

# **DEVELOPING SME SECTOR IN AZERBAIJAN: REDUCING DEPENDENCE ON PETRODOLLARS**

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## **Abstract**

*Azerbaijan as an energy producing country, and as any country with rich natural resources is prone to resource curse. Presently the most important priority of the government is to restructure current resource dependent economy and to achieve more healthy and stable one. For that, the non-oil sector of economy must be developed. The current research analyzes the possible ways to achieve this and comes to a conclusion that, taking into account present socio-economic factors in Azerbaijan, the most optimal option is to achieve development in the SME sector. The main problems creating barrier for SMEs are identified as formal and informal institutions such as corruption and ineffective governance, poor access to foreign markets and to finance. At the end, policy options are suggested to solve the identified problems.*

## **Acknowledgements**

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## **List of Abbreviations**

CIPE – Center for International Private Enterprise

EBRD – European Bank for Reconstruction and Development

EU – European Union

FDI – Foreign Direct Investment

IFAD – International Fund for Agricultural Development

ILO – International Labour Organization

IOE - International Organization of Employers

NGO – Non-governmental Organization

SME – Small and Medium-sized enterprise

SOFAZ – State Oil Fund of Azerbaijan Republic

UNDP – United Nations Development Program

UNIDO – United Nations Industrial Development Organization

WB – World Bank

## Introduction

Azerbaijan is a recourse rich country. And as any country with rich natural resources is very dependent on the revenues generated from oil and gas extraction. This makes the country prone to resource curse. Currently the main policy priority for Azerbaijani government is to diversify the economy and achieve development in the non-oil sector (EBRD 2007, 7). The current research will focus on this problem.

This topic is very important to be researched right now because Azerbaijan is currently living the most important phase of its 'life' as a country. The revenues from oil and gas production are escalating which effects economy as a whole (EC 2006, 12). It is the time for Azerbaijanis to take the responsibility and make the right use of these revenues in order not to follow the unfortunate fate of many 'recourse cursed' nations.

So far the economic theory paid little attention to the importance of SMEs while researching the conditions that lead to sustainable<sup>1</sup> economy. However, currently interest to this sector of economy is rising. More and more economists start acknowledging the role of small scale production in creating mass job places, generating large amount of taxes for public budget, achieving development in the rural areas, attracting vulnerable minorities into economic activity and finally building healthy and sustainable economy (ADB 2007, 1). Taking these benefits into account, the finding of the research is that SMEs of non-oil sector are the best way to achieve well-structured development of Azeri economy, problems of which are heavy dependence oil and gas revenues, underdevelopment and unemployment in rural areas. This solution is proposed after reviewing literature on SMEs, analyzing beneficial and non-beneficial features of them and matching those benefits with the problems of present economy of Azerbaijan. Currently, a great deal of importance is given to decentralization of political power. However, decentralization of economic activity is not less important. Doing that, the country can achieve equitable development throughout all its regions. Entrepreneurship, especially small-scale production is the most suitable type of activity for rural areas (Uribe-Echevarria 1991, 34). That is why enabling environment should be created in regions to give incentive to entrepreneurs. Only this way, equal socio-economic development in the country can be reached.

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<sup>1</sup> The term 'sustainable economy', in the current research means well-structured and stable economy, and does not cover environmental aspects.

The research focuses on the practice of developed countries such as USA, EU and OECD members on how they support SMEs, and entrepreneurship as a whole, and create enabling environment using public policy tools. The main policy options proposed are reforming ineffective political and economic institutions and liberalize the trade.

The qualitative methods of research have been used in the current paper such as document study and comparative analyses. Also data on SMEs, corruption performance of Azerbaijan, macroeconomic indicator of Azeri economy have been analyzed to reveal the main trends. The research consists of there Chapters. The first Chapter defines what an SME is and which are the benefits of this sector of economy. In the second Chapter, overview of Azerbaijan's economy is presented focusing mainly on the natural resources, their effect on the economy, and favourable and unfavorable features of Azerbaijan's business climate. Finally, the third Chapter elaborates on the possible ways to solve the found problems stemming from the best practice of developed countries, and policy recommendations are provided.



## **Chapter 1: Why SME Sector is an Inevitable Element of Sustainable Economic Development: Theoretical Background**

### ***1.1 What is an SME?***

Definition of SMEs is not consistent worldwide. Depending on the scale of the country's economy, different numbers can set limits for this sector. For instance, in the USA a firm with less than 500 employees is regarded as an SME (SMEDA 2009, 1). The European Commission sets the following criteria in determining an SME: number of employee – 250, annual turnover less than 250 million euro and annual balance sheet less than 43 million euro (EC 2003, 5). Throughout the world, SMEs represents the largest number of enterprises. In the EU, this sector comprises 99% of existing firms (ibid).

In case of Azerbaijan, SMEs are defined by the government decree on “The Extent of Criteria in Identification of Small Entrepreneurship Subjects by Types of Economic Activity” issued in 2004. Number of employees and annual turnover are the main criteria in this identification (Legal Database of Azerbaijan 2007, 1). The table below presents the number of employees and annual turnover for the specific categories. In construction and industry, number of employees is below 40 and annual turnover below 1 billion manats<sup>2</sup>. In scientific, technical and consulting services number of employees is below 20 and annual turnover below 750 million manats. In agriculture, number of employees is below 15 and annual turnover below 500 million manats. In wholesale trade, number of employees is below 10 and annual turnover below 1.5 billion manats. Finally in retail trade, transportation, service and other types of economic activity, number of employees is below 5 and annual turnover below 500 million manats.

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<sup>2</sup> Manat – the currency of Azerbaijan Republic. 1 USD = 0.8041 AZN as of August 18, 2009 (Central Bank of Azerbaijan Republic 2009)

**Table 1: The Extent of Criteria in Identification of Small Entrepreneurship Subjects by Types of Economic Activity**

<b>Types of economic activity</b>	<b>Number of Employees</b>	<b>Annual Turnover</b>
Construction and industry	<40	<1 billion manats
Scientific, technical and consulting services	<20	<750 million manats
Agriculture	<15	<500 million manats
Wholesale trade	<10	<1.5 billion manats
Retail trade, transportation, service and other types of economic activity	<5	<500 million manats

*Source: Legal Database of Azerbaijan, 2007*

## ***1.2 What is the Link Between Free Entrepreneurship and Economic Growth?***

### ***Benefits of SMEs***

So far, economists have given little importance to the entrepreneurship theory (Lydall 1992, 74-79) while trying to explain economy as a whole. The most widely used model is the model of perfect competition which gives almost no importance to the role of small firms. This theory is built on the assumption that individual firms are so small that their decision-making does not affect the prices at all (Mankiw 2003, 46). Lydall (1992) challenges this classic approach and brings entrepreneurship theory as an alternative to explain the economy. He argues that perfect competition cannot be a sound explanation of economic activity because of three reasons (Lydall 1992, 1-2). Firstly, this model treats technological development as a given, whereas Lydall argues the contrary. He claims that scientific innovations are applied in the production process not naturally, but by the initiative of individual entrepreneurs. And this leads to technological advancement. He argues that if it was not true then the Soviets, which had advanced in science a lot, would have a more developed economy than the Western free markets. Secondly, the theory of perfect competition heavily relies on the existence of perfect

information, whereas in the real life it is practically impossible to achieve that. And respectively the price adjustment does not take place as fast as it is depicted in the supply and demand graph. And finally, Lydall claims that capital and labour do not come together naturally. There is again an initiator of this process who is called an *entrepreneur* (ibid). The author argues that the societies which do not provide freedom to entrepreneurship usually stagnate and lag behind the development (Lydall 1992, 79). Consequently, the individuals who take the initiative and perform the economic activity are not less important than John Smith's "invisible hand" which is considered to clear the market (Narveson 2003, 201). Small business is a gateway for an entrepreneur to enter a marketplace. That is why this sector must be effective and well-functioning at a maximum level to ensure that anybody with brilliant business ideas could launch his/her business and run it without any barrier.

The key international organizations working in the field of development such as WB, IFAD, ILO and UNIDO regard small-scale production of great importance while drawing up their research and activity agenda (Romijn 1991). Some governments understand the importance of this sector more seriously than the others. For instance, in India, beginning from 2007 there is an especially dedicated Ministry of Micro, Small and Medium Enterprises (MMSME 2006, 1). Globally, this sector contributes to heterogeneous development and provides large number of *new job opportunities*. In India, SME sector grew at faster rate as opposed to the economy as a whole providing job opportunities for 31 million people (ibid). Large amount of new working places helps not only to fight unemployment but also generates vast amount of *taxes* for a state budget. Finally, SMEs are a very successful tool for achieving *industrialization of rural areas* and *development of agricultural and manufacturing sectors* thus *overcoming geographic imbalances between rural and urban regions* of a country (Uribe-Echevarria 1991, 34). Jeppesen (2005) states that SMEs are crucial for economic development. They contribute to "equitable development, poverty reduction [and] achieving gender equality" (Jeppesen 2005, 465) and "improved socio-economic well-being among the poor" (Jeppesen 2005, 466). Drawing conclusion, Jeppesen highlights that all the above listed benefits can be achieved only in case the economy is liberalized, enabling environment is created and exports are promoted (Jeppesen 2005, 475).

In conclusion, SMEs are very beneficial for equitable development, achieving geographical and gender balance and creating massive work place thus fighting unemployment. On the

other hand, the disadvantage of SMEs is that they are very vulnerable. This sector of economy can survive only in an environment with enabling formal and informal institutions.

## **Chapter 2: Overview of Azerbaijani Economy**

This chapter presents brief overview of Azerbaijani economy focusing predominantly on the natural resources, their effect on the economy, and favourable and unfavorable features of the country's business climate.

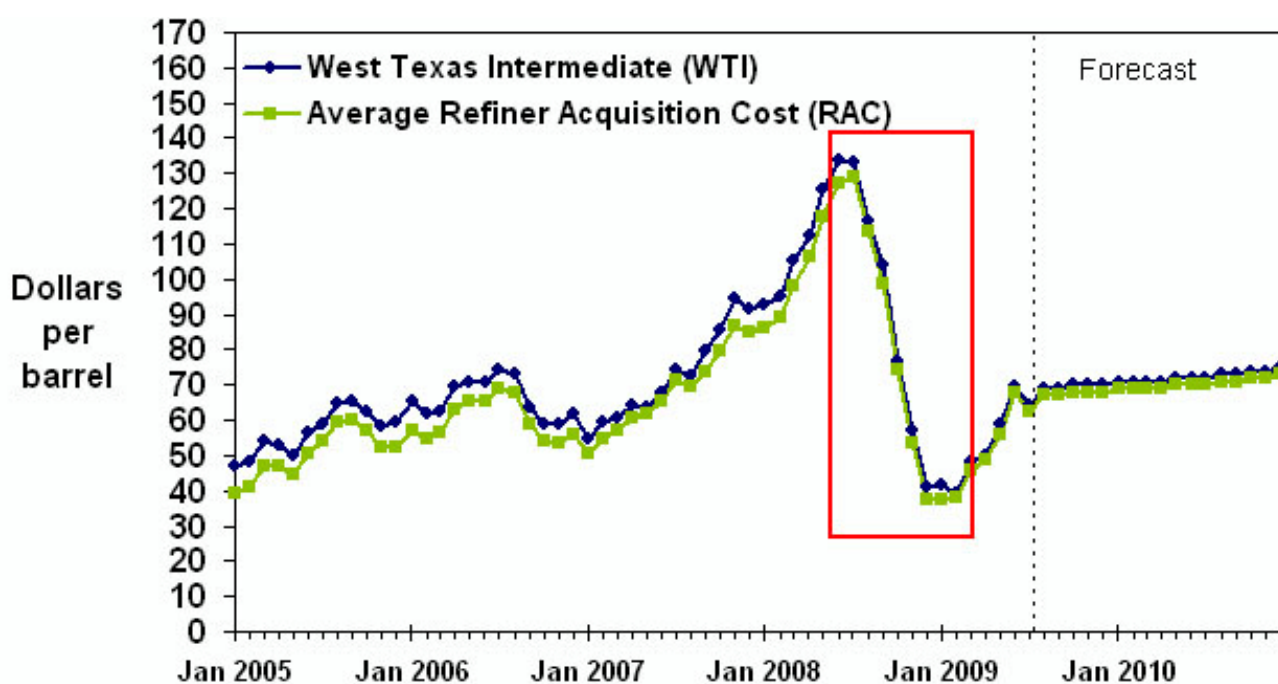
### ***2.1 Strong Dependence on Oil and Gas Revenues***

Azerbaijan is a country with rich energy resources. Industrial production of oil and gas started back in Soviet era. After gaining independence in 1991, Azerbaijani natural resources attracted the attention of the major energy producing companies from Europe and the USA. In September 1994, the first international contract was signed with 11 global energy companies such as Amoco, BP, McDermott, UNOCAL, SOCAR, LUKOIL, Statoil, Exxon, Turkish Petroleum, Pensoil, Itochu, Remco and Delta on exploitation of Azeri-Chirag-Guneshli oil field (Azerbaijan.az 2009, 1). As a result, oil revenues started flooding into the country. After the start of the operation of the Baku-Tbilisi-Ceyhan pipeline in 2006, the oil revenues grew even more and made Azerbaijan the fastest growing economy in the world with 35% of real GDP growth (EBRD 2007, 6).

This kind of commodity driven growth contributes to inflow of vast amount of foreign exchange into the country which results in appreciation of the national currency (Mahmudov 2002, 21). The national currency appreciated by 6.1% in 2005, 5.4% in 2006, and 3.4% in 2007 (TDS 2009, 1). Appreciation of national currency makes in-house production very high-cost and weakens competitiveness of the non-oil sector. As a result number of firms operating in the non-oil sector, as well as SMEs decrease. As a result, diminishing numbers of small businesses is observed in the private sector. For instance, according to the State Statistical Committee of the Republic of Azerbaijan, in 2000 the number of operating small enterprises was 24, 254. In 2007, this number was 13, 465 (2008, 1) which is more than a 55% decrease. The same source reports the decrease in the number of private owners in agriculture from 3248 to 2488 between 2000 and 2007 (ibid). Consequently, Azerbaijan's economy becomes vulnerable to Dutch Disease. Overall, the country's economy grows, but in an unsustainable mode.

Currently, Azerbaijan's economy is very dependent on oil and gas production which is getting even more severe. As the non-oil sector becomes less competitive and less productive, its share in exports also shrinks. According to Economic Intelligence Unit, in 2008 oil products comprised 97.1% of principal exports (EIU 2009, 19), whereas in 2006 this figure was 84.6% (EIU 2008, 20). In the same year, oil production comprised more than 50% of GDP (US Department of State 2008). Petrodollar comprise the main part of state budget's revenues. In 2008, when the budget for 2009, 62% of which is coming from oil and gas revenues, was approved by Parliament, the price of oil was forecasted to be \$70 per barrel (Euraasianet 2008). Starting form July 2008, the price of oil started to drop dramatically from its peak \$147 and reached about 30\$ per barrel in December 2008 (Energy Information Administration 2009). The below chart demonstrates the serious decline of oil prices during the second half of 2008. This severe fluctuation of prices makes the budget vulnerable to huge budget deficit.

**Figure 1: Crude Oil Prices, Short-Term Energy Outlook, August 2009**



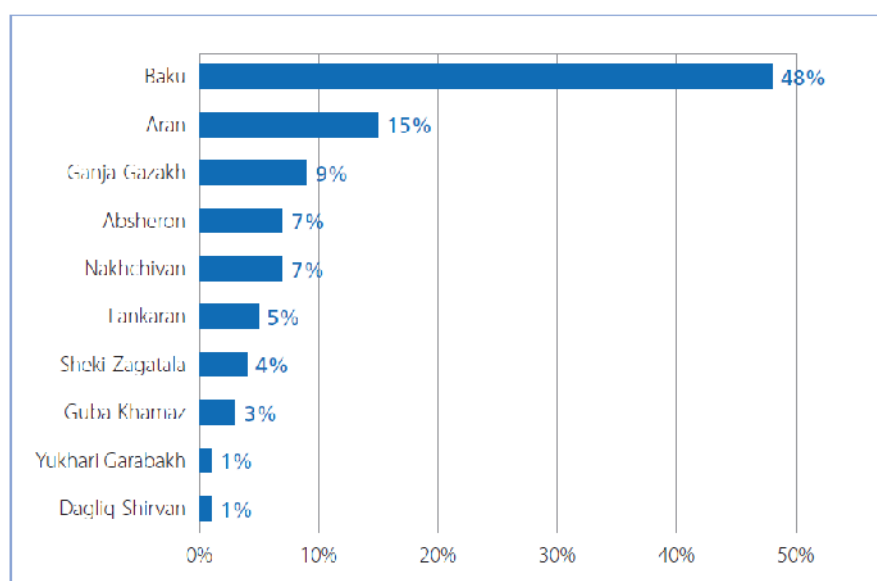
*Source: Energy Information Administration, 2009*

In order to ensure sustainable management of the oil revenues and to preserve them for future generations of country, and extra-budgetary fund – the State Oil Fund of the Republic of

Azerbaijan (SOFAZ) was established in 1999 (SOFAZ (a) 2009, 1). All revenues coming from oil and gas directly go to this stabilization fund. Those revenues are invested overseas. As of April 2008, \$3.34 billion was accumulated as international reserves of the fund. Currently, essential part of the SOFAZ resources is spent to cover government expenditure. For instance, in 2008, the government spending increased by 80% compared to 2007; the main increase was made in military, social and capital spending. Big proportion of this was covered by SOFAZ (TDS 2009, 1). In 2009, 40% of the revenues of SOFAZ were channeled to the state budget (US Department of State. 2008, 1). The main problem with SOFAZ is that it lacks independence in its activity. It is under the subordinate of the president of Azerbaijan. The president appoints the head and the council of the fund (Aliyev 2009, 1). The annual budget of the fund is also approved by the president (SOFAZ (b) 2009, 1). The revenues of a fund which are supposed to protect today's resources for future generations are being used in present. It is obvious that using capital revenue to cover recurrent expenditure of government is not sustainable in the long term.

Oil and gas industry is mainly located in the Absheron Peninsula, where the capital Baku is located, and in the Azerbaijani sector of the Caspian sea (See Appendix 1). Consequently, other regions which do not have oil resources, suffer from unemployment, poor infrastructure and deteriorating socio-economic situation. Large numbers of the population in these regions, therefore migrate to the capital to get jobs in the oil sector or the service industry in Baku which creates huge imbalance between capital Baku and regions. Respectively, Baku and Absheron Peninsula account for 90% of the GDP of the country (Ismayilov 2007, 1).

All these mentioned facts about the character of Azerbaijani economy create unfavorable condition for non-oil sector and results in concentration of the main economic activity in the western part of the country. This situation does not bypass the SME sector, neither. As the capital provides more or less favourable condition for entrepreneurship to function, the SME sector also concentrates there. In 2007, 42% of all SMEs were located in Baku and Absheron economic region (SSCRA 2008, 14). At the same year, those 42% of small firms produced 78% of overall output produced by SMEs (SSCRA 2008, 50). The discrepancy between the capital and regions is deepening even more year by year. The below figure illustrates the same information for 2008. As seen from the chart, almost half of the SMEs are located in Baku.

**Figure 2: Percentage of SMEs by Economic Regions**

*Source: International Finance Corporation 2009*

Azerbaijan has a great agricultural potential. These include vast favourable lands, sufficient amount of sunny days and experience of the rural population. Back in Soviet time Azerbaijan was specialized in agriculture. Guba and Khachmaz regions of Azerbaijan (see Appendix 1) exported processed fruits and vegetables to all member states of USSR. However after the collapse of the union, economic ties with other member states were broken. This resulted in loss of markets which previously imported Azeri goods. Accordingly agricultural sector fell down as well. Presently, agriculture is the sector biggest sector of the economy after oil and gas which employs 45% of the population (Mamedov 2004, 1). Nevertheless, according to the Economic Intelligence Unit's country report on Azerbaijan, agriculture accounts only for 8% in the GDP in spite of its capacity and scale (EIU 2008, 30). The provinces that are primarily engaged in agricultural activity severely lag behind the capital.

## ***2.2 Business Environment in Azerbaijan: The Positive Developments***

During the transition period from planned to market economy, a number of positive institutional changes have taken place in Azerbaijan. Support of international community, establishment of a governmental body for supporting entrepreneurship, reforms carried out by

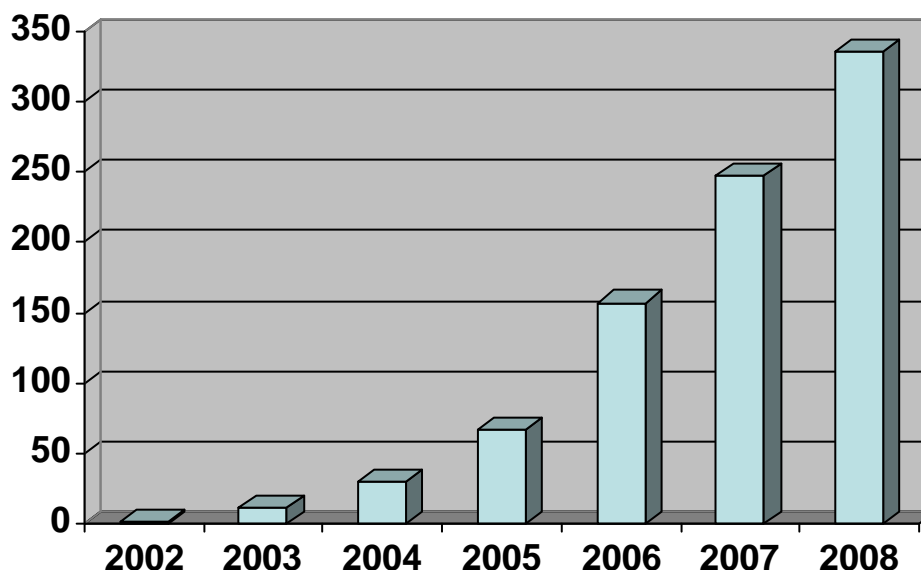


state, as well as unions which create platform for businessmen to cooperate altogether contribute to the creation of enabling environment for entrepreneurship, especially for SMEs.

### **2.2.1 National Fund for Assistance to Entrepreneurship**

After gaining independence in 1991, one the policy priorities for Azerbaijan was the establishment of private sector. For this purpose, the National Fund for Assistance to Entrepreneurship was established in 1992. The fund gives credits at low rates to entrepreneurs from the state budget. The funding for the credits is transferred to the commercial banks which are chosen by the Ministry of Economic Development, Ministry of Finance and Central Bank and then given to entrepreneurs with low interest rates – 7% per annum, for the projects aiming the development of mass media – 6% per annum (National Fund for Assistance to Entrepreneurship (a) 2009 1). Aims and responsibilities of the National Fund for Assistance to Entrepreneurship are as follows: to participate in the activities for the development of entrepreneurship and employment level of the population in Azerbaijan Republic and to render financial assistance to them (National Fund for Assistance to Entrepreneurship 2009 (b) 1). 1). The below chart presents data on the amount of the allocated credit between 2002-2008. Although the fund was established in 1992, it was too active before 2006. Active functioning of the fund took place after 2006 when the country's revenues from oil grew substantially thanks to launch of the BTC pipeline. In 2008, National Fund for Assistance to Entrepreneurship allocated 335.6 million manats to finance 7350 projects (National Fund for Assistance to Entrepreneurship 2009 (c))

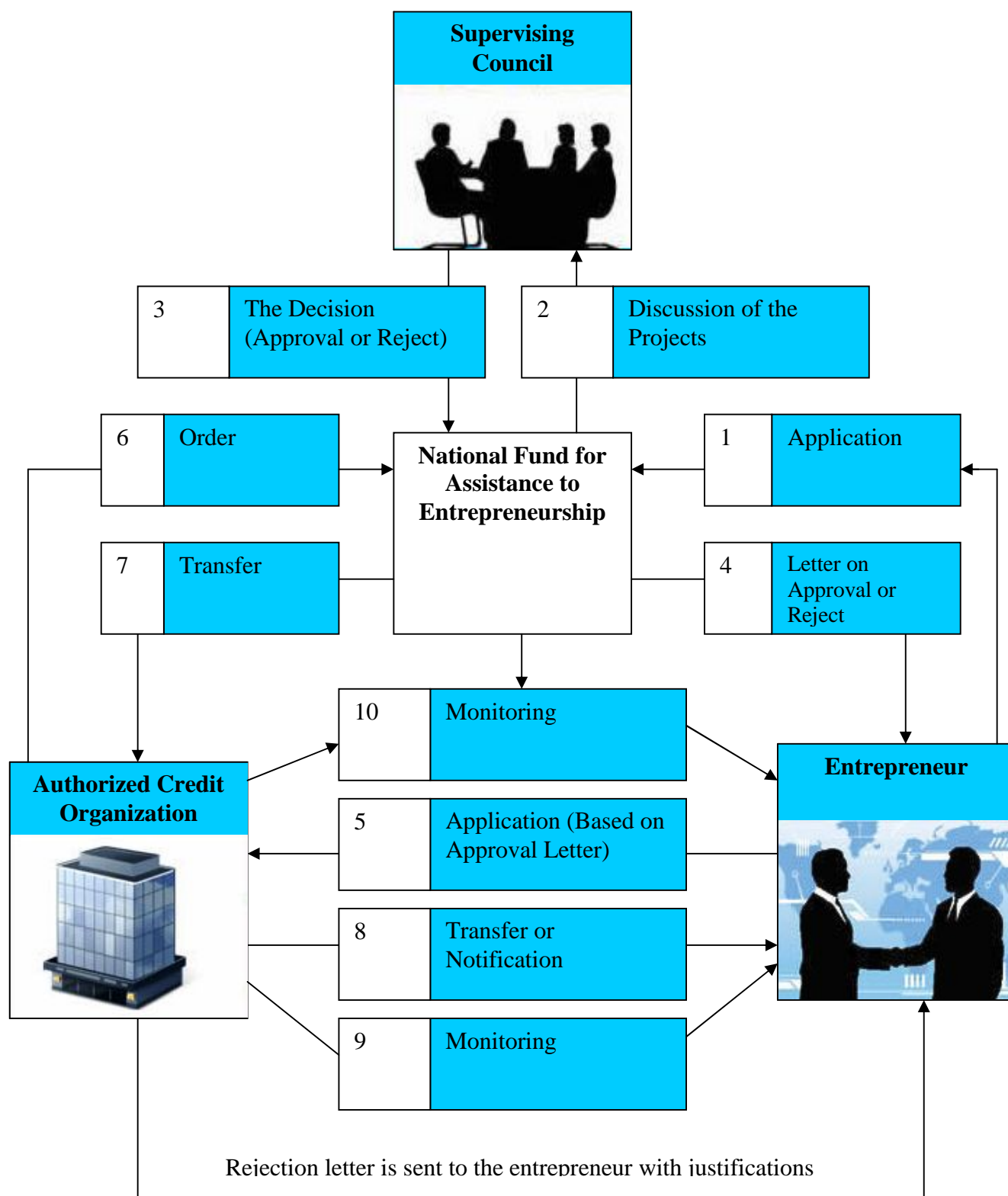
**Figure 3: The Dynamics of Credit Portfolio of the National Fund for Assistance to Entrepreneurship of Azerbaijan Republic (in million manats)**



*Source: National Fund for Assistance to Entrepreneurship (d) 2009*

The below chart depicts the mechanism through which an entrepreneurs acquires credits from the National Fund for Assistance to Entrepreneurship. At the stage one, the initiator – entrepreneur – presents application to the fund depicting his/her business plan. In the fund, this project is discussed by the Supervising Council. Any decision – positive or negative – is communicated to the entrepreneur. In case of positive decision, an entrepreneur gets right to present an application to an authorized credit organization based on the approval letter sent by the fund. After receiving the letter, authorized credit organization presents order to the fund to get the necessary amount. The funding is first transferred from fund to the credit organization and later from the credit organization to the entrepreneur. The usage of the allocated credit is monitored both by the fund and credit organization.

**Figure 4: Activity Scheme of the National Fund for Assistance to Entrepreneurship (except micro credits)**



Source: National Fund for Assistance to Entrepreneurship (e) 2009

### **2.2.2 Single-Window System in Business Registration**

In 2008, the World Bank announced Azerbaijan as the top reformer in its annual Doing Business 2009 report (WB (a) 2009, 1). The main reason of this advancement was the reform carried out by the Ministry of Taxes in business registration (Wordpress 2008, 1). Starting from January 2009, the Ministry has introduced single window system in business registration. This reform was carried out with the support of the International Finance Cooperation (IFC). The coordinator of the IFC for the business assessment in the Commonwealth of Independent Countries, Dina Nikolas stated that the new reform will contribute to the simplification of the business. It will be a great support for the development of SMEs. It will also contribute to the overall business climate of the country (Trend 2008, 1). Four million manat was allocated to the new system from the reserve fund of the president (ibid).

As it is noted by the Minister of Taxes Fazil Mamedov, the new usage of system has reduced the number of business registration procedures three times and registration period – 20 times. Before the reform, an entrepreneur needed to pass 15 procedures and present 33 documents to start a new business. The registration period was 72 days. However, after the application of the new system, three days are enough if all of the necessary documents are presented. The number of all necessary documents is five. Previously, multi-pillar system was creating bureaucratic obstacles. The simplification of the business registration is supposed to solve those problems (Trend 2008, 1). Before implementation of the reform, the best practices of European countries were learnt by the Ministry of Taxes. The single window system of Latvia, along with other European countries, was researched and the best practices were applied in Azerbaijan by the Ministry. The new system saves human resources as well. Previously, 500 government employees were dealing with the registration process; after the change, only 85 employees of the Ministry of Taxes cover this job (ibid).

### 2.2.3 Professional Unions of Entrepreneurs

During the transition period to market economy, professional unions of entrepreneurs came into existence. The main advantage of these organizations is that they create a platform for dialogue and cooperation among entrepreneurs. *National Confederation of Entrepreneurs* (Employers) is the most important union of entrepreneurs in Azerbaijan. The organization was established in 1999 (NCE (a) 2009). NCE is non-profit NGO combining all the entrepreneurs regardless of the domain. The entrepreneurs join the union voluntarily. This union pursues the following goals: along with the government, to protect entrepreneurs, the assets and their gains; in accordance with the state's activity, contribute to the development of market economy; participate in the good governance of labour market; assists its members in any kind of project contributing to the creation of enabling environment; cooperate with government in the related projects; create dialogue between local entrepreneurs and international stakeholders; participate in the drafting of laws on entrepreneurship, study and implementation of the best practices of developed countries (ibid). The Confederation closely cooperates with such international organizations as UNDP, ILO, IOE and World Association of NGOs, International Industrialists and Entrepreneurs Congress, as well as with the analogical unions from Russia, Israel, Poland, Slovakia, Georgia, Greece, Spain, UK, Turkey, Romania and Moldova (NCE (b) 2009). NCE has 36 regional branches all over the country and brings together 3500 entrepreneurship subject (NCE (a) 2009).

*Foundation for Assistance to the Development of Entrepreneurship and Market Economy* is a public union established in 1994 by 12 private companies and banks. The mission of the foundation is to assist the reforms for the development of business climate and transition to the market economy in Azerbaijan. The main activity directions of the foundation are education and consulting new beginner entrepreneurs, organizing conferences and workshops and carrying out research on entrepreneurship (FADEME (a) 2009, 1). Up to date, the foundation has carried large number of projects with the financial assistance of international organizations such as CIPE, Eurasian Foundation, Soros Foundation, EU, UNDP and British Embassy. Within these projects the following activities were carried out:

- Problems of entrepreneurs were researched (1997);
- Educational materials for farmers and businessmen on business registration, firm management, accounting, IT, business planning, advertising, negotiations, pricing,

contracts, remuneration of labour, exports and cooperation were published (1997-1999);

- Twenty nine local newspapers were monitored and businessmen, journalists and economists were interviewed for identifying corruption incidents (1999);
- Book was presented and conference was held on corruption (1999);
- Sixteen main legal statutes were analyzed to identify the loopholes that create favourable environment for corruption (2001);
- For journalists writing on economy, training was held and educational materials on economic development and macroeconomics, modern statistics, indicators of economic development, taxes in Azerbaijan, corporate management was published. (2001);
- Regional conference was held to reveal the development problems of socio-political institutions in the South Caucasus and the book on the same topic was published (2001);
- Training was held for NGO managers and accountants and an educational material was published about the basics of NGOs (2002);
- A book was published on corporate ethics (2003);
- The Coalition of Azerbaijan Business Association was created to support the government reforms (2003);
- Regional project was implemented on the research of the transparency problems of customs services of the South Caucasus countries (2003-2004);
- The new anti-corruption law was analyzed and comments on it were published (2004);
- Educational material was published on the basis of public unions (2004);
- Within the project called “Oil revenues: the problems that Azerbaijan might confront”, round tables and sociological surveys were held and information bulletins were published (2006-2007);
- Quarterly bulletins were published called “Ecological costs of energy projects” (2007-2008) (FADEME (b) 2009, 1).

As a final point, the advantage of this kind of professional unions is that they contribute to creation of enabling environment for SMEs and increase civic participation in reforming the private sector.

## 2.2.4 International Non-governmental Aid to SME Sector

The international community has been urging Azerbaijan to make a better use of its oil and gas windfalls, diversify the economy and achieve development of SMEs in the non-oil sector. For instance, EBRD reckons that “developing the non-oil and gas sectors of the economy to ensure poverty alleviation and sustainable development throughout the country including rural areas and cities outside the capital through long-term economic policies and incentive schemes” is one of the most important challenges for Azerbaijan (EBRD 2007, 7). For this purpose, a number of key organizations working in the field of development have implemented technical assistance programs in Azerbaijan to assist the SME sector.

*Asian Development Bank* in cooperation with Bank of Baku launched Credit to SME program in 2007 (Asian Development Bank 2007, 1). Within the project, \$6 million was allocated to financing SMEs. The aim of the project is improve access to finance of SMEs which is very problematic presently, assist development of private and banking sectors, and contribute to the sustainable development of Azerbaijan (ibid).

*BP Azerbaijan*, operator of the major production sharing agreement in Azerbaijan, has implemented a number of projects contributing to good governance and creation of enabling environment for small businesses. Enhancing Access to Finance for Local Businesses is the project of the company in cooperation with EBRD (BP Azerbaijan (a) 2006, 1). Within the project BP Azerbaijan has allocated \$5.25 million to provide micro finance to SMEs. Technical assistance is also rendered to SMEs along with micro credits. The aim of the project is to support the development of the private sector of Azerbaijan (ibid).

Another project of BP Azerbaijan is Access to Finance Programme implemented in Cooperation with IFC and Micro Finance Bank of Azerbaijan (MFBA) (BP Azerbaijan (b) 2007, 1). Within the project, which was launched in 2007, \$1 million was allocated by the company; respectively \$2.3 million was allocated by IFC and MFBA. The project provides micro finance to small businesses in Ganja, Kazakh and Mingechevir regions of Azerbaijan (See Appendix 1). The project aims to create new job opportunities in the regions and improve socio-economic condition of the regions (ibid).

In 1998, **EBRD** started \$20 million project which aimed financing SME sector and contribute to liquidity provision of Azeri banks (EBRD 1998, 1). Within the project, the credits were provided to entrepreneurs through the state-owned International Bank of Azerbaijan and other private banks. Charles Frank, president of the EBRD noted that aim of the project was to assist to job cremation, development and macroeconomic stability in Azerbaijan (ibid).

Along with the discussed project, there are a large number of international aid organization in Azerbaijan working in the area of good governance and development. Below table present the list of those organizations.

**Table 2: International NGOs in Azerbaijan Working in the Field of Good Governance and Development**

<b>Name</b>	<b>Focus</b>	<b>Head Quarters</b>
ACDI/VOVA	International development; technical assistance in agriculture; business	USA
Citizens Democracy Corps	Support to SMEs	USA
Counterpart International	Humanitarian Assistance/ Relief; Organizational Development; Community Development; Relief and Food Security; Environment and Natural Resources; SME Development	USA
FINCA – Foundation of International Community Assistance	Community development; promotion of local crafts producers; village banks.	USA
Friedrich-Naumann Foundation	Training in ideas of liberty and freedom; development of market economies; political education.	Germany
Hearth to Hearth International	Relief & Development; humanitarian assistance.	USA
Initiative for Social Action and Renewal in Eurasia – ISAR	Community development; social development; civil society development; grant-making.	USA
International Fertilizer	Food security; agricultural productivity;	USA



Development Center	agricultural marketing expertise.	
International Foundation for Elections Systems	Democracy; elections; rule of law, governance; civil society.	USA
Lutheran World Relief	Disaster relief; health; agriculture; work with communities.	USA
Mercy-USA for Aid and Development	Relief and development; improving health; promoting educational and economic growth.	USA
Microfinance Center for Central and Eastern Europe and the Newly Independent States	Support to microfinance institutions; focus on poverty alleviation, employment; policy and advocacy work.	Poland
National Democratic Institute	Democracy; citizen participation; government accountability.	USA
National Endowment for Democracy	Democracy; human rights; grant-making; NGOs capacity-building.	USA
Relief International	Humanitarian/emergency relief; community development.	USA
Soros Foundation/Open Society Institute	Promotion of open societies worldwide/ Democracy/civil society.	USA
Transparency International	Combating corruption.	International Secretariat in Germany
World Vision International	Christian Relief Organization, community development.	USA

*Source: World Bank (b), 2009*

Drawing conclusion, the activity of these organizations brings best practices of Western democracies in the field of governance and development, and contribute to the creation of the enabling environment of private sector and SMEs as well.

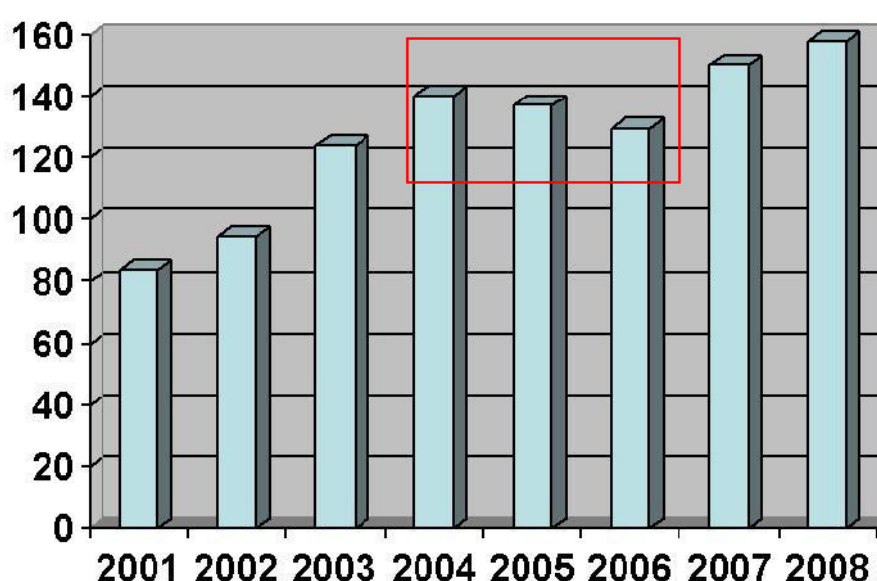
## 2.3 The Main Obstacles for the Development of SMEs

Along with positive developments there are a large number of hindrances for an entrepreneur starting up and running an SME. Ineffective formal and informal institutions, and poor access to international markets and finance are the main obstacles confronted by SMEs.

### 2.3.1 Corruption and Ineffective Governance

There are a large number of informal institutions that hinder the development of SME sector. **Corruption** is one of the main ones of them. Corruption is a serious problem of Azerbaijan. In the Corruption Perception Index of Transparency International Azerbaijan is ranked 158<sup>th</sup> (Transparency International (a) 2008, 1). The neighboring countries from Caucasus perform much better than Azerbaijan: Georgia is 67<sup>th</sup>, and Armenia is 109<sup>th</sup>. Although Azerbaijan is a middle income country, it shares its 158<sup>th</sup> position with such underdeveloped countries as Angola, Burundi, Congo, Gambia, Guineas-Bissau (ibid). Below chart, presents CPI ranking of Azerbaijan between 2001-2008. As seen from the chart, Azerbaijan's position is worsening year by year. There is a minor positive change between 2004-2006; however that is again followed by worsening performance in 2007

Figure 5: Corruption Perception Index of Azerbaijan, 2001-2008



Source: Transparency International (b) 2009

The positive change in 2004 coincides with the approval of the Law on Combating Corruption which for the first time contained definition of public corruption (Commission on Combating Corruption of the Republic of Azerbaijan 2004, 1). The Law specified who might be subject to such criminal behavior, established measures to be taken to fight corruption and possible punishments for corrupt behaviors. According to the statute, a Commission on Combating Corruption of the Republic of Azerbaijan was founded. The Commission has 15 members. The members are appointed by the President, Parliament and Constitutional Court of Azerbaijan Republic – 5 members by each branch of the government (ibid). Nevertheless, the fact that a body which fights corruption in the public sector is part of the government sets questions regarding objectiveness and accountability of this body. There is no any representative of non-governmental and international anticorruption organizations, and civil society among the members of the commission.

Corruption, which is harming the entire socio-economic activity of the state, does not bypass the SME sector, neither. An entrepreneur needs to bribe a public official such as representatives of Sanitation and Epidemiology Station, Territorial authority, the Service for Fire Protection, Trade Department, Insurance Office and Ministry of the Taxes almost on the daily basis in order to survive in the market. According to the Entrepreneurship Development Foundation, corruption is the main barrier impeding business growth in Azerbaijan (CIPE 1998, 19).

For SME corruption is harder barrier to pass than for a big multinational company. Having large financial resources, big companies can afford bribing state official and run their daily businesses. However, for SME with its limited budget, this is not that easy. Business of SME, which has to bribe public officials in its every step, becomes non-profitable at the end of the day. Finally, this may even make this loss making firm exit the market.

***Weakness of rule of law*** is another barrier impeding the development of small-scale enterprises. As reported by the US Department of State's Azerbaijan country profile, despite of Azerbaijani governments activity in carrying out reforms and liberalizing the trade, inefficient administration do not let this reforms bring positive changes (2009). "... Azerbaijan is still plagued by an arbitrary tax and customs administration, a weak court system, monopolistic regulation of the market, and corruption" (ibid). ***Informal networks*** such as cronyism and nepotism is an inevitable reality of the private sector in Azerbaijan. The entrepreneurs who have personal ties with government official are more advantaged compared to the ones

operating on their own (US Commercial Service 2008, 34). In fact, this phenomenon is the distinctive feature of the transition economies. Aidis argues that informal networks are crucial for operating in transition economies and those enterprises in emerging markets have to combat with large government intervention (Aidis 2002, 3). Finally, *monopolies* are one of the main informal institution that disables activity of entrepreneurs (US Commercial Service 2008, 34). Entrepreneurs mostly suffer from monopolization while trying to import foreign goods into Azeri market. The next sub-section will discuss the monopolization as a barrier for imports in more details.

### 2.3.2 Access to Foreign Markets

The volume of *exports* of Azerbaijan is increasing year by year. However, that is due to rising oil and gas production. As it was noted earlier, oil products comprise 97.1% of principal exports (EIU 2008, 30). Exporting single product puts Azerbaijan into risky position. Furthermore, by exporting crude oil, the country loses its potential profit from exporting refined oil and ready petrochemicals. The reason why the portion of non-oil products is so tiny in exports is that high cost in-house production makes it very difficult for firms to produce and later export their products. The SMEs with their modest budget suffer from this problem even more. Only 2% of entrepreneurs surveyed by International Finance Corporation stated that they export their goods and services (IFC 2009, 141). The reasons for this are high cost in-house production and expensive and time consuming procedures. The table below presents comparison of time and resources needed to engage in exporting activity between Azerbaijan and Georgia. As compared to Georgia, an Azerbaijani entrepreneur needs to pay four times and wait 2.2 time more in order to be able to export his/her goods.

**Table 3: A Comparison of the Procedures Necessary to Export Standardized Cargo of Goods in Azerbaijan and Georgia**

Nature of Export Procedures (2008)	Duration (days)		Cost (in USD)	
	Azerbaijan	Georgia	Azerbaijan	Georgia
Document Preparation	28	5	150	255
Customs clearance and technical control	7	2	250	140

Ports and terminal handling	5	2	375	235
Inland transportation and handling	8	3	2 300	750
<b>Totals</b>	<b>48</b>	<b>12</b>	<b>3 075</b>	<b>1 380</b>

*Source: International Finance Corporation, 2009*

Due to underdevelopment, majority of Azerbaijan's exports are semi or unprocessed goods that does not meet international standards. Absence of international certification of most of Azerbaijani goods makes it impossible for entrepreneur to export those products to international markets (IFC 2009, 157).

In the *imports* side, strong monopolies and ineffective customs system create the biggest obstacle to entrepreneurs. Importing each product is the domain of certain oligarchs and state officials, and bringing those products to Azerbaijan without their permission is practically impossible (BBC Monitoring Service 2009). On the papers Azerbaijani customs law is in accordance with the international standards. However, in practice, this system is the main obstacle for importing entrepreneurs along with strong monopolization. Economist Rasim Huseynov notes:

“... Azerbaijani legislation is mainly directed at modernization, but in real life the contrary is taking place. Instead of applying official customs duties and fees the customs registration is being conducted visually and in cash. The customs officer may look at the goods from a window and say how much you need to pay him for registration” (BBC Monitoring Service 2009).

Although the laws and regulations are modernized, this does not lead to positive changes. The reason is the transplant effect of those laws. Small entrepreneurs do not have time and resources to follow every change in the law. As a result they are not thoroughly informed about their rights and procedures they need to follow. This gives an opportunity to corrupt state officials to manipulate the laws and extort the entrepreneurs (IFC 2009, 150).

As in case of exports, high cost and time consuming procedures again create hardships for imports. The below table presents comparison of time and resources needed to engage in importing activity between Azerbaijan and Georgia. As compared to Georgia, an Azerbaijani

entrepreneur needs to pay again four times and wait 2.5 time more in order to able to import goods into Azeri market.

**Table 4: A Comparison of the Procedures Necessary to Import Standardized Cargo of Goods in Azerbaijan and Georgia**

Nature of Export Procedures (2008)	Duration (days)		Cost (in USD)	
	Azerbaijan	Georgia	Azerbaijan	Georgia
Document Preparation	28	8	170	255
Customs clearance and technical control	8	2	275	150
Ports and terminal handling	6	2	375	235
Inland transportation and handling	14	2	2 600	700
<b>Totals</b>	<b>56</b>	<b>14</b>	<b>3 420</b>	<b>1 340</b>

*Source: International Finance Corporation, 2009*

Up-to-date, Azerbaijan is not member of World Trade Organization which is an indicator that the country's foreign trade is not liberalized. Again comparing the county with its neighbors shows that Azerbaijan lagged behind them: Georgia joined WTO in 2000, and Armenia in 2003 (WTO 2008, 1). Application for membership is presented to the organization in 1997, and form 1997 observer status is given to Azerbaijan (WTO 2009, 1). Currently Azerbaijan is carrying out reforms on modernization and standardization of the economy (Azerbaijan and WTO 2009,1). International community gives a great importance to this process. For instance, USAID has allocated \$3.7 million to capacity building in the sphere of trade (USAID 2007, 1).

### **2.3.3 Access to Finance**

Poor access to finance is one of the problems for Azerbaijani SMEs. Due to poor financing SMEs are not able to use their potential in the maximum level. Despite of comprising 80% of all the firms, SMEs account for only 10% of the GDP (ADB 2007, 1). 90% of the SMEs finance their activity either by themselves or by private borrowing (IFC 2009, 9). The main

reasons for this are unfavorable conditions – high interest rates and collaterals and short maturity period – that bank offer to SMEs (IFC 2009, 18).

According to Islam Ibrahimov, head of the department for the Development of Rural Areas and Entrepreneurship of the Ministry of Agriculture, this problem is more severe for producers of agricultural products (Day.az 2009). As a result, underdevelopment is observed in the agricultural sector of the country. Although the country has strong agricultural potential, most of the food products are imported from overseas. Food products comprise 15.8% of overall imports (EIU 2009).

## Chapter 3: Practical Application

In Chapter 1, the SME sector was discussed and its main benefits of this sector were summarized. The main findings were that SMEs are beneficial for creating massive work places, achieving rural development thus fighting geographical imbalances, reaching equitable development, socio-economic well-being and macroeconomic stability. In Chapter 2 analyzed economy of today's Azerbaijan. Heavy dependence on oil and gas revenues, underdevelopment and unemployment in the rural areas were identified as problem areas. Combining this two broad picture we can see that, development of SMEs can be very beneficial for Azerbaijan to diversification its economy and to achieve sustainable economic development. For that, enabling business environment must be established which requires a number of institutional reforms. In this Chapter a number of policy recommendations are provided stemming from the experience of developed countries. Implementation of these recommendations can contribute to the creation of such favourable business climate.

### *3.1 Reforming Formal and Non-formal Institutions*

Despite many positive developments, there many formal and informal institutions in Azerbaijan that need to be further reformed in order to achieve favourable business and investment climate.

- Corruption should be eliminated in order to achieve development in the private sector because it creates hardship not only to the local SMEs, but also impedes attraction of FDI;
- Disabling informal institutions such as monopolies, informal networks and arbitrary taxes should be abolished. Otherwise, no any legal reform would make positive change;
- In order prevent transplant effect of the legal reforms, entrepreneurs should be educated about this reforms by legal intermediaries;



### ***3.2 Supporting Foreign Trade: The World Practice***

As noted earlier, one of the main obstacles confronted by SMEs in Azerbaijan is access to foreign markets. Consequently, the share of non-oil products comprises only 2.9% of overall exports (EIU 2009, 19). In the long run this puts the country into a very dangerous situation taking into account the fact that oil production is expected to decline by 2025 (EC 2007, 7). To improve this non-sustainable picture, the government needs to support in-house production and exports. Access to foreign markets and liberal trade are among the most important factors that gives entrepreneurs an incentive to increase production and scale of their business. Globally, especially in EU countries and in the US, governments render assistance to their companies by financing their exports and insuring risky deals which eases burden of small firms greatly. Learning from the best practices of developed countries the following actions needs to be taken:

- Export finance and export finance insurance model should be introduces; Export financing is a wide spread tool utilized to boost exports of a country. Among OECD countries, Agreement on Guidelines for Officially Supported Export Credits is the main international document regulating this process. It is a “Gentleman’s Agreement” binding the parties which are member countries of OECD. The agreement states the fundamental rules of export financing among the parties (OECD a. 2009).
- Export finance insurance is taking away insolvency and political the risk of the deal from the exporter (MEHIB 2009, 1). This mechanism is also widely used in countries as USA, Indonesia, Israel, Spain Canada, Australia, Germany, Denmark, Sweden, Belgium, China and so on (Berne Union 2009).
- Accession process to WTO must be accelerated. It will contribute to liberalization and transparency in foreign trade and eliminate monopolies that currently control non-oil imports. WTO accession will also create new markets for Azerbaijani goods and services. Finally, Azerbaijan’s accession to WTO will be a sign for investors that the counties trade is liberal which will contribute to inflow if FDI from abroad (USAID 2007, 1).

### ***3.3 Enhancing Access to Finance***

Enhancing access to finance of the entrepreneurs is one of the main actions to be taken by Azerbaijani government. After gaining independence in 1991, Azerbaijan started attracting Foreign Direct Investment (FDI) from the US and European countries. The country received more FDI per capita than any post Soviet country. However, this investment was mainly directed to oil and gas industry (Laurens 2002, 1). The main reason why the investor restrain from investing is the corruption in the public sector (ibid). Obviously, the main obstacles faced by the SMEs – weak political and economic institutions, poor access to foreign markets and to finance – are interconnected among themselves. So, in order to attract FDI to non-oil sector, Azerbaijani government needs to fight corruption and eliminate such informal institutions as monopolies and cronyism.

## Conclusion

Natural resources are 'blessing' for a nation. However, if managed in a wrong way it can be a 'curse'. It can destroy the real economy by decreasing the competitiveness of non-oil sector. It can also become a threat for democracy because when there is a source of revenue for government activity besides taxes, the government loses accountability to its people. For Azerbaijan now it is a very responsible phase of history as oil production is expected to reach its peak in 2010 then decline up until it fishes in 2025 (EC 2006, 12). It can reform its political and economic institutions and make maximum use of its oil windfall or repeat the sad history of oil exporting countries as Nigeria Turkmenistan, and Venezuela. That is why, the contemporary history of the county is of great importance. It is turning corner where Azerbaijan where the choice of the right path is crucial.

The present research analyzed current situation of Azerbaijani economy and identified its main problem areas which are strong dependence of economy on oil revenue, underdevelopment of non-oil sector, and geographical imbalances between the capital Baku and the regions. The benefits of SME sectors were also summarized which are creation massive work places, achievement of rural development thus fighting geographical imbalances, reaching equitable development, socio-economic well-being and macroeconomic stability. Matching the problems of Azerbaijan's economy and the remedies that SMEs can provide, the conclusion is that this sector is the most suitable way to achieving development of Azerbaijan's economy. Finally the relevant policy recommendations are provided based on the best practices of developed countries.

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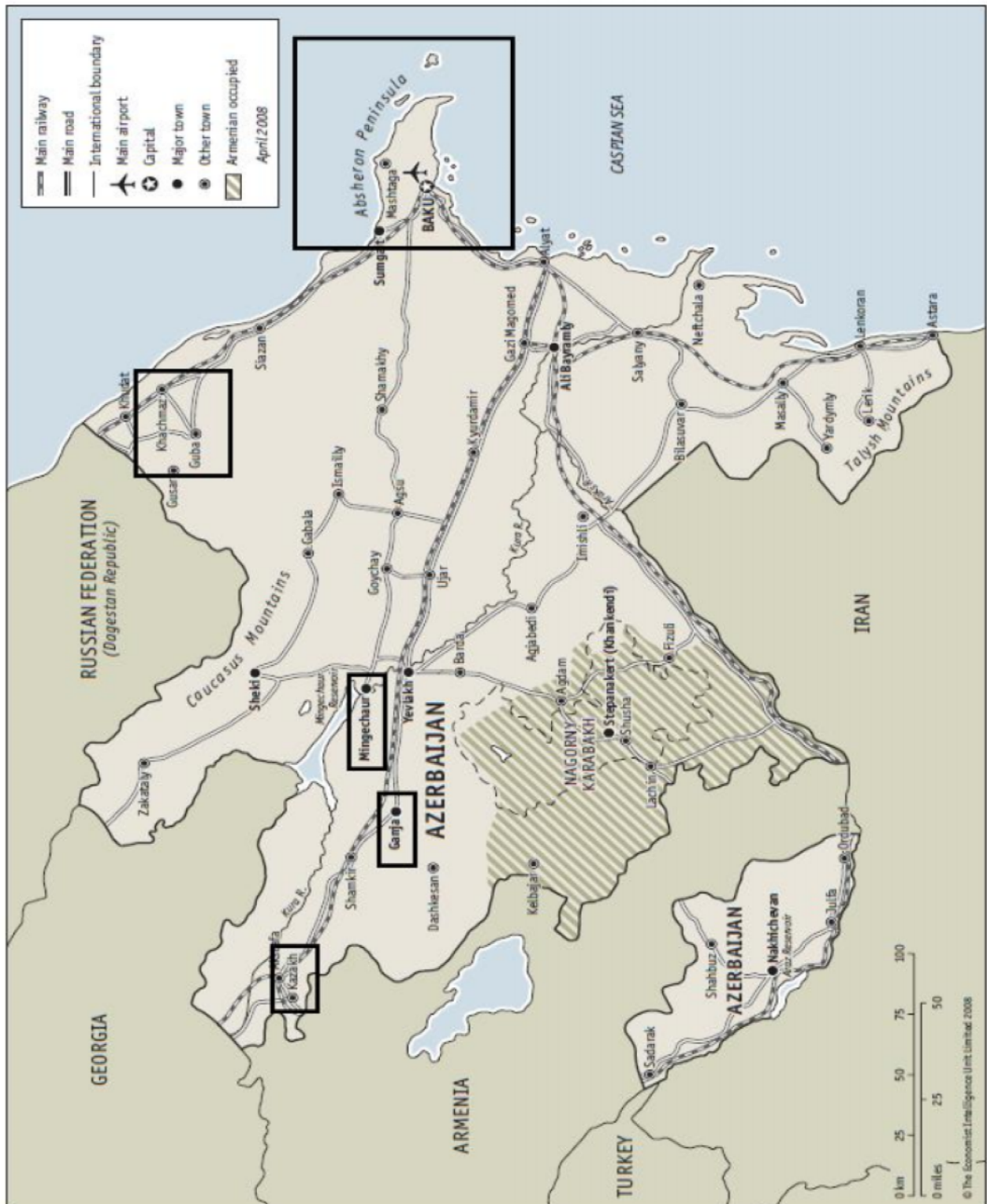
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## Appendix 1 Map of Republic of Azerbaijan



Source: Economic Intelligence Unit: Azerbaijan Country Profile, 2008