markets (Financial Markets Supervision Agency (FMSA) [59]). On the one hand, an increased investment activity and the necessity to expand the access to financial resources require to lower interest rates on loans and to conduct expansionary monetary policy, on the other hand, ensuring stability in macro-financial and currency markets has made the implementation of contractionary measures (to increase discount rate and conduct tight monetary-credit policy, to limit the money in circulation[60]) inevitable. While the promotion of investment activity requires an allocation of concessional loans and subsidies from the state budget, the tight financing conditions of the government require budget consolidation and contractionary taxation policy.

[57]http://www.president.az/articles/24080
[58]http://president.az/articles/20613
[59]http://www.president.az/articles/17670
[60]https://www.cbar.az

In such a situation, the flexibility and efficiency of the operations of respective state authorities, to make the timely and appropriate decisions and to ensure efficient implementation of undertaken decisions are essential. A number of cases of failure to implement the approved laws and decisions due to various reasons (for instance, the lack of justification, the absence of executive mechanisms, the lack of necessary environment, the lack of interest of government officials in the implementation process) have already been observed in Azerbaijan. That is to say, despite the adoption of tens of decrees and decisions on preventing illegal interventions by government officials to the operations of entrepreneurs since 2002, this issue yet to be resolved: The President underlined the unprecedented level of intervention by government officials to the activities of businessmen in the meeting on September, 2015 and thereafter a law has been approved on a temporary suspension of examinations of enterprises for 2 years.

Although the discussions on the adoption of "Competition Code" commenced since 2004 and the project of the Code was presented to the National Assembly in 2006 and passed two readings, the Code has not been adopted yet. In 2009, drafts of new laws on "Investment activity" and "The protection of foreign investments" had been prepared and presented to the National Assembly with the support of a group of international organizations. The discussion of those laws and their adoption had not been achieved yet. This approach to the adoption of necessary laws on the investment promotion undermines investor confidence. For this reason, it is essential to ensure timely adoption and implementation of necessary laws and decisions in the context of ongoing reforms.

Ensuring the fairness of the judiciary system is one of the (even the first) challenges to be addressed to improve business environment and free entrepreneurship. The government reforms should be based on these issues, rather than merely creating Appeal Councils[61] under the central and local executive bodies for dealing with the complaints of entrepreneurs.

RECOMMENDATIONS AND PROPOSALS ON STRENGTHENING THE INVESTMENT PROMOTION POLICY

There have been a number of policy decisions related to the transition to investment-based growth model and promotion of investment activity and several important measures for the improvement of business environment, promotion of investment activity and non-oil exports. Nevertheless, our research concludes that, these measures and policy decisions are not sufficient to reinforce the investment activity. Therefore, we deem necessary the implementation of the following recommendations to strengthen the investment promotion policy:

1. **On the formulation of the investment promotion policy**:
   - the government should formulate a unified investment strategy for reinforcing the investment activity and investment promotion. The strategy should list all the barriers to the activity of potential investors and present concrete policy tools and instruments in a systematic and detailed way;
   - the institutional reforms, its main targets and dates of execution should be communicated to the public and potential investors in a detailed way;
   - the government should provide the mechanisms that ensure real, rather than formal protection of property rights, business

[61] http://e-qanun.az/framework/31998

activities of public officials should be suppressed, income statements of public officials should be publicized;

- the fate of investment activity and business development depends on independence and fairness of the judiciary. The development of fair and independent judiciary is at the heart of institutional reforms, because the elimination of the majority of barriers to business and investment activity is possible only through guaranteeing fair judiciary;
- decision-making mechanism of the government of policy decisions related to business sector should be changed: proposals of such decisions should be put up for public discussion, affected parties should be consulted, justifications of the decision and the results of evaluation of its effect on the business sector should be communicated to the public;
- the government should abolish the practice of secret discussions of policy decisions that affect costs and profits of businesses. Such decisions should have program, and their time table and justifications should be publicized. Business sector should be informed at least 6 months in advance of such decisions, to allow businesses to plan their activities accordingly;
- the government should coordinate its fiscal, monetary and investment promotion policies;
- the government should adopt "Competition Code" and new laws on "Investment Activity" and "Protection of Foreign Investment" etc.

2. **On public investment:**
   - the level of physical capital in the country is satisfactory, so the main target of public investment should be the creation of "human capita". It is essential to increase the quality of education on all fields, adjustment of education system to the challenges of the markets, and to develop vocational training.

- reduce the size of the public sector: the government should abolish the policy of expanding the size of public sector adopted during oil boom, should ensure efficient operation of state-owned enterprises and implementation of modern management principles in them; the adoption process of corporate governance standards in state-owned enterprises should be accelerated;
- the government should prepare and apply mechanisms for evaluation of public investment projects (for example, World Bank proposed the government of Azerbaijan to prepare such a mechanism back in 2009, "Annual Report Card", which would have assessed the infrastructure quality of public investment projects);
- the selection criteria of sectors that are to be supported by the state to boost economic growth should be identified, the selection mechanism should be prepared, fairness and objectivity should be guaranteed. Competitive advantage of the sector, export potential and export markets of the product, expected growth rate of market share during the period of state support, the duration of state support and the potential of growth of the sector after the end of state support can be used as criteria for selection.
- prioritization of manufacturing sectors when selecting sectors for state supported;

3. On promotion of foreign investment:

- the government should design and implement action plan regarding the attraction of foreign direct investment, especially in the export-oriented manufacturing sectors;
- the government should conduct individual negotiations with a number of world known brands to create necessary conditions for their operations in Azerbaijan;

- activities of AZPROMO should be significantly transformed to improve its ability to attract foreign investors in non-oil sector: its activities should concentrate around more concrete targets, its performance should be evaluated based on special indicators, it should publish periodic reports, the costs of the institution's operations should be compared to investment amount it helped to attract, the website of the institution should be improved, it should be enriched with detailed information that may interest potential investors. The information in the website should be presented in at least 6 languages (Azerbaijan, English, Turkish, Russian, Arab, Chinese etc.);

4. **On promotion of domestic investment**:
   - in order to improve the performance of investment promotion institutions in the country, the government should: i) to reorganize their activities based on the experience of successful similar institutions abroad; ii) to design and implement evaluation indicators to ensure their efficient and effective operation; to formulate the long-term accountability system for the projects funded by these institutions to assess their contribution to the welfare of society; iii) to ensure close cooperation of these institutions with similar institutions abroad, to establish a system of experience-sharing; iv) to increase their funding from state budget after their operations are restructure.
   - considering the experience of similar institutions abroad, NFES should prioritize loans to micro and small entrepreneurs, and especially to newly created enterprises. The assessment of Fund's performance should be based on such concrete criteria as the number of successful entrepreneurs assisted by the Fund, the share of enterprises created with the support of the Fund in export and value added etc.

- the government should closely participate in the creation of specialized sector banks (such as Agrarian Development Bank, Export Bank, Investment Bank etc.);
- the government should establish guarantee and insurance fund for loans to SMEs.

INVESTMENT PROMOTION POLICY:
HOW TO IMPROVE IT?

Dr. Azer Mehtiyev

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