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Foreign direct investment (FDI) in the non-oil sector in Azerbaijan, opportunities and obstacles: The case of the impact of FDIs on small and medium-sized organizations

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ABSTRACT

Foreign direct investment (FDI) is widely recognized as a crucial driver of economic growth, and the non-oil sector of Azerbaijan has recently experienced a significant influx of FDI. Small and medium-sized enterprises (SMEs) in the non-oil sector play a vital role in Azerbaijan's economy, but little is known about the impact of FDI on these enterprises. This study aims to investigate the relationship between FDI and non-oil SMEs in Azerbaijan from 2010 to 2019, using descriptive approach.

The study seeks to answer two research questions: What is the impact of FDI on Azerbaijan's non-oil SME sector, and how does FDI affect the performance of small and medium-sized enterprises in Azerbaijan's non-oil economy? Data was collected from government papers, scholarly journals, and online databases. The results of the descriptive analysis will be used to assess the influence of FDI on Azerbaijan's non-oil SME sector. The study will contribute to the existing literature on the impact of FDI on Azerbaijan's non-oil SME sector by examining the opportunities and barriers faced by SMEs and exploring the role FDI may play in addressing these challenges. The research will offer valuable insights into the issues faced by SMEs in the non-oil sector in Azerbaijan and the potential benefits of FDI for the development and growth of these enterprises.

Keywords: SME, economy, GDP, non-oil sector, growth, FDI

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Introduction

Foreign Direct Investment (FDI) has long been seen as a significant role in the expansion and growth of global economies. The non-oil sector in Azerbaijan has also received a substantial amount of FDI in recent years. Small and Medium-Sized Enterprises (SMEs) play a crucial role in the growth of the non-oil sector and considerably contribute to the Azerbaijani economy. However, the effect of FDI on non-oil industry SMBs is poorly studied. Foreign direct investment can provide various benefits to non-oil sector SMEs, including access to new markets, new technologies, and enhanced management practices. FDI can also bring capital and technical experience to the local economy, which can contribute to economic expansion and employment creation.

FDI can also boost the competitiveness of non-oil sector small and medium-sized enterprises (SMEs) by exposing them to new technology, improved management practices, and wider markets. This increased competitiveness can lead to increased production, efficiency, and profitability, so contributing to the long-term success and viability of SMEs. Additionally, FDI can boost innovation and entrepreneurship in non-oil sectors. By bringing new products, processes, and technologies, FDI can stimulate the development of new and innovative products and services by domestic companies. This can result in enhanced competitiveness, more economic growth, and better living conditions for the local population.

Current thesis examines the influence of foreign direct investment on small and medium-sized enterprises in the non-oil sector of Azerbaijan. The research analyzes the relationship between FDI and SMEs in the non-oil industry using descriptive approaches. This thesis addresses the following research questions: What is the impact of FDI on Azerbaijan's non-oil SME sector? How does the presence of FDI in Azerbaijan's non-oil economy affect the performance of small and medium-sized enterprises? Author collected data from a variety of sources, including government papers, scholarly journals, and online databases.

This study will make a significant contribution to the literature on the impact of FDI on Azerbaijan's non-oil SME sector. This research will provide insights into the issues encountered by SMEs and the role that FDI may play in addressing these challenges by examining the opportunities and barriers faced by SMEs in the non-oil sector in Azerbaijan.

Chapter 1. Theoretical frameworks of FDI and SMEs

1.1 The concept of foreign direct investment

Foreign Direct Investments (FDI) can be defined as companies that started their operations in any country and moved their field of activity to the borders of different countries to establish a facility from scratch, purchase an established facility or establish partnerships in those countries for the purpose of profit maximization. With the beginning of international liberalization movements in the economic field, the rate of liberalization and diffusion in foreign capital movements began to increase in the 1980s. As the importance and impact of liberal economic policies began to be felt, international markets and production began to gain momentum. It was seen that this situation contributed to the understanding of the importance of FDI and to increase its volume on a world scale. Today, thanks to the globalization process, it is known that FDI is at the forefront as an important resource for the removal of borders between countries and especially for developing countries to meet their capital needs. Since FDIs have a positive impact on both employment and technology in the invested country, especially developing countries concentrate on FDI in terms of providing resources.[1]

Understanding the importance of FDIs has led countries to start developing strategies and policies that will increase the attractiveness of current market environments in order to attract these investments to their borders. Investing activity is the sum of all the actions of investors related to investment and realization. Investing in financial assets includes securities and other financial assets, namely loans, other regulatory funds and other investments.[2] They combine investments in the country and foreign financial assets. Sufficient economic reserves and production factors are needed for the uninterrupted continuation of every economic process. Creating business buildings and equipment for entrepreneurial activity will take time and money. Therefore, an entrepreneur first creates the factors of production by increasing the costs of obtaining resources to start any economic activity. Therefore, in the economy, there is an obligation to invest in the production process and as a result the projected income is obtained. As is known, there is a time difference

[1] Denisia, V. (2010). Foreign direct investment theories: An overview of the main FDI theories. European journal of interdisciplinary studies, (3).

[2] Miyamoto, K. (2003). Human capital formation and foreign direct investment in developing countries. Organisation for Economic Co-operation and Development (OECD) Paper, (211).

between the formation of the production process in the economy, the funds invested in raw materials, the supply of materials and the beginning of the production process. Therefore, additional funds are needed to constantly repeat the economic process and ensure the continuity of production. Increasing the volume of production through capital investment can be called investment.

Foreign Direct Investment is an investment made abroad by establishing a new production facility or acquiring a minimum share of an already existing company. A direct investor can be an individual, a firm, a multinational corporation (MNC), a financial institution, or a government. FDI is the core of MNCs as some of them are made abroad. In addition, MNCs (Multinational Corporations) are a major source of FDI, as much as ninety-five percent of world FDI flows. Unlike foreign bank loans and foreign portfolio investment, there are foreign direct investments with the existence of a long-term relationship between the direct investor and the enterprise and the direct investor being significantly affected in the business management.[3]

Foreign direct investment, according to many scholars and policymakers, may significantly benefit the host nation's development efforts. Along with providing direct equity investment, FDI may also be a vital source of technology, support economic growth, and fortify ties with local businesses. These justifications have led developed and developing nations to provide incentives to boost FDI into their economies.

A corporation is considered a multinational one if it is open to international business ventures and investments, which indicates that it operates on a worldwide scale. As a result, MNCs are crucial to the expansion of FDI movements. MNCs frequently relocate various stages of the production process to nations they deem to offer better economic conditions. The home country notion, which is another element that will aid in a better understanding of FDI, refers to the nation in which MNCs that engage in FDI primarily conduct their business and house their management and control centers. The MNCs are effectively pushed to look for a market outside of the home country by factors including the inadequate home country technology, the absence of a market to

[3] Kuemmerle, W. (1999). The drivers of foreign direct investment into research and development: An empirical investigation. Journal of international business studies, 30(1), 1-24.

attain the required profit, and the expensive labor and production expenses. MNCs provide various benefits in comparison to the home nation with the investments made in the host country.[4]

Representatives of the Neoclassical School define investment as an increase in resource demand. Therefore, the investment includes the entire growth of production facilities with basic circulation and liquidity. The factors necessitating the investment are different and can be grouped in three directions: renewal of the existing material technical base, expansion of production activity, formation of a new type of activity. In general, the economic development of society and the improvement of the material well-being of each citizen are determined by the success of investment projects.

However, recently, the specific values of foreign direct investments and especially the types of incentives offered to foreign firms have begun to be questioned. Fueling this debate is that the empirical evidence for FDI to generate positive spillovers for host countries is uncertain at both the micro and macro levels. In a recent literature review, Hanson (2001) argues that the evidence for positive spillover of FDI for host countries is weak.[5] Examining the microdata on foreign spillovers from foreign-owned firms, Gorg and Greenwood (2002) concluded that the effects were mostly negative.[6] Lipsey (2002) takes a more positive view of the review of micro literature and argues that there is evidence of positive effects.[7] Searching for macro-experimental research, Lipsey concluded, there is no consistent relationship between the size of internal FDI stocks and their flows relative to GDP and growth. He also argues that more consideration should be given to the different circumstances that hinder or encourage spillover events.

Both the governmental sector and the civil society sector engage in investment initiatives. Governmental agencies, companies, institutions, and organizations engage in investing activities in the public sector. Non-state investment is a type of private investment activity carried out by a company that is not a subsidiary of another company, organization, or government agency.

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[4] Aharoni, Y. (2015). The foreign investment decision process. In International Business Strategy (pp. 24-34). Routledge.

[5] Alfaro, L., Rodríguez-Clare, A., Hanson, G. H., & Bravo-Ortega, C. (2004). Multinationals and linkages: an empirical investigation [with Comments]. Economia, 4(2), 113-169.

[6] Alfaro, L. (2003). Foreign direct investment and growth: Does the sector matter. Harvard Business School, 2003, 1-31.

[7] Assaf, A. A. (2014). The Effect of Macroeconomic Variables on Jordan's Economic Growth. European Journal of Social Sciences, 42(1), 101-111.

Additionally, there are foreign investment operations that involve foreign nationals, businesses, governments, and other organizations. These activities make up the institutional foreign investment environment.

Joint investment operations are those conducted by foreign and domestic businesses together in the public and private sectors. An investment strategy is an action taken throughout the investing process that is only known to the investor and investor. The ivory habitat is where this action takes occur. The profit or income of the investor, entrepreneur, or businessman is the final outcome of investing activity in an investment environment. Investment is a catalyst for macro and microeconomic growth, establishing a financial foundation for bettering structural changes in the nation, speeding e-businesses, and raising performance standards. The country's socioeconomic transformations, improvements to the production and social infrastructure, and capitalization of investment activity are all strongly tied to the country's escalating radical economic reforms.

1.2 Types and realization of foreign direct investments

Multinational companies invest in foreign countries in various ways after making a direct investment decision. The types of these investments are classified in different ways in the literature. In this study, FDI types will be discussed in three dimensions: direct investments according to their form, direct investments according to ownership change and direct investments according to production stage.

1.2.1. Direct Investments by Type

Here, FDIs are examined according to their form from two perspectives: Green Field Investments and Brown Field Investments.

1.2.1.1. Greenfield Investment

Green field investments are a sort of investment that allows multinational corporations to grow their company and capital stock by building a brand-new facility in the host nation or by enlarging an existing one. Since the investor constructs a facility from start in the host nation, this sort of investment is also known as a greenfield investment. Foreign investors prefer developing nations and want to increase the company's profit by constructing a new facility with their own management style, technology, and marketing plan. The host nation prefers and welcomes green field investments more than any other sort. Because these investments are anticipated to boost the host nation's economy, generate jobs, transfer technology to raise productivity, increase capital inflows in comparison to other investments, boost production capacity, and add value. All of these benefits enable the host nation to interact with international markets.[8]

Investments in green space have benefits and drawbacks. For instance, the fact that the investor is from outside the host nation, their different cultural backgrounds, the significant expenditures associated with establishing a facility from the start, and the lengthy return time all work against the foreign investor. In order to determine whether there is a market for its product in Germany, a food packaging and processing company with its headquarters in Sweden is conducting research. As an example of a green field investment, it is discovered that there is a market for the company's products and that it can build a strong customer base. Because it began operations by building new manufacturing facilities there, the firm management decided to extend its business by creating its subsidiary in Germany. This is regarded as a green field investment.

1.2.1.2. Brownfield Investment

A brownfield investment is a foreign direct investment by a company in an existing facility to begin operations in a foreign country. In other words, a brownfield investment is the lease or purchase of an existing facility in a foreign country. The most important feature that distinguishes this investment from green field investments is that the facility in the host country is rented or purchased by the investor and put into operation. When the etymology of the term brown field is examined, the difference between green field investments and green field investments can be distinguished. The term brownfield is regulations designed by investors and researchers in the early 1990s to protect the environment by removing the negative impacts that hinder the reuse, cleanup and development of old industrial and commercial facilities. Brownfield visionaries have reconsidered vacant lots and abandoned properties and coined the term brownfield to express the challenges and opportunities presented by such areas.[9]

As can be seen, brownfield investments carry out their activities by restructuring existing facilities. In addition to the fundamental differences between brown field investments and green

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[8] Qiu, L. D., & Wang, S. (2011). FDI policy, greenfield investment and cross-border mergers. Review of International Economics, 19(5), 836-851.

[9] Hollander, J. (2010). Private property owners and the remaking of brownfields. Public Works Management & Policy, 15(1), 32-56.

field investments, the new formation that occurs as a result of the large-scale restructurings applied by the investor to the purchased facilities emerges as a similarity between the two investment types. The investor, who will make a direct investment, plans the restructuring of the company he bought with the brown field investment, in line with the integration or restructuring strategy at the beginning of the purchasing process.[10] Investors make investments before to entering a market by considering the range of products, level of competition, and market openness. The organizational structure and culture of the particular nation are other elements that influence the direct investor who will undertake brownfield investments. Tata Motors is a prime example of a brownfield investment. During the years 2007 and 2008, this business was one of the biggest automakers in India and a pioneer in the creation of commercial vehicles. For $2.3 billion in cash, Tata Motors purchased the UK-based Jaguar and Land Rover companies in June 2008. As a result, the Indian manufacturer obtained intellectual property rights, two design studios, and production facilities in the UK. Tata Motors offered a quick entry into the market and made a brown field investment without incurring startup expenses since it entered the UK market by buying an existing firm rather than starting from scratch.[11]

1.2.2. Direct Investments by Change of Ownership

Regarding the ownership of the direct investment they would achieve, foreign investors differ based on a number of circumstances. The corporation needs certain technical information to complete the product's production, which is the cause of this unpredictability. Because businesses turn to other methods when they are unable to get technical data due to market conditions or contractual obligations. When making direct investments in this situation, foreign investors can create a joint venture with local investors. They can also try partnerships with other foreign investors or under their own ownership. In order to take advantage of greater chances, international investors also operate through current or alternative legal companies or make direct investments through strategic mergers.

[10] Meyer, K. E., & Estrin, S. (2001). Brownfield entry in emerging markets. Journal of international business studies, 32(3), 575-584.
[11] Rodriguez-Arango, L., & Gonzalez-Perez, M. A. (2016). Giants from emerging markets: The internationalization of BRIC multinationals. In The challenge of BRIC multinationals (Vol. 11, pp. 195-226). Emerald Group Publishing Limited.

1.2.2.1. Joint Ventures and Full-Ownership

As international competitiveness becomes increasingly critical, many companies are teaming up to enter new markets, learn new skills, share risks and increase competence. Therefore, the use of joint ventures in both international and local contexts has increased significantly in recent years. There are many different views on the definition of joint venture in the literature. Mariti and Smiley (1983), on the other hand, defined a joint venture agreement as the way in which two independent law firms establish a third independent law firm. In line with this information, joint venture, which is a type of FDI, is a cooperative strategy in which the local company investor creates an alliance with the company in the host country by combining their skills, resources and market forces.[12]

In the joint venture between the local investor and the foreign investor, a relationship can be established between political and authority figures, however, in such investments, conflict of interest among the investors, the management style of the companies and the sharing of some secrets are disadvantageous. Joint venture can take place between local and foreign companies as well as between local companies. Making these investments with local investors is more advantageous than making them with companies located in foreign countries. These advantages can be listed as follows:

- Benefit from customs, institutions and practices related to the local partner's own country.
- Provides easy access to local capital markets due to the local partner's knowledge.
- Joint ventures have the feature of reducing the nationalization rate of the host country for political reasons.
- Technology held by the local partner may also be valid in that country.

For small businesses with finance and specialist management skills, entering new markets with a joint venture is a way of acquiring the necessary resources. This is generally true for developing countries. In addition, the increase in the competitiveness of small enterprises against large enterprises, the convenience of acquiring new technologies and the reduction of risks that may occur at the beginning make joint venture investments attractive. Joint venture is an important FDI type in terms of saving by sharing advertising and marketing costs, meeting human resource

[12] Mariti, P., & Smiley, R. H. (1983). Co-operative agreements and the organization of industry. The Journal of industrial economics, 437-451.

needs, creating opportunities for production, distribution and research and development experiences, and tax advantage.[13]

The partnership between Sony and Ericson to make cellphones is the greatest illustration of a joint venture. Full ownership occurs when one or more investors create a business together in the host nation. The local investor does not have a voice in the property, which is how this sort of investment differs from a joint venture. Over joint ventures, direct investments with complete ownership are preferred by investors. The transmission of knowledge and expertise may halt in some procedures, the interests of the foreign investor and the local investor may clash after a certain amount of time, and cultural differences may manifest themselves as reasons for this predicament. The investor considers consumption trends, patent and property rights, conventions and traditions, understanding of religion, market structure, business contacts, and manufacturing technology before deciding which sort of investment to make.

1.2.2.2. Mergers and Acquisitions

Although the terms "merger" and "acquisition" are frequently studied together, these ideas have separate connotations. When two or more firms merge, they give up their legal rights and pool all of their assets so they may operate as one company going forward. The term "intercompany marriage" also applies to this circumstance. The main drivers of a merger between a company from the source country and one from the host country are factors like facilitating easier entry into a foreign market, gaining from the experience of the owner of the company with which it will merge, and gaining a sizeable market share globally by combining its own technology, management expertise, and competitive forces. Apart from these, the reasons that push MNCs to merge are listed as follows:[14]

• The acceleration of international competitiveness;

• Changes in prices of goods subject to purchase and sale;

• Development of technology;

• Reducing the impact of exchange rate fluctuations on prices;

[13] Jiang, K., Keller, W., Qiu, L. D., & Ridley, W. (2018). International joint ventures and internal vs. external technology transfer: Evidence from China (No. w24455). National Bureau of Economic Research.
[14] Nelson, T. (2018). Mergers and Acquisitions from A to Z. Amacom.

• Benefiting from economies of scale and tax advantages;

• Innovations in financial services;

• Restructuring activities in service areas such as transportation, telecommunications, banking are the factors that unite companies.

Mergers, which are a type of FDI, have both positive and negative sides. It may not always be possible to access reliable information about the foreign company. The owner of the company can hide the existing problems and at the same time, keeping different accounting records can hinder the objective evaluation of the investor directly. Cultural differences arising from the merger of companies from different nationalities cause conflict between organizations with various traditions and values, as well as some problems in terms of workers' wages and collective agreements.[15]

Legal merger: It is defined as the dissolution of one of the companies merging within the scope of the state company laws in another company, and the transfer of assets and liabilities to the remaining company.

Subsidiary Merger: It means that the company acquired by the parent company turns into a subsidiary and continues its activities in this way.

Consolidation: A type of merger that refers to a business combination in which two or more companies go into partnership to form an entirely new company. After the merger, the organizations carry out their operational activities through the completely newly formed company. The integration of the investor according to the business activity field is generally examined under four headings as horizontal, vertical, mixed and geographical merger.

Horizontal Merger: It is a type of merger between companies operating in the same sector. In horizontal mergers, two rival firms may also merge in order to increase their market power. The primary objective of these investments is to increase market power, reduce competition in the sector, and reduce costs by using economies of scale more efficiently. The integration of Facebook, Whatsapp and Instagram, which is used by almost everyone today, can be shown as the most

[15] Mockevicius, P. (2014). The Effects of FDI on Economic Growth in Central and Eastern Europe: Mergers & Acquisitions, and Greenfield Investment.

suitable example of horizontal merger. Although these applications initially operated within independent companies, they later turned into a single company under the umbrella of Facebook.

Vertical Merger: It is defined as the combination of two or more companies involved in different stages of the supply chain of a common product or service. A hypothetical example of such investments is the acquisition of a dairy that produces milk and cheese by a company that sells milk and cheese.

Mixed Merger: It is the merging of companies in different sectors that have no similarity between them. An example of such merger investments is the merger of Pizza Hut and Pepsico companies.

The primary objective of investors who participate in mergers is to generate synergy, which improves operational effectiveness and results in value gains that are greater than the investors' individual stakes. In addition, the investor stands to benefit from the merger in the form of an increase in market share, tax advantages, greater production capacity, and scenarios such as entering new markets after the merger, which makes the merger an appealing option for the investor. A corporation is said to have completed an acquisition when it has obtained all or the majority of the stocks or assets of another company that is based in a different nation. By acquiring the majority or all of the assets and liabilities of the firm that they have bought, the objective is to provide the foreign investor with a greater opportunity to exercise influence and control over the business. Because the investing firm assumes control of the purchased company in the host nation, the acquired company's legal existence is not terminated in the same way that it would be in the case of a merger between the two companies. Companies that are bought with the intention of privatizing them are an illustration of this sort of investment. The growth of a company's market share in an international arena is typically the key motivation for multinational corporations when it comes to making foreign direct investments through acquisitions. Other reasons for choosing this type of investment by companies are listed as follows:[16]

• Increasing market power by reducing the number of competitors.

• To incorporate the efficiency and profitability that will emerge from synergy into the company's structure.

[16] Jauch, L. R., & Glueck, W. F. (1988). Business policy and strategic management. McGraw-Hill.

• To obtain market value by increasing the value of the stocks of the acquired company.

• To benefit from the cash assets of the acquired company.

Examples of acquisitions today are Disney's acquisition of 21st Century Fox and Microsoft's acquisition of LinkedIn.

1.2.2.3. Strategic alliances

In today's global business, a strategic merger, which is quite common, refers to the merging of two or more companies without sacrificing their independence in order to boost their global competitiveness, collaborate on R&D projects, adapt to market conditions, and gain an advantage by sharing production, marketing, and distribution responsibilities. When a corporation swaps some of its equity with another business it respects, a strategic merger takes place. But unlike FDI, portfolio investments analyze equities. A partnership created for products and services as well as an exchange of stocks between firms are necessary in order to consider strategic mergers under the purview of FDI. In order to represent one another in international markets, businesses can also create strategic alliances by agreeing to work together on joint marketing and service initiatives. However, this could lead to unfair competition. Today, the following list of factors may be used to explain why strategic mergers are so common, particularly in the area of international business:[17]

• The globalization of competition across regional borders;

• The prolongation of the use of short-lived products with the developing technology;

• Emerging capital needs to undertake risky projects and improve business processes;

• Development and expansion of communication networks;

• Industry driven economic development of America, Europe and Japan.

An example of a strategic merger is the partnership between Starbucks, the internationally famous chain of coffee shops, and the book retailer Barnes & Noble.

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[17] Bernile, G., Lyandres, E., & Zhdanov, A. (2012). A theory of strategic mergers. Review of Finance, 16(2), 517-575.

1.2.3. Direct Investments by Production Stage

In contrast to the industry in which they operate in their home country, multinational corporations are permitted to make direct investments in the host country in an entirely other industry. For instance, firm A may be involved in the chemical sector in its home country, but it may engage in foreign direct investment in the forest products industry in the nation that it is doing business in. Direct investments may be split into two categories: horizontal and vertical, depending on which level of production they pertain to.

1.2.3.1. Horizontal Investments

Businesses may seek to export products that they manufacture domestically and sell on the domestic market. However, investors recognize that the same or comparable goods and services produced in their own nations may be used for investment purposes in the host country in order to minimize the cost of transportation charges, import duties, and other trade obstacles while exporting. Horizontal investments are those that a foreign investor makes in the host nation to meet the needs of a new market. Market-seeking FDI is another name for horizontal investments.[18] By adjusting to shifting local conditions, these investments seek to boost competitiveness while lowering market costs.[19]

In addition to being close to their customers, minimizing transportation costs, increasing their familiarity with local production and standards, removing barriers brought on by cultural differences, and increasing their exports to markets with horizontal investments they create by producing the same or similar products in different countries, investors also seek to: provide sales opportunities for their goods in the host country market. prefers these expenditures to gain control. Examples of horizontal investments include Ford Motor Company's purchase of Volvo and Jaguar, two British automakers. since both businesses are involved in the automobile sector.[20]

[18] Chung, S. (2014). Environmental regulation and foreign direct investment: Evidence from South Korea. Journal of Development Economics, 108, 222-236.
[19] Lim, E. G. (2001). Determinants of, and the relation between, foreign direct investment and growth a summary of the recent literature.
[20] Bennett, D. Acquisition Projects in the Automotive Industry-The cases of Volvo-Geely and Fiat-Tritec.

1.2.3.2. Vertical Investment

Vertical investments are made by multinational corporations (MNCs) when they partition their manufacturing processes regionally. In order to keep production costs to a minimum, an investor will frequently go to other geographical places in search of cheaper inputs while they are creating a thing. The pricing of inputs might differ from country to country. For instance, labor-intensive industry typically takes place in nations where the cost of labor is relatively inexpensive. Because of the disparity in the cost of inputs, this circumstance gives the investor the opportunity to increase their profits by moving some production stages to nations where the cost of living is lower than in their own country.[21] The production stage of the labor-intensive goods is moved to countries where labor is inexpensive, and the production stage of the capital-intensive goods is moved to regions where capital is inexpensive. This allows the investor to reduce the costs of production while maintaining a high level of production quality.[22]

Different foreign factor prices, the amount of raw materials used, and the application of various technologies all have an impact on vertical investments. Additionally, raw materials, manufacturing prices, the amount of labor intensity, and quality may all be cited as crucial variables for investors who will be making vertical investments. Backward vertical investments and forward vertical investments are the two categories that fall under the vertical investment category.[23]

Backward vertical investments are when a foreign company establishes its own suppliers in order to create the essential inputs for its operations in a different country and then obtains those inputs from the activities themselves in the same country. To put it another way, when a firm makes a backward vertical investment, it means that it has purchased another business that supplies the necessary goods and services for manufacturing. For instance, the supply chain for textile industries encompasses quite a few different types of production. The price variations in cotton will have a negative impact on these businesses if they purchase cotton from a manufacturer

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[21] Roy, S., & Viaene, J. M. (1998). On strategic vertical foreign investment. Journal of International Economics, 46(2), 253-279.

[22] Hanson, G. H., Mataloni Jr, R. J., & Slaughter, M. J. (2001). Expansion strategies of US multinational firms.

[23] Protsenko, A. (2004). Vertical and horizontal foreign direct investments in transition countries (Doctoral dissertation, lmu).

located outside of the country. Cotton is one of their primary raw materials. As a result, when the textile firm makes a backward vertical investment, it also begins the manufacturing of cotton, which is the raw material that is used in the production process.

When a firm makes a forward vertical investment, it means that it purchases its inputs and intermediate products from the parent company, which is the most important component in the supply chain, and then carries out its production in the host nation. Upstream integrations are what are referred to as forward vertical investments in a lot of different foreign literature. These kinds of investments are made by businesses so that they may increase their market share, take control of distribution networks, and obtain an advantage over their competitors.

1.3 Effects of foreign direct investment on the host country

The effects of foreign direct investment on the host country can be explained on the basis of traditional trade theory or by considering industrial organization theory. In traditional trade theory, an influx of capital of any kind, whether portfolio investment or direct investment, affects the host country's economy by raising the marginal return on labor and lowering the marginal return on capital. Industrial organization theory, on the other hand, seeks to answer the question of why firms invest in the host country rather than in the source country.[24]

According to traditional theory, the main reason for capital flow from one country to another is the different rate of return on capital between the two countries. Considering the assumption that rates of return converge over time, it follows that the capital flow must end after a while. However, in the 1970s and 1980s, foreign direct investment made by European countries approached or even exceeded the foreign capital investments made by the United States. The reason for making foreign direct investments has been tried to be explained not from factor movements but from organizational reasons. These reasons are elements such as knowledge, experience, research and development activities, technology and human capital.[25]

R&D activities, which can be expressed as technological innovation for organizational reasons, have been accepted as the source of economic growth and have gained importance. This

[24] Blomström, M., & Kokko, A. (1996). The impact of foreign investment on host countries: a review of the empirical evidence. Policy Research Working Paper, 1745.
[25] Kokko, A. (2006). The home country effects of FDI in developed economies (Vol. 225). Stockholm: European Institute of Japanese Studies.

is due to the fact that R&D activities can be expressed as technological innovation for organizational reasons. In addition, one can differentiate between physical capital and non-physical capital, and knowledge is seen as a component of production in its own right. Investments in fixed capital are crucial to the activation of all other elements because of their position in the hierarchy of physical investments.

When technological advancement is factored into the factors of growth as an endogenous variable, only then does the role that foreign direct investment plays in long-term growth become apparent. Even in situations in which the law of diminishing returns applies to companies on an individual basis, externalities help differentiate between private and public returns on investments. In an economy that has such externalities, the international business will have the chance to raise its level of productivity, and direct investment will also help to encourage domestic investment and technological advancement. The amount to which the host nation embraces the technology and increases its use will be the determining factor in the growth rate.

When it comes to foreign direct investment, one of the most important and fundamental issues that should be answered is whether or not this investment will have a beneficial impact on the production level of the host nation and, as a result, on the economic growth of that country. Not only does increased foreign direct investment provide a boost to the current investment rate, but it also contributes to economic growth in the host nation by boosting total factor productivity and, at the same time, improving resource utilization efficiency. This effect happens through foreign direct investment and international trade flows, spillovers and other externalities in the business sectors of the host country, and direct effects on the structural aspects of the host country.

At the micro level, the contribution of foreign investment firms to economic growth in the country where the investment is made can be associated with the demand for labor, capital, and other production factors in that country to create a new added value. This can be said to be the case because foreign investment firms tend to hire people from that country. As a consequence of the production of this new added value, additional revenue will be gained, and the people and businesses who earn this additional income will have the ability to invest more money. For instance, because of the rise in demand for unused land, there will be an increase in the number of people looking for work, and because of the rise in interest rates and profits, there will be an increase in the number of individuals investing in financial assets. These kinds of effects have the potential to kickstart a growth trend in the economy. On the other hand, businesses will be able to make goods that are of the nature of raw materials in a manner that satisfies the requirements of customers by making such goods more desirable in the eyes of customers.[26]

Several different studies have come to the conclusion that local investments are unable to compete with the productivity gains that may be achieved through foreign direct investment in the host nation. However, it is unclear if such an impact, which is primarily found in developing nations, is the outcome of economic growth for a different reason or whether it is the direct influence of foreign investment. What is apparent is that such an effect is mostly recorded in developing countries. It is clear that these types of investments do not include any domestic investments in some instances. In spite of the fact that there are studies that provide evidence for both scenarios, it is possible to assert that the ultimate result is a growth in the economy. The twin deficit problem occurs in the economies of emerging countries when the quantity of capital and imported inputs necessary for investments cannot be satisfied by the nation's exports. In other words, the exports of the country are not sufficient to meet the requirements of the investments.[27]

The savings deficit and the deficit in goods and services traded with other countries make up the twin deficit. The country has better access to financial markets as a consequence of foreign direct investments; simultaneously, the presence of one foreign investor in a sector encourages the entry of other foreign investors into that area. A step like this might result in financial assistance for the country's growth being provided by the investor's home nation. It is also possible that this will stimulate local investors, which will lead to an increase in domestic savings. By increasing domestic savings, the issue of the country's trade imbalance can be resolved. Under these circumstances, foreign direct investments give benefits in the form of being more stable than other types of financial funds, having a long-term presence in the host nation, being related to the performance of the host country's economy, and making it simpler to service debt.[28]

Traditionally, the influence of foreign direct investment in developing nations has been emphasized by greater capital accumulation, technology transfer, access into global markets, and

[26] Ahiakpor, J. C., & Rugman, A. (2008). Multinationals and economic development. Routledge.
[27] Lipsey, R. E., & Sjöholm, F. (2005). The impact of inward FDI on host countries: why such different answers?. Does foreign direct investment promote development, 23-43.
[28] Moosa, I. (2002). Foreign direct investment: theory, evidence and practice. Springer.

increased tax revenues. However, these benefits are not the only ones that foreign direct investment may have. It is possible to assert that these conventional impacts are accurate, particularly for nations that are still in the process of developing. The reason for this is that emerging nations have a low rate of overall capital accumulation and a restricted rate of overall financial capital accumulation.

The policies of governments that try to attain better growth rates by boosting the investment rate also increase these elements. These policies involve keeping the exchange rate low. In such a scenario, money from outside would not only assist balance interest rates but will also promote growth by eliminating the country's current account deficit.[29] In addition to supplying the developing nation with the necessary capital, the effect of foreign direct investment on economic growth can also be seen in the form of the creation of externalities and an increase in productivity. This is despite the fact that the effect of foreign direct investment on the accumulation of capital is extremely important. In addition to an increase in the amount of capital stock in the nation in which the foreign investor is present, several other effects can also be observed. These effects include the expansion of technological knowledge, the growth of human capital, and an increase in the number of activities related to research and development.

When a foreign investor enters a domestic market, the arrival of that investor might have a variety of distinct repercussions on the pay of the domestic workers. To begin, these international companies could provide better compensation than the domestic companies do. On the other hand, this does not necessarily imply that the pay level will rise across the board. In many cases, high pay levels can be observed in industries where workers already have higher earnings or where wages are already higher because of the superior expertise of the workers. On the other hand, there are situations in which the salary payment made by the international company has the potential to have the impact of raising the wage level made by the domestic company. This phenomenon is referred to as pay spread. As a result of the fact that the international company pays high wages and the effect that this level has on the choices made by the domestic manufacturers, it is possible that the overall wage levels will go up. There are a number of factors that might contribute to wage

[29] Ahiakpor, J. C., & Rugman, A. (2008). Multinationals and economic development. Routledge.

dispersion, including higher salaries paid by the foreign manufacturer and increased demand for labor.[30]

The foreign investor that is investing in a different nation is larger than many of the companies that are located in that country, and the workforce that it requires for its employees is for workers who have a great deal more experience than what is required by the local enterprises. If there is a shortage of competent labor in the host nation, it is likely that foreign companies will have to raise their pay rates in order to attract the employees they require. As a direct consequence of this, the productivity of workers earning high wages can go up.[31]

Even while the impact of foreign direct investment on employment and earnings varies from nation to nation, one can say that the most significant variation is found in the shifts in the structure of the industrial economy (increase in productivity and quality). The structure of human resources, as well as the employment of those resources, and the attitude of host nations to this development are both influenced by foreign direct investments. This sort of company behavior is determined by the degree of competition present in the industry in which the foreign investor will be investing, taking into account the employment requirements and goals of either the host nation or the source country.[32]

It was noted that one of the motivations for businesses to invest directly would be to work toward the goal of reducing non-tariff obstacles. As a result of the fact that businesses that want to overcome non-tariff barriers produce their goods and services in the country where they will be marketed, rather than producing in their own country and then exporting their products to other countries, there may be a decrease in the volume of international trade. This may be the case because companies that want to overcome non-tariff barriers produce goods and services in the country where they will be marketed. However, now that multinational corporations have a voice in the global economy, the trade of intermediate goods and raw materials that is carried out by multinational corporations in order to transfer them to different production areas has also taken its

[30] Lipsey, R. E., & Sjöholm, F. (2005). The impact of inward FDI on host countries: why such different answers?. Does foreign direct investment promote development, 23-43.
[31] Dunning, J. H., & Lundan, S. M. (2008). Multinational enterprises and the global economy. Edward Elgar Publishing.
[32] Dunning, J. H., & Lundan, S. M. (2008). Multinational enterprises and the global economy. Edward Elgar Publishing.

place in international trade. This is in addition to the traditional trade that has always existed in the world. When we take a look at the production activities that take place all over the world, we will notice that there has been a significant rise in the amount of trade that involves both finished goods and intermediate goods as well as raw materials over the course of the years that have passed and the years that are currently in progress. Intra-firm trade accounts for one-third of global commerce and refers to the exchange of goods and services between different divisions of a single company that are directly related to the manufacturing process. In this scenario, the question that arises is not whether international commerce and foreign capital are complimentary or if they are alternatives for one another; rather, the question that arises is where businesses wish to locate their value-added operations.[33]

As a result of the fact that firms are now able to segment the manufacture of the products they make into a variety of distinct production processes, they have begun to collaborate with a large number of suppliers located in a variety of geographical areas. Companies operating in developing countries and producing for limited local markets are able to reach customers all over the world, albeit in a roundabout way, through the medium of multinational corporations as a result of the division of production in such a way and its spreading to many enterprises located in various parts of the world. As a result, the power of competition will increase for the local company that has integrated trade. As a direct consequence of this, it will be able to make headway in both the managerial and technological spheres.

According to the statistics provided by the World Commerce Organization, between the years 1986-1989 and in 1995, the flow of foreign direct investment expanded at a rate that was higher than the rate of growth in world trade. The yearly estimated value of foreign direct capital flows surged twenty times between 1973 and 1995, although the value of trade products exported only climbed eight and a half times over the same time period. One third of global commerce is made up of transactions between multinational corporations, another third is made up of

[33] Kone, S. (2009, December). Comparative Analysis of Inward FDI Attractiveness in China and Africa. In 2009 International Conference on Information Management, Innovation Management and Industrial Engineering (Vol. 1, pp. 154-158). IEEE.

transactions between multinational corporations and other firms, and the last third is made up of transactions between national corporations.[34]

The participation of businesspeople from other countries in the economy of the host nation has an effect on the balance of payments for that nation since it tends to boost both imports and exports. It has been discovered that businesses that have access to foreign money are more focused on exporting than local enterprises; as a result, these firms are responsible for a significant percentage of exports, particularly in economies that are still in the process of developing. It's possible that the boost in exports made possible by foreign money won't happen immediately in some cases. It is anticipated that there would be a deficit in foreign trade as a result of the rise in imports in the initial stage due to the fact that foreign cash flowing into the nation will initially be used to acquire machinery and equipment of this kind. Nevertheless, this shortfall will be cancelled out by the rise in the asset side of the balance of payments.

In the second phase, the consequences of foreign capital investments will have a beneficial influence on the balance of payments of the nation that is playing host. These effects include the enhancement of exports and the substitution of imports. The magnitude of this beneficial effect is directly related to the level of activity that the multinational firm maintains in markets located outside of its home country. If the items produced by the multinational firm are successful in finding a position in worldwide markets, the exports of the country that is hosting the multinational company will continue to expand, which will have an influence on the country's balance of payments. On the other hand, if the multinational firm employs imported intermediate products and raw materials, then part of the beneficial effect on the balance of payments can be cancelled out by the imports that the multinational company makes.

1.4 The concept of SMEs in Azerbaijan

Small and medium-sized enterprises, being market subjects, engage in separate types of activities as independent legal entities. Unlike large enterprises, they are unstable, that is, some of the small enterprises engaged in business in different fields of activity disappear from year to year and new ones are created. This process is driven by the ever-renewing production demand. The failure of small and medium-sized enterprises in one area of economic activity prompts competent

[34] Trevino, L. J., & Daniels, J. D. (1995). FDI theory and foreign direct investment in the United States: a comparison of investors and non-investors. International Business Review, 4(2), 177-194.

and experienced entrepreneurs to focus on other profitable areas.[35] The fact that small enterprises exist and operate on the basis of private ownership does not necessarily mean that they are small. In fact, it would not be correct to characterize the activity of small and medium-sized enterprises within the framework of the form of ownership. Because any state, administration, cooperative, shareholder, family, private, etc. enterprises can operate as small-scale economic units. From this point of view, small enterprises can be characterized by two criteria:

- according to the volume of economic turnover;

- according to the number of employees working in enterprises.

According to the existing legal forms in our republic, the size of enterprises is determined by the average number of employees with only one criterion. It should be noted that it is not enough to determine the size of the enterprise by only one criterion, that is, by the average annual number of employees (volume). In conditions of high level of mechanization and automation of production processes, the number of employees in high-tech enterprises is very small.[36] Therefore, it can be considered appropriate to use three indicators (number of employees, total product volume and profit volume) to determine the size of enterprises, as in the European Union countries.

The size of the enterprises largely depends on the characteristics of the area in which they operate (licensed). For this reason, special attention is paid to this aspect when determining the size of enterprises. In order to ensure the addressability of reforms that will have a direct impact on the development of SMEs in Azerbaijan, by the decision of the Cabinet of Ministers of the Republic of Azerbaijan No. 215 dated June 5, 2015 on the approval of the criteria of large, medium and small entrepreneurs, the criteria of SMEs are defined as follows.[37]

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[35] Bayramov, V., Hasanov, R., Aghayarli, L., Kadyrov, Z., Aghahasanli, I., & Isayev, S. (2017). A comparative study on development of small and medium enterprises (SMEs) in Azerbaijan. Available at SSRN 3485576.

[36] Guliyev, H. (2020). The Necessity For Development Of Smes In Azerbaijan Economy. In Вопросы Управления И Экономики: Современное Состояние Актуальных Проблем (Pp. 133-141).

[37] Yusif, A. N. (2022). Policy-Oriented Reforms And Their Consequences On MSME Performance: Evidence From Azerbaijan. Bina Bangsa International Journal Of Business And Management, 2(1), 252-265.

Table 1. Criteria for large, medium and small entrepreneurs

Category of entrepreneurial entities by size	Average list number of employees	Annual income
Small entrepreneur	Up to 25 people	Up to 200 thousand manats
Medium entrepreneur	From 25 to 125 people	From 200 thousand to 1250 thousand manats
Large entrepreneur	125 people and above	1250 thousand manat and above

Source: State Statistics Committee of the Republic of Azerbaijan, https://www.stat.gov.az/

The size requirements that are categorised in accordance with the various field affiliations are very different from one another. Specifically, the size requirements for businesses in the industrial sector are more lax than those in other spheres of operation. The economic operations of the republic's small businesses and cooperatives may be found in virtually every sector of the economy. The number of people who are employed by small and medium-sized businesses in our country rises in tandem with the growth of both the number of these types of businesses and the breadth of the activities they undertake. The following is a list of categories that may be used to classify different aspects of the general activity of small businesses during the period of transition to a market economy. To begin, small businesses play an important role in fostering individual and small-scale forms of entrepreneurship. They are economic entities that serve to adjust economic circumstances in a flexible manner, and they have a relatively modest number of employees.

Second, small and medium-sized businesses are able to take into account market demand with a greater degree of flexibility, adopt new methods and technologies with greater speed, rapidly adjust to the principles of market demand and supply, and produce goods that are able to meet the requirements of the market. Thirdly, small and medium-sized businesses have a greater propensity to specialize in a certain domain and to offer a constrained assortment of goods and services. Fourth, small businesses provide manufacturing services to large businesses, or more specifically, they fulfill their urgent orders. In exchange, major businesses supply small businesses with raw materials, equipment, and term and concessional loans. A very significant contribution to the nation's social fabric is made by small and medium businesses, which brings us to our fifth point. As a result, it helps alleviate social tension in the nation during times of widespread unemployment and economic crises by providing jobs to workers who have been laid off from large businesses. Additionally, it becomes an important tool in the efficient distribution of labor force among the various sectors of the economy.

Sixth, the importance of small businesses in production management cannot be overstated. They stand out in particular for the innovative ways in which they have applied new manufacturing techniques toward the establishment of a new economic system. Seventh, small and medium-sized businesses play an important part in the process of enriching the consumer market, mastering the production of new types of products, expanding the range of products that are released, and increasing competitiveness if they are suitable for the current market conjuncture. A faster rate of capital turnover occurs in smaller businesses, which contributes to the quickening of money circulation in Azerbaijan. This is the eighth factor. Ninth, one of the features of small businesses is that they are less likely to have a high need for large-scale production, social and commercial infrastructure, and instead have a higher demand for services that are performed on a smaller scale. Tenth, small businesses are market entities that generate ideal circumstances for the large utilization of regional production resources.

They establish a material base for the future development of particular areas in a linked manner and activate industrial opportunities that are fit for the local conditions. Small enterprises, in comparison to manufacturing on a big scale, have a greater number of options to function efficiently. Producing on a smaller scale brings you geographically closer to your target market, and it also gives you more flexibility to tailor your goods to meet the specific requirements of your customers. It manufactures items in tiny quantities, which is problematic for major companies because of their production requirements. In addition, small businesses typically have fairly straightforward management structures, which results in very low management expenses.

After a resolution was made by the Cabinet of Ministers of the Republic of Azerbaijan on October 12, 1990, the first step toward the establishment of new small businesses and the beginning of their operations was taken in the country of Azerbaijan. According to that decision, it was determined to be necessary to increase the role that small and medium-sized enterprises (SMEs) from market subjects play in the formation of a new economic system, comprehensive development, and management of the economy in Azerbaijan, and this is not without reason. The gradual formation of the market mechanism in the republic, the emergence of new demands, the emergence of a sharp contradiction between demand and supply, the existence of the need for production and market competition, the strengthening of the process of inflation, and other factors all necessitated the rapid expansion of the network of small enterprises. Small and medium-sized businesses, on the other hand, are the ones who are tasked with the responsibility of quickly mastering production, applying new techniques and technology, owning technology, and quickly paying the costs and making a profit during the transition to market relations.

This responsibility falls on them for a certain period of time. According to Azerbaijani law, individuals are permitted to engage in whatever sort of business enterprise they see fit, including those that combine the rendering of services with the manufacturing and retailing of goods. When we talk about entrepreneurship in this context, we're referring to things like commercial partnerships, limited liability companies, production cooperatives, joint-stock corporations, small and medium enterprises, peasant farms, and so on. The scale and type of manufacturing are both directly impacted by the various forms of entrepreneurship.

In spite of the fact that they differ in a number of specific characteristics, the primary functions of small businesses, medium businesses, and large businesses are all compatible with one another on the basis of the general elements they carry out at the same time. To begin, it indicates that everyone of them is successfully carrying out their roles in a productive manner. But at the same time, every single one of them is superior to the others in some respect or another. In turn, small business, in the course of carrying out its tasks, possesses a number of characteristics and benefits. This may be seen, for starters, in the adaptable response that small enterprises have to shifting conditions in the market. Small business entrepreneurship ensures high profitability of products that are not so efficiently produced in large enterprises, has the ability to quickly fill the consumer market with goods, and is able to ensure the payment of costs. These benefits come from the fact that small businesses can quickly fill the market with goods. In addition to these benefits, small business ownership offers considerable advantages in contexts in which output is restricted, demand is unidirectional and stable, and manufacturing processes are not amenable to standardization. As a consequence of this, the influence that small businesses may have on the economy is nearly nonexistent and is exclusively exercised with regard to their own unique concerns.

One of the social (public) purposes of small business is demonstrated by the fact that these functions allow the flexibility of extensive reproduction and the market economy. This is a manifestation of one of the social (public) functions of small business. It makes it possible to deepen specialization in production and to collaborate on production on several fronts, which in turn makes it possible for the market to be rapidly supplied with goods and services that are in great demand. Small and medium-sized businesses are the ones responsible for creating marketplaces with free competition. One of the important contributions that small businesses provide to society is the upkeep and reinforcement of the nation's political and social stability. This may be accomplished through the expansion of the class of owners as well as the creation of new jobs by small businesses. Therefore, small businesses contribute to the process through which municipal budget funds are created. This is something that is handled at the municipal level.

As a result of all of this, it is abundantly evident that small and medium-sized businesses (also known as SME's) play a significant part in the functioning of society and carry out highly important duties. However, it is evident that in some instances they are identified, while in other instances they are differentiated amongst businessmen, businessmen, capitalists, and so on. This raises an interesting problem. Such economic categories are highly essential both as a science of economic theory and as a specific sphere of people's activities; in addition, they provide a number of very important roles. Both of these aspects contribute to the importance of such categories.

Chapter 2. FDI in Azerbaijan, focus on non-oil sector and SMEs

2.1 The general situation of the Azerbaijani economy and the evaluation of non-oil sectors

After implementing the State Program for Poverty Reduction and Economic Development for 2003-2005, the Azerbaijani government implemented a new program for the years 2003-2006. In 2010, the poverty rate was 11.5%, down from 44.7% in 2003, when the first program was implemented. Since 2005, this rate has decreased marginally each year.

Table 2. Azerbaijan macroeconomic indicators

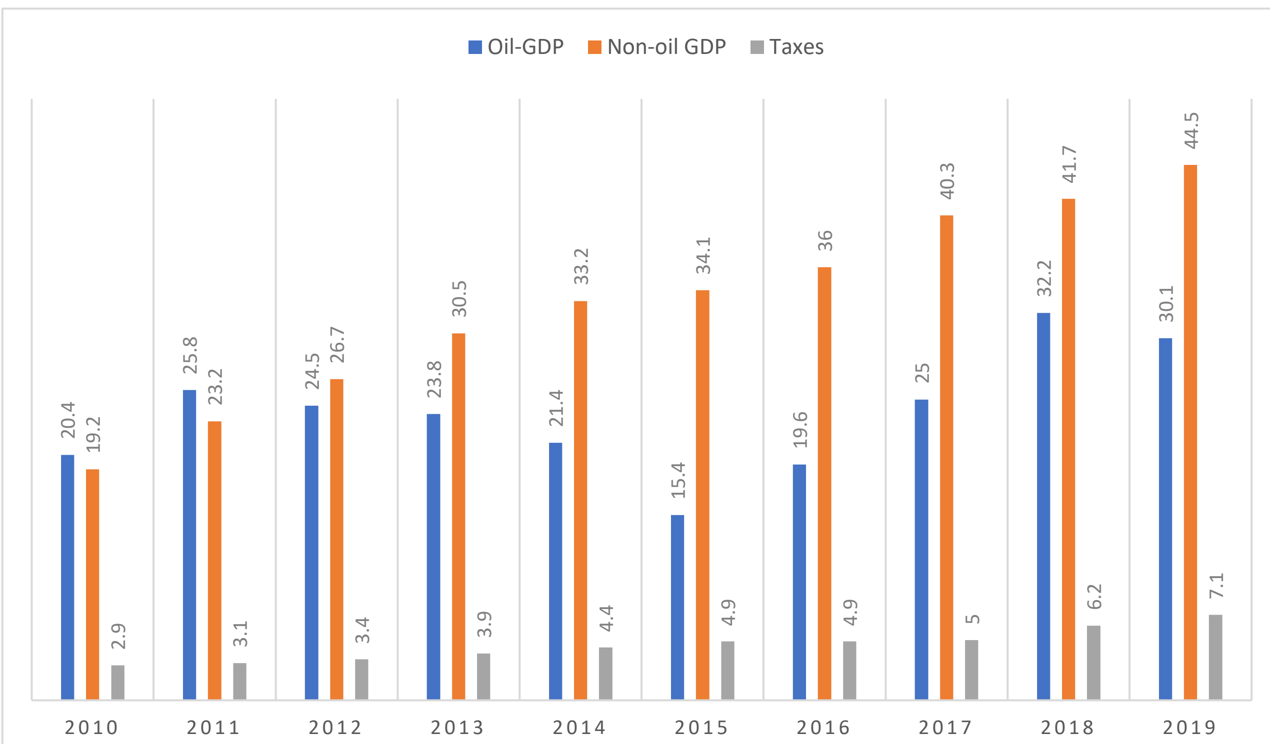
	2015	2016	2017	2018	2019	2020	2021
GDP, mln manats	54380,0	60425,2	70337,8	80092,0	81896,2	72578,1	92857,7
Pop. Income, mln manats	41744,8	45395,1	49187,9	53103,7	56769,0	55754,1	57181,5
Av. nominal salary, manat	466,9	499,8	528,5	544,6	635,1	707,7	732,1
Budget revenues							
mln manat	17498,0	17505,7	16516,7	22508,9	24398.5**	26077.9	26631.7
% of GDP	32,2	29,0	23,5	28,1	29,8	36,0	28,7
Budget expenditures							
mln manat	17784,5	17751,3	17594,5	22731,6	24425,9	26416,3	27412,4
% of GDP	32,7	29,4	25,0	28,4	29,8	36,5	29,5
State budget deficit (-), surplus							
mln manat	-286,5	-245,6	-1077,8	-222,7	-207,8	-1734,6	-1016,1
% GDP	0,5	0,4	1,5	0,3	0,3	2,4	1,1
Deposits, mln manats	9473,9	7448,7	7561,2	8375,4	8637,9	8177,9	9241,5
Population, mln people	9705,6	9810,0	9898,1	9981,5	10067,1	10119,1	10119,1

Source: State Statistics Committee of the Republic of Azerbaijan, https://www.stat.gov.az/

Azerbaijan regained its economic growth after the pandemic and closed 2021 with high economic growth. In 2021, the Azerbaijani economy grew by 5.6%, capturing the highest growth rate in the last eight years. In 2020, economic growth grew by over 5%, non-oil economy grew by

7.2%, industrial production by over 5% and non-oil industry by about 20%. These development indicators can be considered as one of the most successful growth indicators in the post-pandemic world. Thus, in 2021, the country produced 92.8 billion manats, or 5.6% more than the previous year. In other words, the Azerbaijani economy has entered a new stage of development from stagnation. Let's now take a look at a brief analysis of several economic indicators related to the non-oil sector in order to more objectively assess the potential and reserves for solving the problems of diversification of the economy of Azerbaijan in the context of the current situation, new demands and challenges. Figure 1 shows the volume of GDP covering the years 2010-2019 in the oil and non-oil sectors of Azerbaijan's economy.

Figure 1. GDP in the oil and non-oil sectors of the Azerbaijani economy, 2010-2019, billion manats



Source: State Statistics Committee of the Republic of Azerbaijan, https://www.stat.gov.az/

The table 3 below shows some indicators of Azerbaijan's non-oil sector for 2015-2019.

Table 3. Some indicators of Azerbaijan's non-oil sector for 2015-2019

Indicators	2015	2017	2018	2019
Added value in the non-oil sector, bln	37.7	44.1	46.7	50.4
The share of the added value of the non-oil sector in the total GDP, %	69.3	62.8	58.5	61.7
The share of non-oil industry in added value in the non-oil sector, %	8.2	7	7.1	12.5
Volume of production in non-oil industry, million manats	7660.3	9484.8	10047.9	11321.7

Source: State Statistics Committee of the Republic of Azerbaijan, https://www.stat.gov.az/

There are significant reserves and potential for the development of chemical and metallurgical industries, etc.

Various approaches are used to assess the export potential of the non-oil sector, which can be classified as follows:

- a general description of the level of development of the export potential in dynamics over a number of years.

- commodity structure of exports reflecting the volume and dynamics of commodity groups, as well as the specific weight of raw materials and processing products in it.

- partner countries in foreign trade.

Following its declaration of independence, the Republic of Azerbaijan has made consistent efforts to broaden its commercial ties with other countries, therefore becoming integrated into the global economy. The country's economy was dependent on imports in the early years of independence as a result of the transition crisis; however, with the signing of the agreement of the century, the country started to operate as an oil exporter in the global market. This changed the country's economic status. During that time period, the nation made the shift to an economy based more on free market principles. Both the country's advantageous geographical location (it is situated on the transport corridor between Europe and Asia) and its abundance of natural resources made it appealing to potential international investors. Oil was the sole commodity that the nation was able to ship out of its borders and sell on international markets at that time. The government of the country made the decision to prioritize the growth of the oil industry as a priority for the country's economic development and became a guarantor of the safety of foreign investments in the oil industry of the economy as a result of this decision. At this time, the Republic of Azerbaijan is concentrating on the expansion of its agricultural sector as well as its processing industry. The improvement of agricultural practices across our nation contributes to the alleviation of poverty in the surrounding areas. The agriculture industry is distinguished by its own particular qualities and is credit-efficient. One of the most significant things that can be done to attract loans to the agricultural sector in the Republic of Azerbaijan is to make sure that there is growth in the number of mortgage loans available in the regions. The expansion of the regional land market is helped along by the rise in the availability of regional mortgage lending, which generates advantageous conditions. To cover service areas (such as winter tourism or underdeveloped insurance regions) that are not widely represented in Azerbaijan's credit base but nevertheless have a significant amount of unrealized potential, special approaches should be implemented. Because more people are able to find work as a direct result of increased tourism, the unemployment rate has been going down. According to the findings of the study, if the tourism industry accounts for 20-25 percent of the state budget, the country will no longer be dependent on oil in any way. The profits generated from the successful non-oil method that was applied for the sake of the economic development of the country are directed toward the people, with the goals of resolving the social issues that they face and improving their standard of living. Along with the more liberal components of the market economy, it foresees the implementation of socially oriented policies such as the establishment of a social security organization.

As a consequence of this, the growth of human capital, which enables countries to produce a greater amount of money, is beneficial to all nations. Almost every nation on the face of the planet is currently making significant progress in this area. In the first eight months of the year 2021, the total value of Azerbaijan's exports was thirteen billion dollars. The non-oil industry operates with a daily monetary volume of 1.6 billion dollars. The value of non-oil exports reached 429 million dollars, representing a 37.1 percent increase compared to the same time period in 2020. There was a total of 364.7 million dollars worth of non-oil fruits and vegetables that were exported during the first eight months of 2021. The continuous socio-economic development of Azerbaijan conditioned the successful foreign economic activity. Thus, during the years 2000-2013, the foreign trade turnover of the republic increased from 2917.3 million US dollars to 43554.1 million US dollars. If we look at the table, we will see that the lowest trade turnover occurred in 1993-1995, which was caused by the Karabakh war between Azerbaijan and Armenia. The lowest export was observed in 1995-1996. In 1994-1999-2003, Azerbaijan's foreign trade balance was negative, imports exceeded exports.

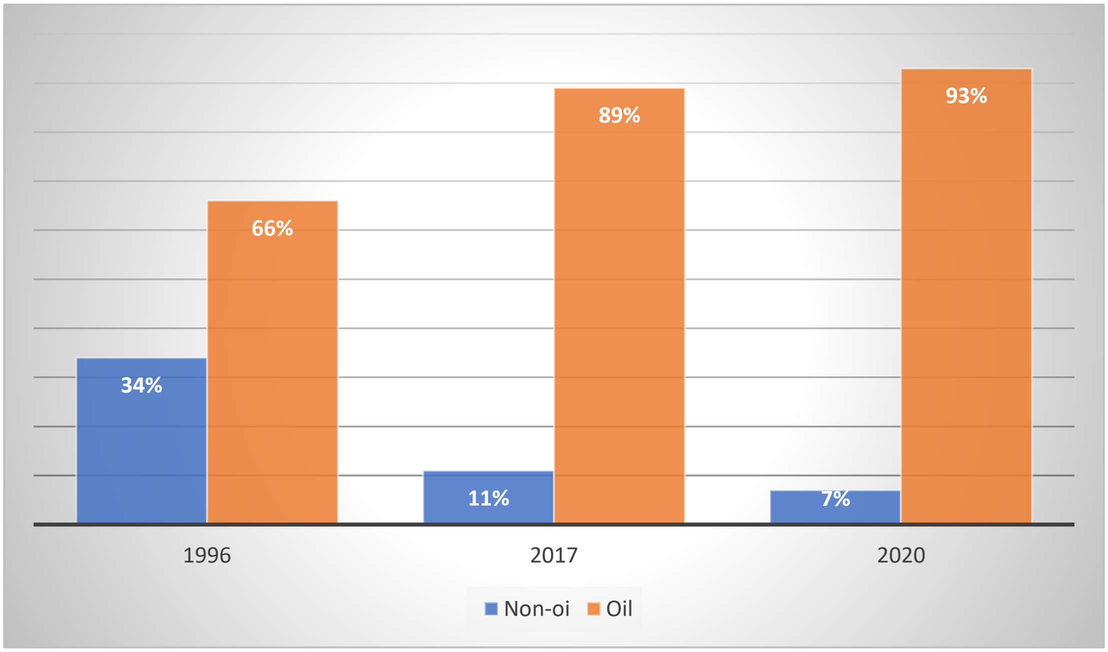
The lowest point is 1998, and the highest is 2008. As we mentioned, after the restoration of our independence, the highest trade turnover and exports occurred in 2008. In that year, the total trade turnover was 55 billion dollars, and exports - about 48 billion dollars. In 2008, the total volume of foreign trade turnover was 12.7 times higher than in 1991. The highest level of imports was about 11 billion dollars in 2013. Due to the economic fluctuations in the country and the world during 2013-2020, as well as the Covid-19 pandemic that occurred in early 2019 and had a negative impact on the world economy, the country's foreign trade turnover decreased from $43,554.1 million to $24,201.1 million. The main reason was the oil factor, which made up the main part of national exports. The fall in the price of oil, the main export commodity of Azerbaijan, has sharply reduced foreign trade (State Statistical Committee of the Republic of Azerbaijan).

Table 4. Volume of foreign trade turnover (1991-2020)

Years	Mln USD				In actual prices compared to the previous year,%		
	Trade turnover	Import	Export	Saldo	Trade turnover	Import	Export
2013	43,554.1	10,712.5	32,841.6	22,129.1	102.7	109.1	100.7
2014	39,407.5	9,187.7	30,219.8	21,032.1	95.7	85.4	99.0
2016	21,596.6	8,489.1	13,107.5	4,618.4	92.7	89.6	94.4
2017	24,263.8	8,783.3	15,480.5	6,697.2	89.3	83.8	92.9
2018	31,782.7	11,465.9	20,316.8	8,850.9	100.5	100.2	100.7
2019	33,065.3	13,667.5	19,397.8	5,730.3	96.1	93.5	97.6
2020	24,201.1	10,730.7	13,470.4	2,739.7	78.1	64.0	88.0

Source: State Statistics Committee of the Republic of Azerbaijan, https://www.stat.gov.az/

Figure 2. Share of oil and non-oil sectors in total exports in 1996, 2017 and 2020



Source: State Statistics Committee of the Republic of Azerbaijan, https://www.stat.gov.az/

The chart above shows the distribution of oil and non-oil share in total exports. As we can see, the first year is 1996 where the distribution is 34% and 66% for non-oil and oil products respectively. But in 2017 there is a huge difference compared to 1996. Export of non-oil products decreased more than 3 times, oil products increased to 89 percent. The reason for this is that after the agreement of the century, the main attention in Azerbaijan was directed to the exploration and processing of oil. This trend continued in 2020 as the non-oil sector was more affected by the coronavirus pandemic and exports fell by 7%. Oil exports increase to 93% of total exports. This proves once again that the export of Azerbaijan is mainly dependent on oil and there is a need to diversify the economy in order to increase dependence on oil products (State Statistics Committee of the Republic of Azerbaijan).

In 2021, the country's non-oil exports amounted to 2.7 billion dollars. Government officials also often see export growth in the non-oil sector as a major success. However, it should be noted that the share of non-oil exports in total exports is still very low. According to the results of 2021, the total export of Azerbaijan amounted to 22.2 billion dollars. This means that the oil sector accounts for 88% of the country's exports, and only 12% for the non-oil sector.

Table 5. Azerbaijan's non-oil exports in 2015-2021, billion dollars

Years	Non-oil sector exports
2021	2.7
2020	1.85
2019	1.95
2018	1.68
2017	1.53
2016	1.24
2015	1.58

Source: State Statistics Committee of the Republic of Azerbaijan, https://www.stat.gov.az/

88 out of every $100 the country earns still comes from the oil and gas sector, unable to compensate for declining oil revenues from non-oil exports.

2.2 SME contribution to Azerbaijan economy

Small and medium-sized enterprises (SMEs) play a crucial role in the economy of Azerbaijan. They contribute to the country's economic growth, employment generation, and overall competitiveness. In this chapter, we will discuss the contribution of SMEs to the Azerbaijani economy, their current status, and the latest indicators. In Azerbaijan, SMEs are defined as enterprises with fewer than 250 employees and annual revenue or balance sheet total of less than 50 million AZN. This definition is in line with the European Union's (EU) definition of SMEs, which is widely used in many countries.

SMEs play a significant role in the Azerbaijani economy, contributing to its economic growth and competitiveness. They account for a significant proportion of the country's gross domestic product (GDP), employment, and exports. According to the State Statistics Committee of Azerbaijan, in 2020, SMEs accounted for over 90% of the country's total number of enterprises and around 40% of its total employment. In the same year, SMEs generated approximately 56% of the country's total industrial output and 33% of its total export volume. SMEs also play a crucial role in creating new jobs and reducing poverty. They provide employment opportunities to a large number of people, particularly in rural areas, where large enterprises are scarce. By creating new jobs, SMEs contribute to the country's overall economic development and social stability.

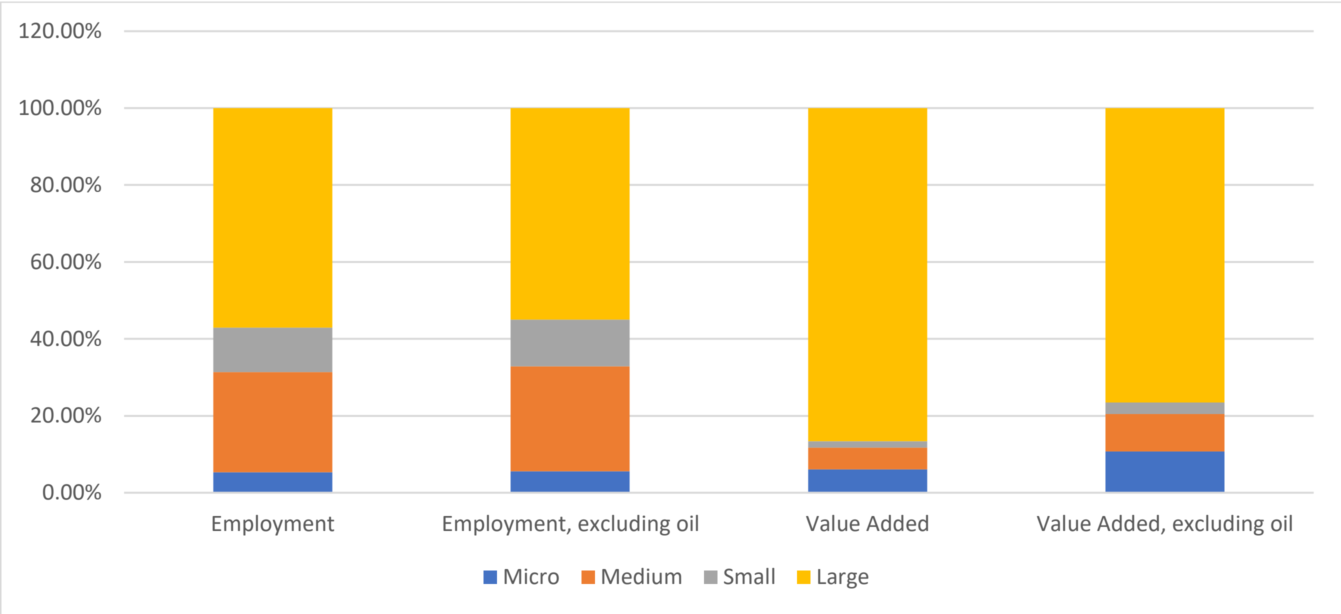
SMEs play a significant role in promoting entrepreneurship and innovation in Azerbaijan. By providing a supportive environment for small businesses, the country can encourage entrepreneurship and foster innovation. This can lead to the development of new products, services, and technologies, which can drive economic growth and increase competitiveness. SMEs also provide a source of new ideas and business models that can drive innovation in the economy. By promoting entrepreneurship and innovation, SMEs can help to create a more dynamic and flexible economy, which is better able to respond to changing market conditions. SMEs play a crucial role in supporting economic diversification in Azerbaijan.

They provide a source of innovation and entrepreneurship that can help to drive the development of new industries and services. By promoting economic diversification, SMEs can help to reduce the country's dependence on its oil and gas industry, which has been the main source of its economic growth in recent years. SMEs can also help to promote economic growth in rural areas, which are often neglected by larger enterprises. By providing employment opportunities and creating new businesses, SMEs can help to reduce poverty and promote social stability in these areas.

Despite their significant contribution to the Azerbaijani economy, SMEs in Azerbaijan face several challenges. One of the main challenges is access to finance, as SMEs often struggle to obtain the funding they need to grow and expand their businesses. This is due to a lack of access to bank financing, as well as a shortage of alternative sources of finance, such as venture capital and angel investors. Another challenge faced by SMEs in Azerbaijan is a lack of skilled human resources. Many SMEs struggle to find and retain skilled employees, particularly in rural areas, where the availability of skilled workers is limited. This makes it difficult for SMEs to grow and compete with larger enterprises.

Additionally, SMEs in Azerbaijan face regulatory and administrative barriers, which make it difficult for them to start and operate their businesses. These barriers include complex and time-consuming procedures for registering a business, obtaining licenses and permits, and complying with tax and labor regulations. In Azerbaijan, the vast majority of the economic potential held by SMEs has not yet been fully realized. Compared to OECD countries, which created 60% of total value added and 60-70% of employment in 2018, small and medium-sized enterprises (SMEs) were responsible for producing 13.4% of all value added and 42.9% of all jobs. In the non-oil sector of Azerbaijan's economy, production by SMEs was responsible for 45 percent of employment and 23.5 percent of value added.

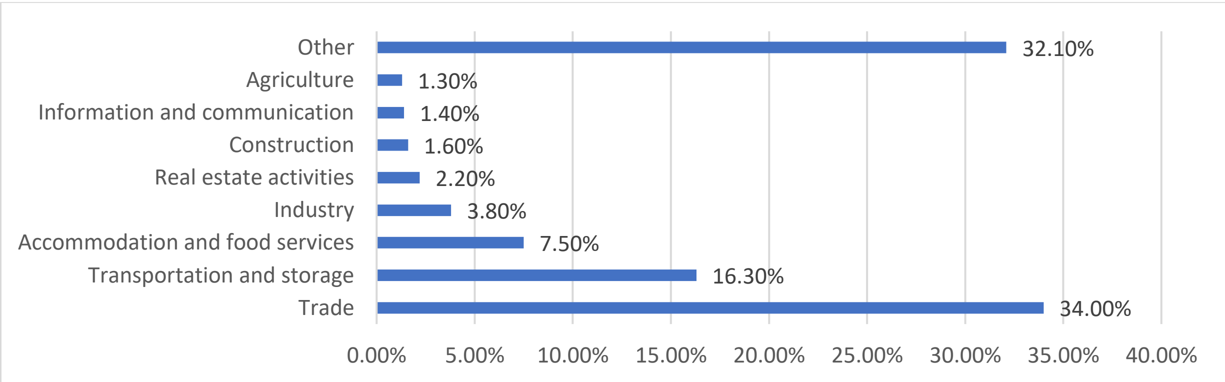
Figure 3. Azerbaijan's business demography indicators (2020), %



Source: State Statistics Committee of the Republic of Azerbaijan, https://www.stat.gov.az/

The vast majority of small and medium-sized enterprises (SMEs) in Azerbaijan are primarily involved in relatively low value-added operations. These businesses include the sale and repair of autos, transportation and storage, as well as activities related to hotel and food services.

Figure 4. Sectoral distribution of SMEs in Azerbaijan, %



Source: State Statistics Committee of the Republic of Azerbaijan, https://www.stat.gov.az/

According to the data, the trade sector has the largest share of SMEs, accounting for 34.00% of the total. The transportation and storage sector is the second largest, with 16.30%. Accommodation and food services sector is also a significant contributor, with 7.50%. SMEs in Azerbaijan are relatively small in the industry sector, accounting for only 3.80%. Real estate activities and construction both make up a small portion of the total, at 2.20% and 1.60% respectively. The information and communication and agriculture sectors are also small, with 1.40% and 1.30% respectively. The "other" category accounts for the remaining 32.10% of SMEs in Azerbaijan, which can include a wide range of industries and business types.

The expansion of Azerbaijan's small and medium-sized businesses (SMEs) into foreign markets is one of the five strategic goals outlined in the country's SME Roadmap. AZPROMO is, as it has been for many years, the major body that is responsible for delivering services for export promotion. The vast bulk of its services, on the other hand, are concentrated on facilitating the presence of enterprises at international trade fairs and the organization of trade missions. The goal of the "Single Window" Export Promotion Center, which was established in 2016 under the auspices of the CAERC and aims to boost the internationalization of small and medium-sized enterprises (SMEs), is to connect local businesses that produce goods with the label "Made in Azerbaijan" with consumers in other countries.

The Export Promotion Centre provides a variety of services, some of which include informational support, services for clearing customs, and the production of documentation known as Free Sales Certificates, which attests to the quality and origin of the items being sold. Even though exact plans for its development are not yet known, it is anticipated that SME Houses, which will work under the SME Development Agency, will offer training and consultation services to increase SMEs' export readiness.

These SME Houses will operate under the SME Development Agency. In addition, the Ministry of Economy formed fifteen export associations with the purpose of increasing exports in a variety of industries, including as agriculture, tourism, and the textile industry. Despite this, the associations do not have the resources or the skills necessary to successfully recruit members or to provide effective advocacy or support services.

ITC is now carrying out the EU4Business initiative "Ready to Trade," which fosters the globalization of Azerbaijan's light industrial and agriculture sectors. This effort is being carried out in conjunction with the measures being carried out by the government. As time passes, Azerbaijan may be able to ensure a coordinated approach to the provision of export support programs offered by the public institutions and may be able to guarantee that the SME Development Agency and its regional branches have sufficient capacity to successfully implement their support programs in response to the demand from SMEs. These two goals may be accomplished by ensuring that the SME Development Agency and its regional branches have sufficient capacity.

Having regard to the financing of trade, the government has begun providing export subsidies for a few different categories of items with origins in Azerbaijan. These categories include leather, textiles, and agricultural goods. However, there is no systemic financial support framework that either provides services related to trade insurance or assists SMEs that are engaged in exporting across different industries. Azerbaijan does not have any plans that will help with the integration of non-oil producers into global value chains or the enhancement of relationships between local suppliers and large foreign companies already present in the country.

On the other hand, the preliminary work necessary to develop such a program has already been completed, and going forward, Azerbaijan may focus on making the program operational. In addition to this, the Baku E-Commerce Academy, which is a program that is administered by CAERC, provides training and advising services to small and medium-sized businesses (SMEs) in order to increase their capability of utilizing big international e-commerce websites such as Amazon or Alibaba.

2.3 Sectoral distribution of foreign direct investments in Azerbaijan

It can be said that the entry of FDI into the independent Azerbaijan economy began in 1995. The political instability observed in the first years after its independence in 1991 disappeared to a large extent at the end of 1994, especially in September 1994, the signing of the Production Sharing Agreement within the scope of the Azeri-Chirag-Guneshli project, the country's first international oil agreement, paved the way for foreign direct investment in the country.[38]

[38] Feyziyeva, G. (2017). Azerbaijan in the South Caucasus policy of great powers. Американська історія та політика, (4), 151-160.

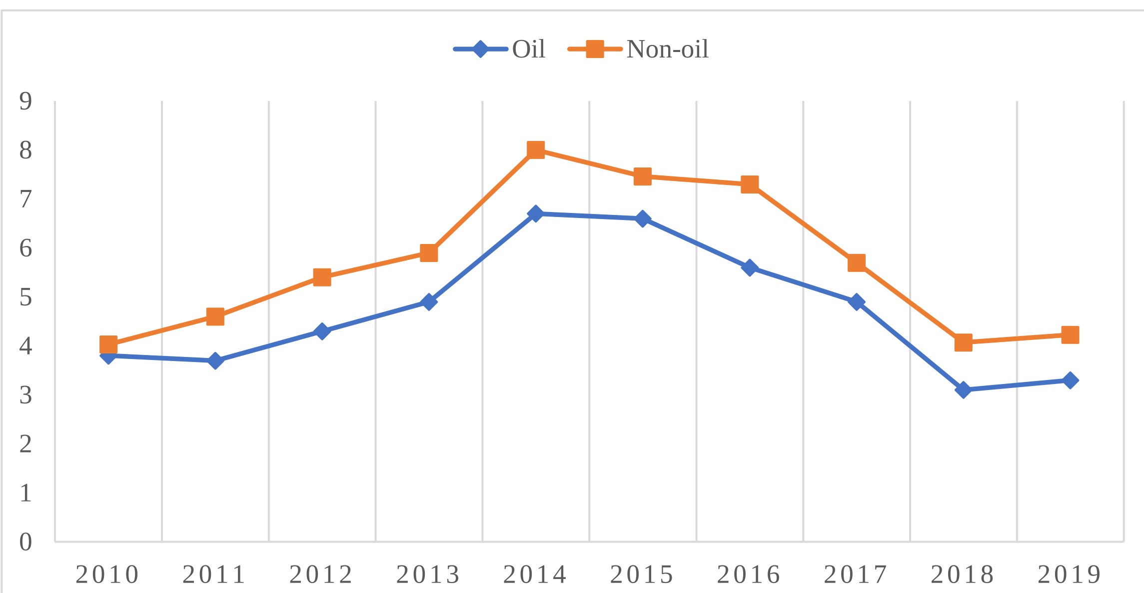
Table 6. Investments in the economy, million USD

	2015	2016	2017	2018	2019	2020
Investments from All Sources (Including Foreign Investments):	19547,2	14228,0	14213,3	15221,7	14698,0	13225,9
Foreign Investment	10719,1	10161,1	9120,5	8236,5	7129,1	6125,4
Domestic Investments	8828,1	4066,9	5092,8	6985,2	7568,9	7100,5

Source: State Statistics Committee of the Republic of Azerbaijan, https://www.stat.gov.az/

Between 1995 and 2017, a total of 125.5 billion manats were transferred to the country's economy. Foreign investment amounted to US$ 1 billion, of which 96.1% occurred between 2003 and 2020. In the 2003-2020 period, all foreign investments in the country reached 29.2 billion. In 2003-2020, 77.8 billion dollars were allocated to the Azerbaijani economy. 66.8 billion or 85.9% of foreign direct investment was sold in the oil sector, the remaining 19.9 billion dollars in the non-oil sector. Over the years, the amount of FDI entering the oil sector has always been much larger than the non-oil sector.

Figure 5. Dynamics of attraction of foreign investments in specific sectors of Azerbaijan's economy in 2010-2019, billion.



Source: State Statistics Committee of the Republic of Azerbaijan, https://www.stat.gov.az/

Table 7 provides information about the total amount of foreign direct investment (FDI) received by Azerbaijan's non-oil industry from a variety of countries between the years 2003 and 2016. Turkey was the greatest investor in Azerbaijan's non-oil industry, with a continuous growth in foreign direct investment over the years, reaching its peak in 2014 with $481.4 million. The Netherlands, the United States of America, Russia, and Great Britain were also key investors, but their levels of participation changed significantly over the course of the project's lifetime. Moreover, significant investments were made over a period of time by Switzerland, Germany, and the United Arab Emirates. Iran and France both made very modest contributions in the non-oil sectors of Azerbaijan's economy, with some years seeing either low or no investment at all. During the course of several years, the overall amount of FDI in Azerbaijan's non-oil economy climbed, reaching a high point of $1.3 billion in the year 2014. Yet, there was a significant amount of variation in the amounts of investment coming from each country as well as from one year to the next.

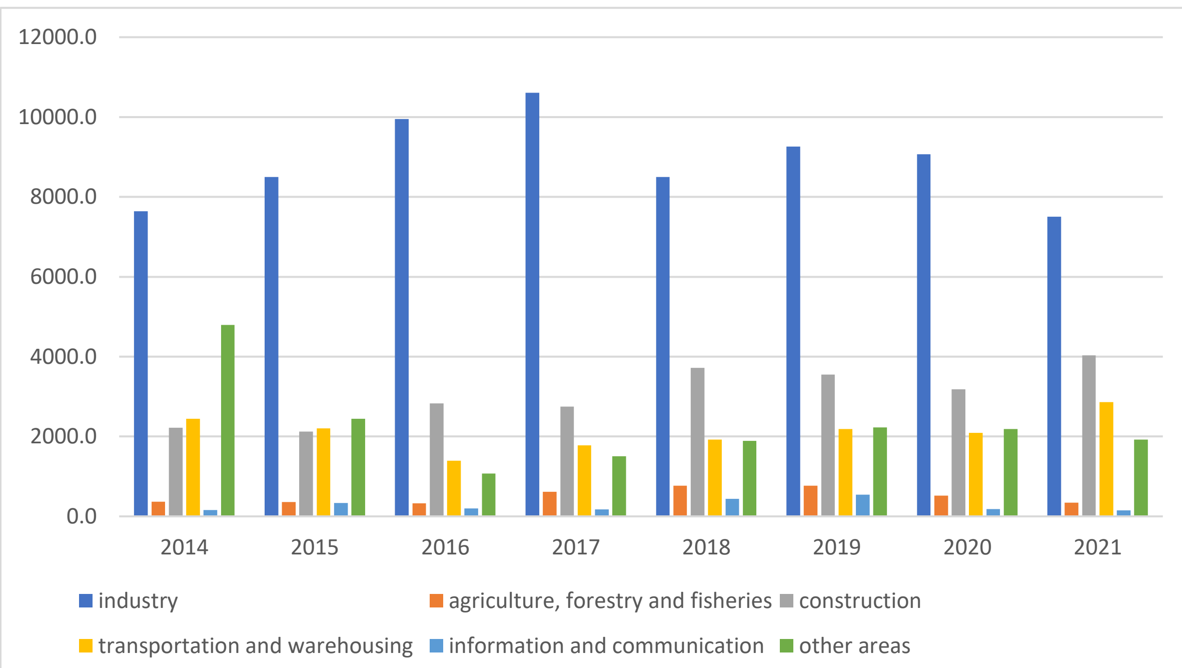
Table 7. Country shares of FDI directed to non-oil sector (2003-2016)

	03	**04**	**05**	**06**	**07**	**08**	**09**	**10**	**11**	**12**	**13**	**14**	**15**	**16**
Turkey	17.1	80.1	96.2	137	109	60.8	76.8	148	89.1	186	401	481.4	220.4	307.5
The Netherlands	-	-	1.2	-	-	43.8	28.0	164	173	186.4	141.6	103.8	85.9	127.9
USA	4.9	8.4	24.8	70	78	109	118	40.0	73.8	92.5	24.4	89.3	18.9	38.2
Iran	-	-	1.2	17.5	4.6	-	6.8	3.2	11.2	-	-	40.5	0.0	0.2
Germany	-	2.1	21.5	17.4	22.9	48.2	38.8	17.0	32.5	45.6	15.1	51.0	60.1	36.4
Russia	1.2	1.8	5.1	4.6	10.7	5.8	50.3	11.7	35.0	21.8	36.1	13.6	15.9	363.2
Great Britain	9.0	4.2	39.5	39.1	80	146	160	144.0	148.8	149.3	136.0	153.5	173.1	174.4
United Arab Emirates	4.4	4.4	5.7	18.3	12.3	38.5	43.2	30.3	75.3	92.4	109.3	90.2	103.9	60.2
Switzerland	-	-	0.5	2.7	3.5	3.7	16	11.7	26.7	79.4	18.2	18.9	15.7	370.5
France	2.2	2.2	2.6	11.1	4.4	-	4.5	6.2	14.3	14.4	6.1	7.2	4.5	5.5

Source: State Statistics Committee of the Republic of Azerbaijan, https://www.stat.gov.az/

The manufacturing sector of the Azerbaijani economy has traditionally been the non-oil sector that has attracted the greatest amount of foreign direct investment (FDI). The manufacturing sector continues to lead in terms of the amount of foreign direct investment (FDI), but the building industry has moved up to second place. In spite of the fact that the agriculture industry possesses a significant amount of untapped potential, there has been no foreign direct investment (FDI) in this sector during the past several years. Investments from outside the country in the agricultural sector might result in the adoption of cutting-edge technology in that area, which would likely lead to a rise in agricultural output. It is concerning that the majority of Azerbaijan's gross domestic product comes from oil income, as well as the fact that more money is being invested in the oil industry there. Variations in GDP are caused by price variations on global markets, which are in turn caused by the unilateral expansion of the oil industry.

Figure 6. Distribution of FDI Directed to Non-Oil Sectors (million, USD)



Source: State Statistics Committee of the Republic of Azerbaijan, https://www.stat.gov.az/

Figure 6 shows the sectoral distribution of foreign direct investment (FDI) in various industries over the years 2014 to 2021. The industries listed in the table are: agriculture, forestry, and fisheries; construction; transportation and warehousing; information and communication; and other areas. In 2014, the highest amount of FDI was received by the "other areas" category, with a total of 4795.4. The second-highest amount of FDI was received by the information and communication sector with 2440.6. Meanwhile, the agriculture, forestry, and fisheries sector received the lowest amount of FDI with 7639.5. In the following years, there were fluctuations in the amount of FDI received by each sector. For example, in 2018, the construction sector received the highest amount of FDI with 3721.4, while in 2021 the transportation and warehousing sector received the highest amount with 4033.2. The information and communication sector received the lowest amount of FDI in 2020 with 185.5.

State regulation of investment activity implies a complex system of measures for the implementation of a unified economic, scientific, technical and social policy in the country. These measures are financed by the state, local budgets and private funds. Investments are mainly aimed at meeting the social needs of the country and developing strategic sectors of the economy. Regardless of ownership and form of ownership, investments are regulated according to the legislation of the country in which they operate. The state strictly controls the regulation of the socio-economic development of the country, as well as the creation of the necessary proportions in the national economy, the creation of production and social infrastructure.

As it is known, the creation, reconstruction and expansion of all kinds of production and social areas and thus providing employment requires appropriate investments and more efficient use of them. In a market economy, taxes become more of a tool than a traditional financial instrument to regulate socio-economic processes. Thus, tax regulation performs the function of systematizing, distributing and controlling in the reproduction process. Tax regulation covers almost all areas of government intervention in the economy. Such measures are the main directions in which the taxation function of the body is performed. Using these instruments, the state encourages or restricts capital investment, while at the same time having a significant impact on the formation of living standards.[39]

Meeting the increasing socio-economic needs of the members of society makes it a duty to use the current production potential fully and effectively. In this context, the role and importance of foreign investment is extremely high. Improving macroeconomic indicators in the country requires increasing the role and importance of leading sectors, especially strategic ones, in the national GDP structure. In this context, the increase of foreign investment in the republic and its

[39] Allahverdiyev, H.B., Gafarov, K.S., Ahmedov, A.M. (2002) State Regulation of the Economy, Baku: Nasser

regulation by the state, ensuring the necessary rates in the development of the economy are of great scientific and practical importance.[40]

The Tax Code of the Republic of Azerbaijan provides for the implementation of a tax policy by the state, which encourages investment, entrepreneurship and commercial activity in the economy, encourages taxpayers to earn more and to further expand their production by creating a budget. Such a policy is aimed at creating more favorable conditions for the development of entrepreneurship and business, ensuring the socio-economic development of the country, increasing tax revenues and, ultimately, further reducing the material well-being of the population. The tax legislation of the country has been systematized in the Law, aspects of tax policy and principles of taxation have been adapted to the requirements of the market economy.[41]

In addition, the taxes to be applied have been scientifically verified, and the rules for their determination, calculation, collection and transfer to the state budget have been simplified considerably. A class of entrepreneurs has emerged in Azerbaijan as a direct consequence of significant processes, and the contribution of the country's private sector to the nation's overall socioeconomic growth has grown in importance. In recent years, the Tax Law has lowered the rate of value added tax from 20% to 18%, cut the rate of corporate income tax from 22% to 20%, and set the rate of income tax for those engaged in entrepreneurial activities at 20%. The tax burden between legal entities and individual entrepreneurs has been reduced, the upper limit of the tax rate on the monthly income of individuals and annual income from non-entrepreneurial activities has been reduced from 35% to 30%, and legal entities without VAT registration and those taxed for 150 consecutive 12 months plus 1,000 AZN will no longer be required to pay the additional tax. 90 People who engage in business operations without forming a formal entity or with less than nine employees now have access to a streamlined taxpayer right, and computerized tax invoices for value-added taxes and excise taxes have been implemented.[42]

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[40] Babashkina, A.M. (2007) State Regulation of the National Economy, Baku, Accounting, Finance and Statistics.

[41] Musaev, A.F., Sadygov, M.M., Magerramov, R.B., & Salaev, R.A. (2005). Taxes and Taxation in Azerbaijan, Baku.

[42] Aliyev, K., & Gasimov, I. (2018). Fiscal policy implementation in Azerbaijan before, during and after the oil boom. Contemporary Economics, 12(1), 81-94.

At the same time, tax exemption on income from agricultural production, the introduction of special tax regimes, including a simplified tax system for small business development, the introduction of a simplified tax rate in some regions compared to Baku, the competitiveness of small businesses, and increased investment in a variety of regions all contributed to the success of the country's economic development. One clear illustration of the steps taken to regulate investment activities is the implementation of appropriate measures to address the problem of regional development and employment. These steps were taken to address the problem. In general, the fiscal policy that has been formed in Azerbaijan has been established to improve both the economic climate and the environment for investment.[43]

General social, economic and legal conditions of investment activity in the territory of the Azerbaijan Republic and legal and economic principles of foreign investment are determined by the Law of the Republic of Azerbaijan "On Protection of Foreign Investment". Foreign investors and forms of foreign investment. Article 2 of the Law defines foreign investors, while Article 3 defines foreign investment and investment forms. According to article 2, foreign investors in the Republic of Azerbaijan can be:[44]

- foreign legal entities,
- foreign nationals, stateless persons and citizens of the Azerbaijan Republic with permanent residence abroad; provided that they are registered to engage in economic activities in the country of their nationality or permanent residence,
- foreign states;
- International organizations.

According to article 3 of the law, foreign investors can invest in the territory of the Azerbaijan Republic in the following ways:[45]

- participation in enterprises and organizations established jointly with legal entities and citizens of the Azerbaijan Republic;
- Establishment of enterprises completely owned by foreign investors;

[43] Mammadov, F.A. (2010) Taxes and Taxation, Baku, See
[44] Safarov, R. (2017) Mechanisms to Improve Innovation in the Application of New Technologies in Azerbaijan, Baku.
[45] Atakishiev, M., & Suleymanov, S. (2014). Innovation Management, Baku.

- Purchase of enterprises, property complexes, buildings, facilities, shares in enterprises, stocks, bonds and other securities that may belong to foreign investors, as well as other properties that may belong to foreign investors, in accordance with the legislation of the Republic of Azerbaijan;
- Acquisition of rights to use land and other natural resources, as well as other property rights;
- Conclusion of agreements with legal entities and citizens of the Azerbaijan Republic providing for other types of foreign investment.

The fact that the conditions and rules outlined in the third article are decided by the central government demonstrates that this article, when put into reality, bans foreign investors from taking part in the privatization of state-owned companies. In Azerbaijan, the regulation of options and discrimination against foreign investors by 12 administrative and central administrations has partially limited the ability of foreign investors to privatize businesses since 1995. This occurred during the privatization of small and medium-sized enterprises as well as the transformation of large enterprises into joint stock companies. In the current iteration, the transfer of the right to decide on their participation to the central executive power results in their effective exclusion from the process of nationalization and privatization. This is the case since it is the central executive power that is being transferred.[46]

Article 7 of the law states that the legal regulations of the Republic of Azerbaijan may define such zones that restrict or prohibit the activities of foreign-owned enterprises in these territories for the purpose of defense, national security, environmental protection, and the protection of Azerbaijan. An economic zone can refer to the entirety of a country's territory or just a specific region within that territory. However, regardless of the circumstances, it is impossible to limit the mobility of foreign investors in the financial sector.The local legislative framework, which regulates the extent of activity that can be undertaken by foreign investors, is an essential component in the process of luring overseas capital into the economy of a country. Following the dissolution of the Soviet Union, the process of switching from a structure of planned economy to

[46] Azam, M. (2010). The Determinants Of Foreign Direct Investment: Evidence From Azerbaijan And Kazakhstan. Central Asia (1729-9802), (67).

a structure of market economy got underway, and work also got underway in the direction of establishing a legal infrastructure.

After achieving independence in 1992, the country enacted its first law governing investments made by foreign entities. The first law on the Protection of Foreign Investments came into effect, and with it came the foundation for the construction of legal and economic channels for foreign interests entering the country, as well as the guarantee that the state will protect those investments. According to the law, foreign investors can invest in the territory of the Azerbaijan Republic in the following ways:

1. Shareholding in enterprises and organizations established jointly with legal entities and citizens of the Azerbaijan Republic;

2. Establishment of enterprises completely owned by foreign investors;

3. Purchase of enterprises, property complexes, buildings, facilities, shares in enterprises, bonds, shares and other securities that may belong to foreign investors in accordance with the legislation of the Republic of Azerbaijan, as well as other properties that may belong to foreign investors

4. To have rights to use land and other natural resources and other property rights

5. Conclusion of agreements with legal entities and citizens of the Azerbaijan Republic providing for other types of foreign investment.

The Law on Investment Activities, adopted in 1995, was amended again in 2005 and was accepted with the approval of the Azerbaijan National Assembly. This law covered important issues such as attracting foreign investment to the country's economy, developing international economic relations and guaranteeing all foreign investments.[47] One of the most attractive factors for investment in Azerbaijan's non-oil sector is the availability of cheap labor and rich underground resources. In addition to these attractive factors, other positive parameters should be favorable to the investment climate in general, especially to encourage foreign investors. This necessitates the analysis of the investment environment in the country from various perspectives. The Government of Azerbaijan follows an open door policy in order to attract foreign investors. Currently, the Government of Azerbaijan continues to carry out economic reforms in order to further improve

[47] Guliyeva, G. (2005). Democratization and the rule of law in Azerbaijan: Europe's relevance. The state of law in the South Caucasus, 41-58.

the business environment in the country, to develop the non-oil sectors. The investment policy implemented in the Republic of Azerbaijan has been shaped mainly by the reforms carried out by the state in the following areas:

- Improvement of the direct legal framework;
- Signing agreements with a number of foreign countries on the elimination of double taxation and the promotion and mutual protection of investments
- Simplification of international currency transactions;
- Improvement of tax and customs systems
- Simplifying the licensing system,
- Simplification of state registration of legal entities

Since mid-2015, important steps have been taken to make the business and investment environment in the country more transparent. Steps have been taken to promote entrepreneurship and improve the business environment in the country. The number of activities requiring a license for entrepreneurial activity was reduced from 59 to 37. The number of licenses granted by the Ministry of Economy through ASAN Service centers has reached 33. The number of government agencies issuing licenses has been reduced from 23 to 4. Licenses are granted indefinitely and the procedures for issuing licenses have been simplified.

At the same time, the amount of state fee paid for obtaining a license was reduced and the licensing period was shortened. Azerbaijan Export and Investment Promotion Fund (AZPROMO) was established by the Ministry of Economy in 2003 with the initiative of the public and private sectors. Playing the role of a bridge between local producers, foreign investors and the government is one of the main activities of the organization. The main objective of the organization is to ensure the balanced development of the national economy both on the sectoral and regional basis, to attract and encourage investments to create new employment, especially in the regions, as part of the poverty reduction policy.[48]

[48] Mirzeyev, S., & Baku, A. (2012). Small and medium entrepreneurship in Azerbaijan; country assessment. Baku: CESD.

2.2.1 Factors affecting foreign direct investments in Azerbaijan

Economic, political, social, and cultural values are the categories that can be used to categorize the factors that influence direct investment in Azerbaijan. The size of the market is the single most important economic factor that international investors look for in a country like Azerbaijan. This magnitude is related not only to the population of the host, but also to the effective demand that the population has.[49] Within this framework, it is anticipated that the nation receiving an influx of foreign money will have high real buying power as well as the possibility for stable economic growth. At the same time, investment discounts, exemption from customs fees or delays in payments, cheap loans, and other types of financial incentives may desire to be taken advantage of.[50] It's crucial for there to be a variety of incentives like these for foreign investment.

Another aspect that makes a country appealing to investors from other countries is the high availability of low-cost production factors. It is essential to take into consideration not only the quantitative but also the qualitative aspects of the factors of production. Especially in the use of knowledge-based technologies, a mature workforce and labor market, as well as the requirement for regulation, raise the demand for quality workforce members who are customer-oriented, entrepreneurial, innovative, and have strong relations and sales abilities. Foreign investment companies have an additional obligation to invest in the degree of openness of the economies of the nations in which they invest, the degree of openness of the economies of the world markets, the level of integration with the world markets, and whether or not a free market economy is practiced and what it is capable of achieving.[51]

The economic and political stability of the nation in which direct foreign investors plan to make investments is the single most critical consideration for these investors. It is fair to say that the political climate of a country plays a role in the decisions that are made about investments in general. Many businesses may be afraid to invest or reinvest in nations that have political situations that are unstable because of the risk involved. Because political stability is a factor that ensures

[49] Hübner, G. (2011). Foreign Direct investment in azerbaijan—the Quality of Quantity. Caucasus Analytical Digest, 28(June).
[50] Haciyev, S.H., Bayramov, A.I. (2021). History of the World Economy, Baku
[51] Mammadova, G., & Coskun, A. (2015). Costs and Benefits of Foreign Direct Investment to Azerbaijan's Economy: The Case of Oil Sector. Asian Journal of Finance & Accounting, 7(1), 135-154.

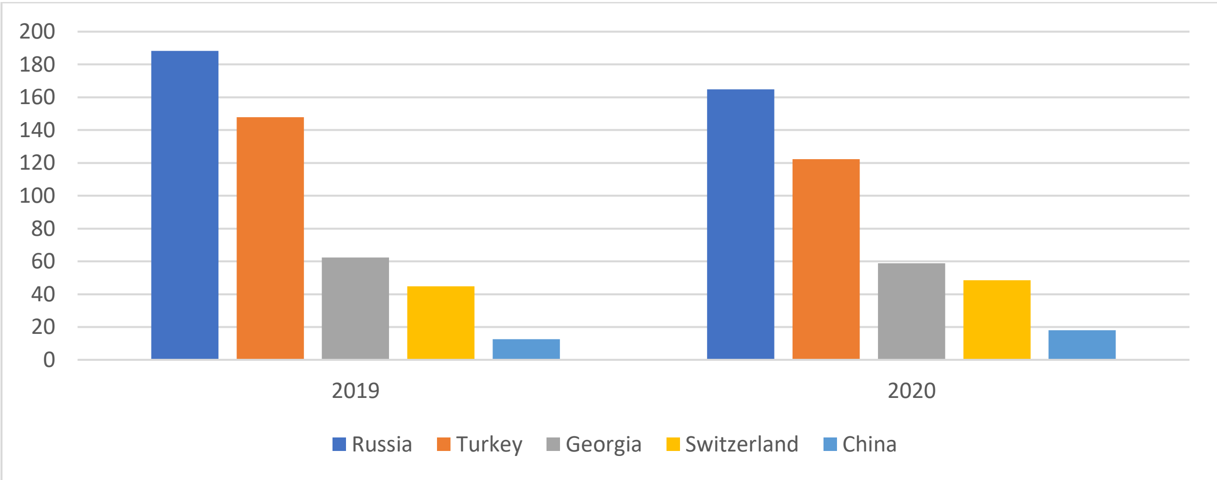
economic stability, it is also a factor that impacts the amount of capital invested from outside the country. Because investors with foreign funds may place a primary emphasis on trust and safety.

2.4 Investments in the non-oil sector

Businesses operating in the non-oil sector have a relatively low investment attractiveness compared to the oil sector of the economy. For this reason, more sensitive commodity masses are formed in non-oil sector enterprises. In the non-oil sector, agricultural products can be considered mainly as a sensitive group of goods. The production of these products mainly depends on natural and climatic conditions. In addition, foreign investments in this area are not profitable for investors, as production is mainly focused on the large development base.

When examining the nature and character of investment in modern times, it is important that investment is the main driver of economic development. Investments play a key role in a capital investment aimed at increasing the profitability of an enterprise, as well as physical and moral renewal and modernization of equipment and fixed assets. From this point of view, the increase in investment creates favorable conditions for the expansion of the volume of goods in the domestic and foreign markets, creating a direct basis for the dynamics of economic development. At the same time, while capital investments are an important factor in economic development, they also play an important role in the socio-economic development of regions. Increasing the volume of investments in this or that enterprise creates favorable conditions for improving the level of social infrastructure in this or that area and region.

Figure 7. Export volume in the non-oil sector, million USD



Source: State Statistics Committee of the Republic of Azerbaijan, https://www.stat.gov.az/

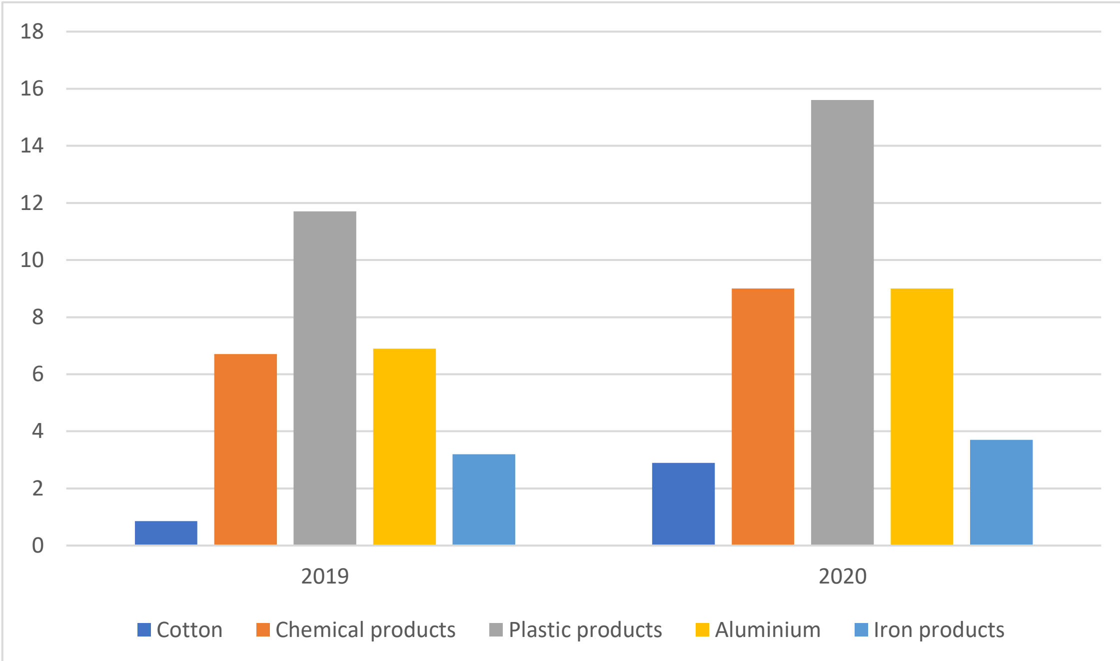
In modern times, there is a domestic market of light industry enterprises that can act as an important part of the non-oil sector in the country. Therefore, the products produced in these sectors are the products of daily demand, and in this context, the revival of production with the investments made in these enterprises can lead to the sale of the products produced in these enterprises, which can have a strong effect on trade.

Encouraging investment in the development of the non-oil sector should be a priority of government investment policy. In this respect, internal and external environmental factors that affect the efficiency and increase the volume of investment processes should be analyzed very reliably and the investment policy of the state should be based on these analyses. Analysis of internal and external environmental factors affecting the volume and efficiency of investment processes can create favorable conditions for increasing the investment attractiveness of the non-oil sector.

The analysis shows that increasing the purchasing power of the local currency is one of the internal environmental factors affecting the investment process as a whole. There is also a special need to change the traditional nomenclature of exports. At the same time, the establishment of an export-substituted production process and increasing competitiveness actually require the physical and moral renewal of enterprises operating in this field. Therefore, it is possible to effectively regulate the development of the non-oil sector on the basis of protecting the domestic market and promoting local production.

In the January-February 2018 period, 816.2 million manats or 44.7% of the 1824.7 million manats directed to fixed capital from all financial resources for the development of the country's economic and social fields were spent on the non-oil sector, and the investment volume in this sector is % compared to the previous year. It increased by 29.8% and exceeded 29.8%. 74.9% of the total investment was spent on construction and assembly works, 79.3% of the funds used were spent on production facilities, 14.8% on service facilities and 5.9% on 242.1 thousand square meters of housing construction. Funds diverted from domestic sources to fixed capital accounted for 50.8% of the total investment.

Figure 8. Sectors of exports, million USD



Source: State Statistics Committee of the Republic of Azerbaijan, https://www.stat.gov.az/

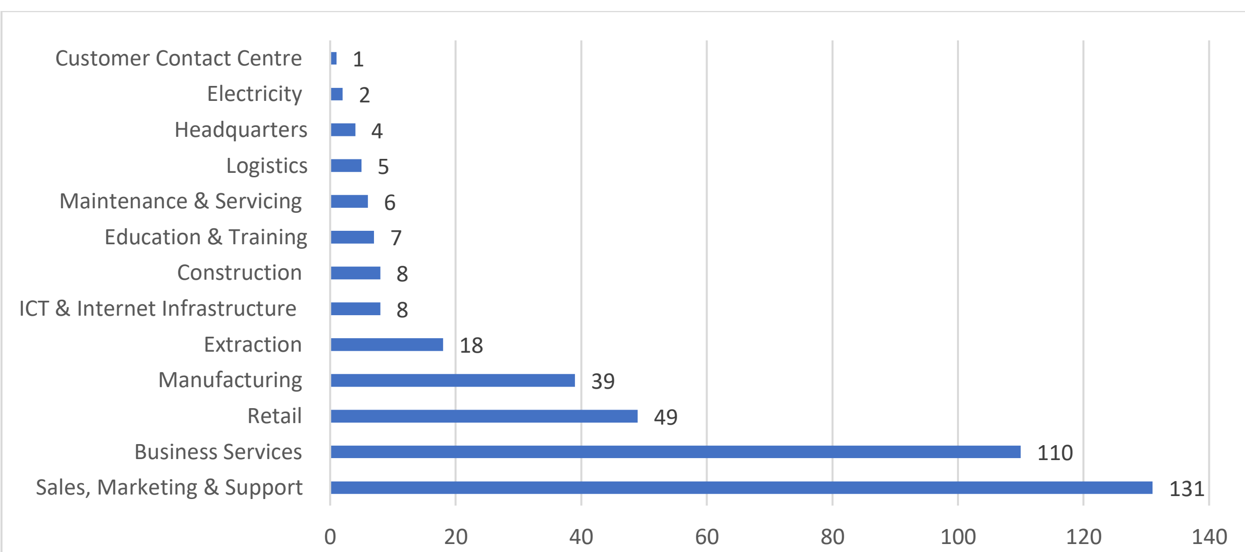
In the total value of investments in fixed assets, 68.1% of enterprises and organizations, bank loans 10.9%, budget funds 15.0%, personal funds of the population 5.4%, extrabudgetary funds 0.5%, other funds % 0 is 1. In January-February 2018, 110/35/10 kilovolt “Yasamal-1” and “Gobu”, 35 / 10-6 kilovolt electric substation 120 in Baku, “Mingachevir Textile” LLC yarn at the Mingachevir 2 production plant in Mingachevir Industrial Park In addition, 2 secondary school buildings with a capacity of 442 students and a polyclinic visited by 15 people in the Nakhchivan Autonomous Republic, etc. facilities have been commissioned.

2.5 Linkages between FDI and SME in Azerbaijan

Foreign Direct Investment (FDI) and Small and Medium-Sized Enterprises (SMEs) are two of Azerbaijan's most significant economic growth factors. Both are essential for the country's development and absorption into the global economy, and there is a substantial overlap between both. In this article, we will investigate the relationships between foreign direct investment and small and medium-sized enterprises (SMEs) in Azerbaijan, as well as the economic ramifications of these relationships. Azerbaijan is a country with abundant natural resources and a robust, expanding economy. In recent years, the government has actively promoted FDI as a means of stimulating economic growth and upgrading the national economy. This has been accomplished through a variety of means, such as tax incentives, business-friendly policies, and a variety of other support systems. Recognizing the importance of Azerbaijan's small and medium-sized enterprises (SMEs) as the economic backbone of the country, the government has also supported their growth. The formation of joint ventures is one of the most significant connections between FDI and SMEs in Azerbaijan. These collaborations enable foreign investors to contribute finance, technology, and management expertise, while using the local knowledge and networks of SMEs. This can be especially advantageous for small and medium-sized enterprises (SMEs) in Azerbaijan, as access to new markets, technologies, and skills can help them develop and compete more successfully.

In Azerbaijan, FDI and SME development are also related through the establishment of supply chains. Numerous foreign investors are drawn to the nation by its enormous natural resources and hospitable economic climate. Once they have established operations in the country, they frequently look to local vendors for inputs and materials. This is particularly significant for Azerbaijan's small and medium-sized enterprises, as it offers them with new business prospects and facilitates the development of closer contacts with overseas investors. According to a comprehensive review of the activities that foreign investors in Azerbaijan partake in, the majority of new investment projects (as opposed to mergers or acquisitions) are in the services sector, particularly in retail and business services. This finding is based on an analysis of the types of activities that foreign investors engage in within the country.

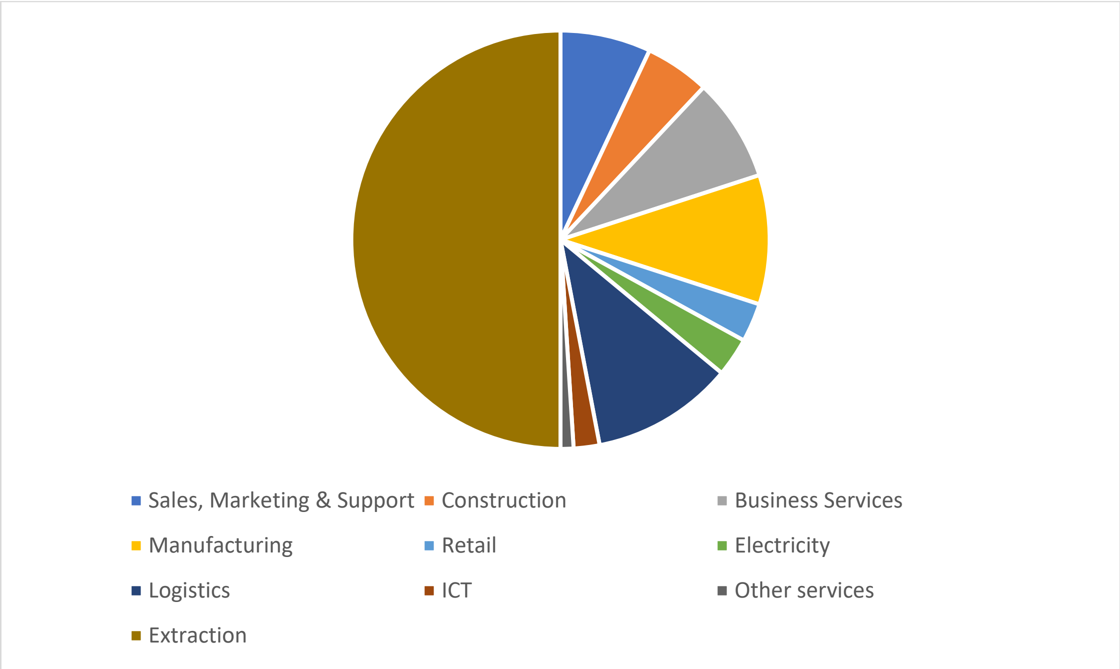
Figure 9. Quantity of new investment project



Source: [Azerbaijan-Linking-Domestic-Suppliers-with-Foreign-Investors.pdf (oecd.org)]

Manufacturing only accounts for roughly 10% of the overall value of greenfield investments made since 2003, with extraction still accounting for the majority of new investment projects in terms of their value.

Figure 10. The percentage of the total value that is contributed by new investments



Source: [Azerbaijan-Linking-Domestic-Suppliers-with-Foreign-Investors.pdf (oecd.org)]

Because participation in global production networks is enabled by manufacturing operations, there is a big opportunity to attract more foreign direct investment (FDI), even while investments in sectors other than oil are growing. In order to use foreign direct investment (FDI) as a tool to assist small and medium-sized enterprises (SMEs) in growing and participating in global value chains, Azerbaijan needs to increase the amount of FDI it receives so that it can diversify its economy and connect it to regional and global production networks. In order to accomplish this goal, you will need to increase the amount of foreign investment, which is currently in short supply in the manufacturing and production-related service industries.

The percentage of manufacturing enterprises in Azerbaijan that were involved in GVC was quite low up until 2013. According to findings from a survey conducted by the World Bank on enterprises in Azerbaijan in 2013, only 15% of the country's manufacturing SMEs imported intermediate inputs from outside the country. Only 3% of these smaller businesses were able to export their products. In comparison, the ratio of imports was frequently fifty percent (50%) while the percentage of exporters was typically fifteen percent (15%) in a few other Eurasian economies.

According to information obtained from a survey conducted by the OECD among Azerbaijani enterprises in 2018, local companies who possess necessary capacities are increasing their involvement in GVC. The purpose of the 201-company survey was to provide additional weight to enterprises that had some possibility of participating in global value chains (GVCs). The survey focused on industrial sectors with the greatest potential for growth and exports. As a consequence of this, it is quite likely that the capacity of the companies that were assessed are greater than the average for the overall economy.

Given that the majority of businesses were chosen from a database of companies that had some evidence of their potential to export, there is an extremely high prevalence of commercial ties: almost 80 percent of businesses obtain their inputs from other countries, and almost 50 percent of businesses supply businesses located in other countries. However, even these companies have only weak ties to multinational corporations: less than 10% of the companies surveyed say they source their goods or services from foreign affiliates of MNEs that are based in the nation. This indicates that even these companies only have weak ties to multinational corporations. This is presumably a reflection of the fact that foreign direct investment in non-oil businesses is still at a relatively low level.

It is possible that establishing connections with other domestic companies that have a higher level of internationalization could be an important step toward participation in GVCs for domestic enterprises. 15% of the respondents are involved in the production of goods that are later processed by other businesses before being exported In a country where there is relatively little direct foreign investment in global value chains, value chains that consist of several stages that are contained within the borders of the nation may offer small and medium-sized enterprises (SMEs) more practical choices for integrating into GVCs.

Chapter 3. Assessment of FDI in SMEs in Azerbaijan

3.1 Benefits and determinants of MNE-SME linkages

The establishment of supply chain relationships between SMEs and multinational corporations can be beneficial in a number of different ways. The growth of managerial expertise, an improvement in product quality, the production of new products, the acquisition of new technology, a decrease in prices, an improvement in working conditions, and a smaller environmental imprint may all be facilitated by linkages. However, the strength of these relationships is likely to have different implications for SMEs. The advantages for SMEs are somewhat dependent on the level of influence that MNEs have over them. In addition, it is anticipated that the benefits would vary depending on the sector, as well as on whether the links will be upstream or downstream.

In the research that has been done, estimating the influence that connections have on the outcomes of companies has been done using a variety of approaches, and the results have tended to be insufficient and usually contradictory. Assessment of Foreign Direct Investment Spillovers Using an Industry-Level Measure of FDI Presence Evaluation of the Impact of Foreign Direct Investment on a Specific Performance Indicator at the Business Level The conventional method involves the evaluation of foreign direct investment spillovers using an industry-level measure of FDI presence.[52]

The problem with attempting to quantify FDI spillovers at the firm level by assessing FDI presence at the industry level is that it assumes all domestic firms are affected by FDI to the same degree. However, firms differ significantly in terms of their capability to build linkages with foreign firms. Emerging research makes an attempt to account for this by explicitly controlling for linkages through the use of survey data; nevertheless, evidence for Eastern Partner economies is rare.

According to primary data obtained for the OECD Enterprise Survey of Azerbaijan, businesses that have some form of trade, investment, or contractual connectivity enjoy a

[52] Damijan, J. P., Rojec, M., Majcen, B., & Knell, M. (2013). Impact of firm heterogeneity on direct and spillover effects of FDI: Micro-evidence from ten transition countries. Journal of comparative economics, 41(3), 895-922.

productivity premium. This premium is evaluated by comparing the ratio of their average productivity to the productivity of firms that do not have any links. This measure is meant to show direct engagement in global value chains through domestic ties rather than indirect participation. As was to be expected, businesses that participate in activities related to outside investment are, on average, ten times more productive than those that do not have any relations. In each and every case, however, it is not possible to determine the sequence of events that led to the observed effects; hence, additional empirical research is required to shed light on this topic. In point of fact, causality may operate in both directions at the same time: businesses that have superior performance may be more desirable to MNEs, and MNEs' incorporation of GVC may ultimately boost their productivity advantage.[53]

Businesses not only earn huge profits from objective indicators of above-average productivity, but also substantial gains via trade and investment ties. These gains come in the form of improvements to operations and products rather than savings in direct costs; this suggests that they are the outcome of knowledge transfer rather than access to cheaper local resource alternatives. Because multinational corporations are held to stringent international labor standards and are held liable for the behavior of their suppliers in many countries, the improvements that have been observed in working conditions may be an indication that domestic businesses have upgraded their standards in order to meet the demands of foreign clients. To put it another way, supply chain links are related with gains in both conduct and efficiency, and fostering responsible corporate conduct can be a means of allowing domestic enterprises better access to global venture corporations (GVCs). The Organization for Economic Cooperation and Development (OECD) is aiding countries in improving the behavior of their corporate sectors by means of its Guidelines on Multinational Enterprises.[54]

Typically, foreign direct investment (FDI) is driven by one of these three goals: resource-seeking, market-seeking, or efficiency-seeking. The search for natural resources is the primary motivation for resource-seeking foreign direct investment. Foreign direct investment that is

[53] Bayramov, V., Hasanov, R., Aghayarli, L., Kadyrov, Z., Aghahasanli, I., & Isayev, S. (2017). A comparative study on development of small and medium enterprises (SMEs) in Azerbaijan. Available at SSRN 3485576.

[54] OECD (2011), OECD Guidelines for Multinational Enterprises, OECD Publishing, Paris, https://www.oecd.org/daf/inv/mne/48004323.pdf

market-driven takes into account demand factors in the host nation such as market size, income per capita, and market growth. Multinational firms have the opportunity to grow their operations and benefit from economies of scale and scope when they enter new markets. Historically, market-seeking foreign direct investment (FDI) was associated with the reason for a company to relocate to a foreign site, which was to avoid import charges or quotas in the home country. Foreign direct investment (FDI) that prioritizes efficiency seeks to maximize profits from geographically dispersed resources and activities by capitalizing on a diverse range of factor endowments, institutional and cultural variables, economic systems and regulations, and market structures while simultaneously serving a number of different markets.

Motives held by international investors are conceptually linked to the process by which relationships between multinational corporations and domestic businesses are actually brought into existence. Investors that are interested in extracting resources might not add anything to the economy of the host nation because that is their primary purpose. Even though market-seeking investors may build links with upstream suppliers and downstream distributors, domestic manufacturers usually regard market-seeking investors as competitors.

This is the case despite the fact that domestic producers may establish ties with market-seeking investors. Investors with a focus on efficiency typically join the market with the intention of capitalizing on the benefits of regional manufacturing. Therefore, it is envisaged that foreign direct investment (FDI) that seeks to maximize efficiencies will be the most advantageous to local producer connections and knowledge transfers. In actuality, investors are rarely motivated by a single cause, and as a consequence, the benefits for domestic enterprises are not always so apparent. Despite this, analyzing the stated major goals of investors can shed light on the likelihood of linkage being realized.

According to the 2018 EU Business Climate Survey, the key incentive for European Union investments in Azerbaijan is the search for new market opportunities. Although this is likely a way to join and serve the market rather than an objective in itself, over a quarter of respondents name strategic partnerships and alliances as one of the most significant factors. This should not come as much of a surprise given that the majority of those who participated in the survey are employed in the service and construction industries, both of which are generally non-tradable. This data is corroborated by qualitative interviews conducted with a subgroup of foreign investors involved in the processing of food and the fabrication of construction materials.[55]

Small and medium-sized enterprises (SMEs) in developing economies like Azerbaijan have the opportunity to gain knowledge when they receive FDI. The capacity of domestic firms, or the capacity to integrate information received via engagement with other firms, is required for the knowledge transfer from foreign to domestic enterprises.[56] The capabilities of indigenous businesses, as well as the technological divide between those businesses and their multinational counterparts, are directly related to absorptive capacity. According to findings from empirical studies, domestic suppliers who possess superior technological capabilities have a greater propensity to create knowledge-intensive linkages with international businesses.[57]

The amount of human capital that domestic firms have is another factor that impacts their capacity for absorption. Human capital and skills are both important in this regard. According to the findings of a number of studies, businesses that make investments in their human capital experience more favorable FDI spillovers than companies that do not make such investments. These findings suggest that providing employees with opportunities for training may be necessary in order to gain access to GVCs.[58]

According to the WBES, manufacturing companies made minimal investments in staff training in 2013. The survey found that less than 10% of manufacturing SMBs offered formal training courses. On the other hand, a significantly higher percentage of SMEs that provide services claimed that they provided formal training. This indicates that the manufacturing industry is lagging behind in this regard, and there is room for SMEs in the manufacturing sector to invest in human resources.

[55] Mammadli, T. (2018). EU Business Climate Report Azerbaijan 2018-Perceptions of EU Businesses active in Azerbaijan.
[56] Cohen, W. M., & Levinthal, D. A. (1990). Absorptive capacity: A new perspective on learning and innovation. Administrative science quarterly, 35(1), 128-152.
[57] Saliola, F., & Zanfei, A. (2009). Multinational firms, global value chains and the organization of knowledge transfer. Research policy, 38(2), 369-381.
[58] Hamida, L. B., & Gugler, P. (2009). Are there demonstration-related spillovers from FDI?: Evidence from Switzerland. International business review, 18(5), 494-508.

3.2 FDI target roadmap for SMEs in Azerbaijan

As a direct consequence of the widespread fall in the prices of commodities around the world, Azerbaijan had a severe economic contraction in the years 2015 and 2016. As a part of the government's response to the economic downturn, it revealed an ambitious plan to make reforms in 12 significant areas, one of which is the sector of small and medium-sized enterprises (SME), in an effort to diversify the economy and improve the environment for doing business.

Figure 11. Comparison of SME index of Azerbaijan for 2016 and 2020

Parameters	2016	2020	EAP average
Institutional and regulatory framework	**3.53**	2.47	3.74
Operational environment	4.20	4.23	3.92
Bankruptcy and second chance	2.97	2.87	2.85
Entrepreneurial learning/Women’s entrepreneurship	3.41	2.59	3.58
SME skills	2.62	2.94	3.36
Access to finance	3.12	2.70	3.57
Public procurement	2.87	2.42	3.49
Standards and regulations	3.10	3.32	3.43
Internationalization	3.08	2.50	2.96
Business development services	3.27	2.98	3.53
Innovation policy	2.83	2.47	2.92
Green economy	2.31	1.54	2.77

The primary guiding document for the development of small and medium enterprises (SMEs) is called the "Strategic Roadmap for the Production of Consumer Goods at the Level of Small and Medium Entrepreneurship." Under this document, the government has launched a number of programs and initiatives, some of which include the establishment of a dedicated SME development agency and a credit guarantee fund, as well as measures supporting entrepreneurial education and women's entrepreneurship. The operating environment for small and medium-sized firms (SMEs) as well as the provision of export support and promotion services have both seen improvements since the assessment in 2016.[59]

Because Azerbaijan has produced such a comprehensive collection of competition rules, they should be able to act as the basis for a competition law system that is both effective and efficient. Since the 1990s, each and every regulation has been in place. The competition authority falls under the purview of the Ministry of Economy and is known as the State Service for Antimonopoly Policy and Consumer Rights Protection (SSAPCRP). In addition to being in charge of enforcing competition laws, the SSAPCRP is also accountable for safeguarding consumer rights and managing public procurement. It would appear that the vast majority of SSAPCRP's efforts, if not all of them, are geared toward safeguarding consumers. The application of certain aspects of competition law has not been expanded significantly.

The government agency known as SSAPCRP has never stepped in to block a merger, and the number of concentrations that have been declared is quite low in comparison to the size of the economy. The competition authorities did not find any evidence of cartels throughout the 2016-2018 time period, and as a result, they did not apply any penalties. Even though the rule prohibits enterprise inspections, the legislation does allows unannounced on-site inspections; nevertheless, this instrument has been used very infrequently. This is mainly due to the rule that prohibits inspections of businesses. In spite of the fact that Azerbaijan does not yet have a risk-based business integrity policy, the National Action Plan on the Promotion of Open Government (2016-2018) indirectly addressed the issue of business integrity through the implementation of measures aimed at preventing corruption and promoting transparency and accountability in the private sector.

In general, the efforts made by the government to improve the environment for business and to encourage openness in the public sector have had a positive impact on the reduction of corruption.[60] In the future, the government may work closely with business associations to conduct surveys or studies to study the potential for bribery and other forms of corruption in the business

[59] Guliyev, F. (2016). Azerbaijan: Low oil prices and their social impact. Caucasus Analytical Digest, (83).
[60] ACN, OECD (2016), Anti-corruption reforms in Azerbaijan, OECD Publishing, Paris, https://www.oecd.org/corruption/acn/Azerbaijan_Report.pdf.

sector, as well as to evaluate the efficiency of the corporate integrity measures that are now in place.[61] The recent institution of criminal accountability for legal persons who commit corruption offenses is a significant step in the direction of boosting the anti-corruption measures being undertaken by the corporate sector. In a similar vein, companies that operate in the financial sector are the only ones that are required to reveal the identities of their companies' beneficial owners. Other types of companies, especially those classified as small or medium-sized businesses, are exempt from the obligation to declare their ultimate beneficiaries. In spite of growing pressure from civil society and business organizations, the government has not yet passed rules to safeguard anyone who blow the whistle on corrupt practices. It would appear that the private sector does not make use of the existing channels for reporting corruption very often, and there are no publicly available statistics on the amount of charges of corruption made against businesses.

A variety of awareness-raising programs pertaining to the prevention of corruption in the public sector have been carried out in Azerbaijan as a result of a collaborative effort between the Azerbaijan Anti-Corruption Academy and the Commission on Combating Corruption. However, there has not been a lot of progress made to promote corporate integrity measures, such as coordinated actions including the government, businesses, and business organizations.[62] Consideration should be given by the government to broadening the scope of the awareness-raising activities on business integrity. This could be accomplished in a number of ways, including the introduction of dedicated sessions on issues pertaining to SMEs, the introduction of financial and other incentives for businesses to adopt compliance mechanisms, and closer collaboration with business associations to support business integrity initiatives. Azerbaijan has made significant progress since the SBA evaluation in 2016 in both the implementation of the fundamental components of a proactive SME policy and the mobilization of the required human resources to improve its score in this component. These are both necessary steps to improve the country's overall score. A comprehensive Key Road Map for the Production of Consumer Goods by SMEs (also known as the "SME Roadmap") addresses five strategic goals for the expansion of SMEs, and these goals are as follows:

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[61] ACN, OECD (2019), Progress Update Report. Azerbaijan, OECD Publishing, Paris, https://www.oecd.org/corruption/acn/OECD-ACN-Azerbaijan-Progress-Update-2019-ENG.pdf.
[62] Ibid

1) enhancing the business environment and regulatory framework for small and medium-sized enterprises (SMEs);
2) ensuring small and medium-sized enterprises have access to capital;
3) boosting small and medium-sized enterprises' internationalization;
4) boosting small and medium-sized enterprises' skills.
5) Encouragement of creative problem-solving among SMBs

The SME Roadmap includes a number of important performance metrics in addition to a set of time-bound quantitative targets for the SME sector that are set for the year 2020. These targets include a higher proportion of the SME sector's contribution to GDP (15%), employment (20%), and non-oil exports (10%). The establishment of a specialized Small and Medium-Sized Business Development Agency (SMBDA) in 2017, which was a crucial turning point in the development of the SME support system, took place in the same year. The provision of services in accordance with the following five strategic directions is required of the Agency as part of its mandate.[63]

1) encouraging entrepreneurial activity;
2) providing protection for business owners;
3) easing access to financing for small and medium-sized enterprises (SME);
4) providing training and consulting services;
5) acting as a one-stop shop

The implementation of assistance programs by the private sector should be considered by the government agency since it has the potential to improve the efficiency of the ecosystem that is responsible for assisting small and medium-sized businesses. Even while Azerbaijan has made tremendous headway in simplifying pre-existing regulations and lowering the level of administrative complexity, the country may yet do more to ensure that newly enacted laws and regulations do not reverse these accomplishments.

3.3 Descriptive assessment of impact of FDI on SME in Azerbaijan

Table 8 presents descriptive statistics of six variables: FDI inflow, non-oil GDP, number of SMEs, value added by SMEs, inflation rate, interest rate, and exchange rate. The mean FDI

[63] Aliyev, S. (2019). Problems and opportunities for leveraging SME finance through value chains in Azerbaijan (No. 973). ADBI Working Paper Series.

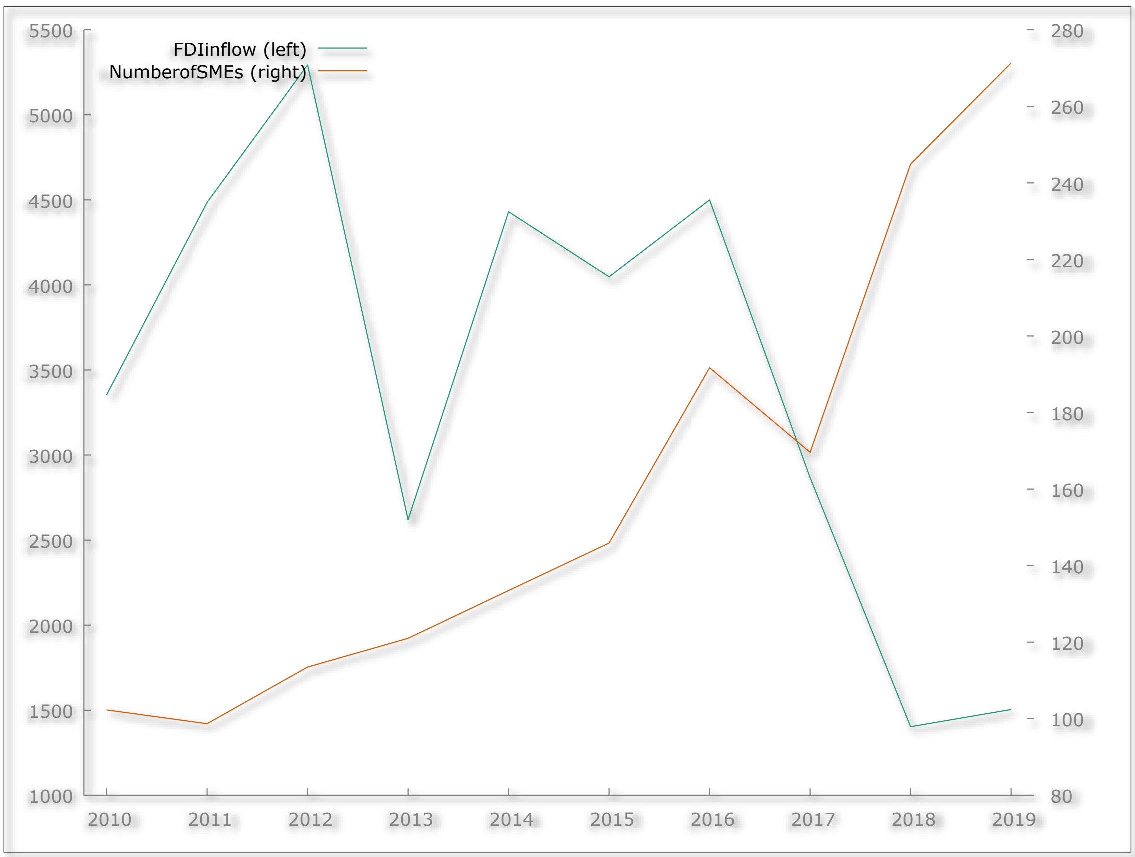
inflow is 3450 million USD, and the median is 3700 million USD. The standard deviation is 1329 million USD, indicating that the FDI inflow varies considerably across the sample. The lowest FDI inflow is 1403 million USD, while the highest is 5293 million USD. The mean non-oil GDP is 32.94 million USD, and the median is 33.65 million USD. The standard deviation is 8.191 million USD, indicating a relatively low variation in the non-oil GDP. The lowest non-oil GDP is 19.20 million USD, while the highest is 44.50 million USD. The mean number of SMEs is 159.2 thousand, and the median is 139.7 thousand. The standard deviation is 59.96 thousand, indicating a significant variation in the number of SMEs. The lowest number of SMEs is 98.70 thousand, while the highest is 271.3 thousand. The mean value added by SMEs is 3570 million USD, and the median is 1727 million USD. The standard deviation is 3727 million USD, indicating a high variation in the value added by SMEs. The lowest value added by SMEs is 998.1 million USD, while the highest is 11072 million USD. The mean inflation rate is 5.27%, and the median is 3.32%. The standard deviation is 4.42%, indicating a moderate variation in the inflation rate. The lowest inflation rate is 1.07%, while the highest is 12.9%. The mean interest rate is 10.9%, and the median is 10.7%. The standard deviation is 10.3%, indicating a high variation in the interest rate. The lowest interest rate is -2.89%, while the highest is 28.9%. The mean exchange rate is 1.17%, and the median is 0.914%. The standard deviation is 0.446%, indicating a moderate variation in the exchange rate. The lowest exchange rate is 0.784%, while the highest is 1.72%.

Table 8. Descriptive statistics of variables

Variable	Mean	Median	S.D.	Min	Max
FDI inflow (Million, USD)	3450	3700	1329	1403	5293
No-noil GDP (Million, USD)	32.94	33.65	8.191	19.20	44.50
Number of SMEs (thousands)	159.2	139.7	59.96	98.70	271.3
Value added by SME (Million, USD)	3570	1727	3727	998.1	11072
Inflation rate %	5.27	3.32	4.42	1.07	12.9
Interest rate %	10.9	10.7	10.3	-2.89	28.9
Exchange rate %	1.17	0.914	0.446	0.784	1.72

The purpose of this study is to examine the impact of foreign direct investment (FDI) on small and medium-sized organizations (SMEs) in the non-oil sector in Azerbaijan. The study adopts a descriptive approach to see the change of indicators such as FDI inflows, number of SMEs, value added by SMEs, and non-oil GDP value. The data covers the period from 2010 to 2019. The data for this study is obtained from the Azerbaijan Statistical Institute and the World Bank's World Development Indicators database. The data will cover the period from 2010 to 2019.

Figure 12. FDI inflow and SME numbers.



The time series plot in figure 12 illustrates the evolution of Azerbaijan's foreign direct investment (FDI) and the number of small and medium-sized enterprises (SMEs) from 2010 to 2019. The total value of foreign investments made in the nation by non-resident companies is referred to as FDI inflow. The number of SMEs refers to the total number of small and medium-sized businesses that are active in Azerbaijan. By carefully analyzing the statistics, we can see that the amount of foreign direct investment (FDI) coming into Azerbaijan went through a period of major ups and downs.

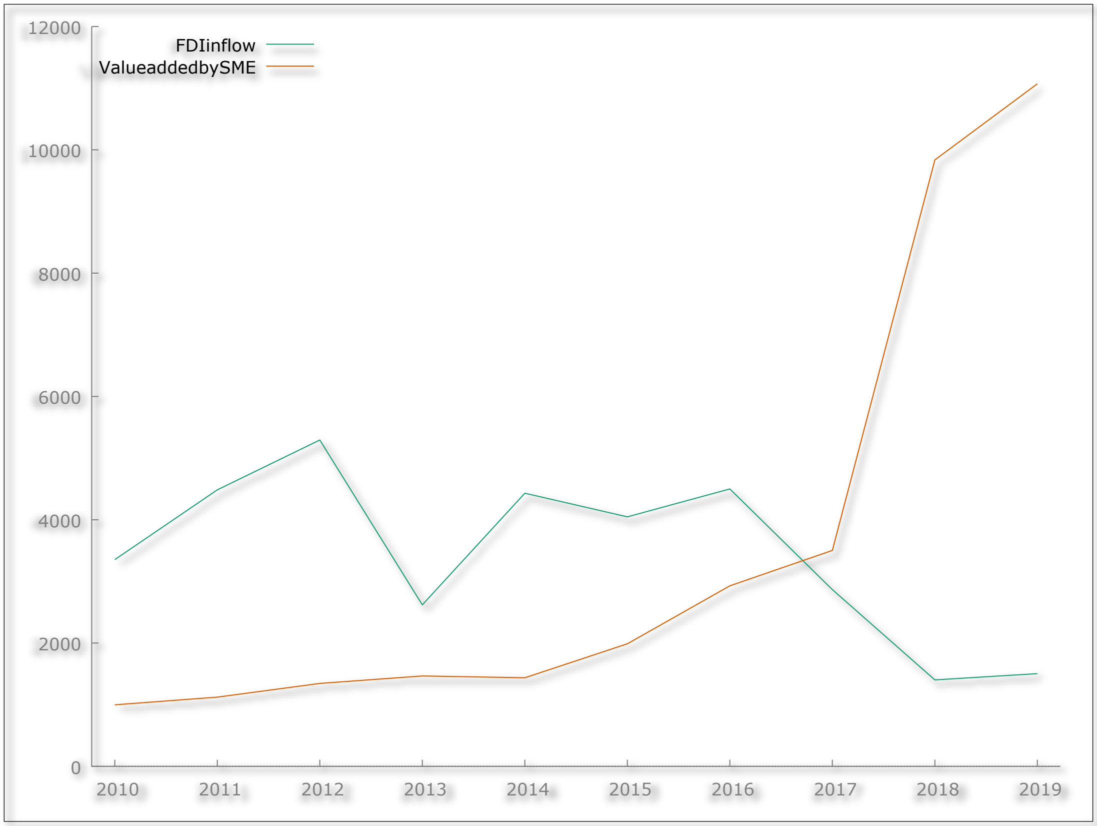
From 2010 to 2012, it went up, eventually reaching its highest point of in 2012. In spite of this, it had a significant drop in 2013, followed by a rebound recovery in 2014 and 2015, culminating in a value that was the second highest ever recorded in 2016. After then, foreign direct investment (FDI) continued to decrease during the coming years, with the figure hitting its lowest point in 2018 and just marginally improving in 2019.

On the other hand, the number of small and medium-sized enterprises (SMEs) in Azerbaijan climbed steadily during the course of the year, with the exception of a little decrease in 2011. There was a considerable rise of 165.6% in the number of SMEs from the time period of 2010 to 2019. It is impossible to determine whether or not the influx of FDI is directly responsible for the increase in the number of small and medium-sized enterprises (SMEs). The reason for this is that the expansion of small and medium-sized businesses can be influenced by a variety of factors, including economic conditions, government regulations, and domestic investment. Yet, foreign direct investment may support the expansion of small and medium-sized enterprises in a variety of ways.

Foreign direct investment (FDI) may assist small and medium-sized enterprises (SMEs) increase their levels of productivity and competitiveness by bringing new technology, managerial knowledge, and access to global markets. FDI may also generate demand for local goods and services, which is beneficial to small and medium-sized enterprises (SMEs) that supply any of these items or services. It is conceivable that foreign direct investment was a factor in the expansion of small and medium-sized businesses throughout the country.

Foreign direct investment (FDI) may be one of the factors that affects the growth of small and medium-sized enterprises (SMEs), but it is not the only driver. SMEs may benefit from possibilities to enhance their performance and increase their market share. The expansion of small and medium-sized enterprises (SMEs) can be affected by a number of factors, including but not limited to economic conditions, domestic investment, and government policy.

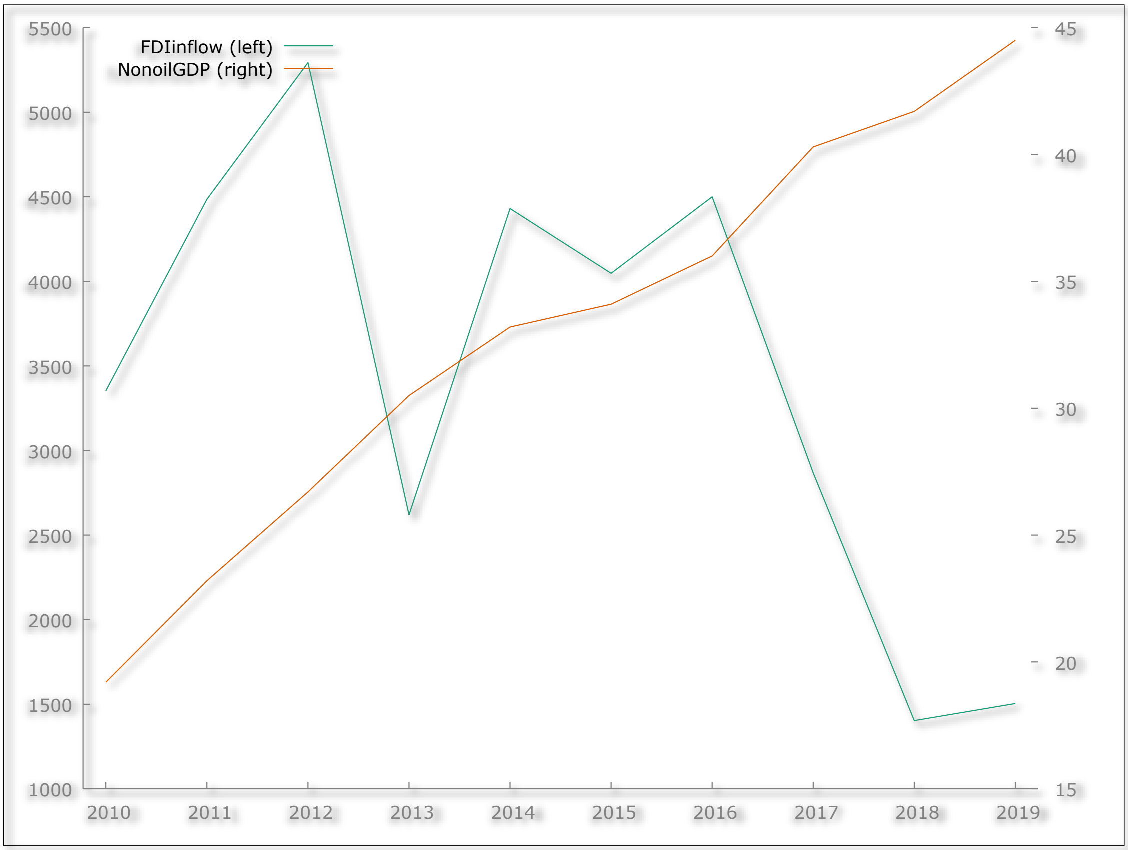
Figure 13. FDI inflows and value added by SMEs



As the data were analyzed in further depth, it was found that the value contributed by SMEs in Azerbaijan followed a pattern of fluctuation throughout the course of the period. It climbed from 998.1 million dollars in 2010 to 1,345.1 million dollars in 2012, reflecting considerable growth of 34.8% from the previous year's level of 998.1 million dollars. Nonetheless, between 2013 and 2014, it went down, eventually hitting a low point. After then, it continued its upward trend throughout 2015 and 2016, hitting a peak value in 2016.

After then, its value went down little in 2017, but then it went up dramatically in 2018, and then it reached its greatest point ever in 2019, when it was 11,071.7 million dollars. The variation in the value that small and medium-sized enterprises (SMEs) add might be the result of a number of variables, including shifts in the economic climate, shifts in government policy, and technical improvements. Foreign direct investment (FDI) may, however, also play a key role in helping to the expansion of small and medium-sized enterprises (SMEs) and, therefore, the value contributed by these enterprises.

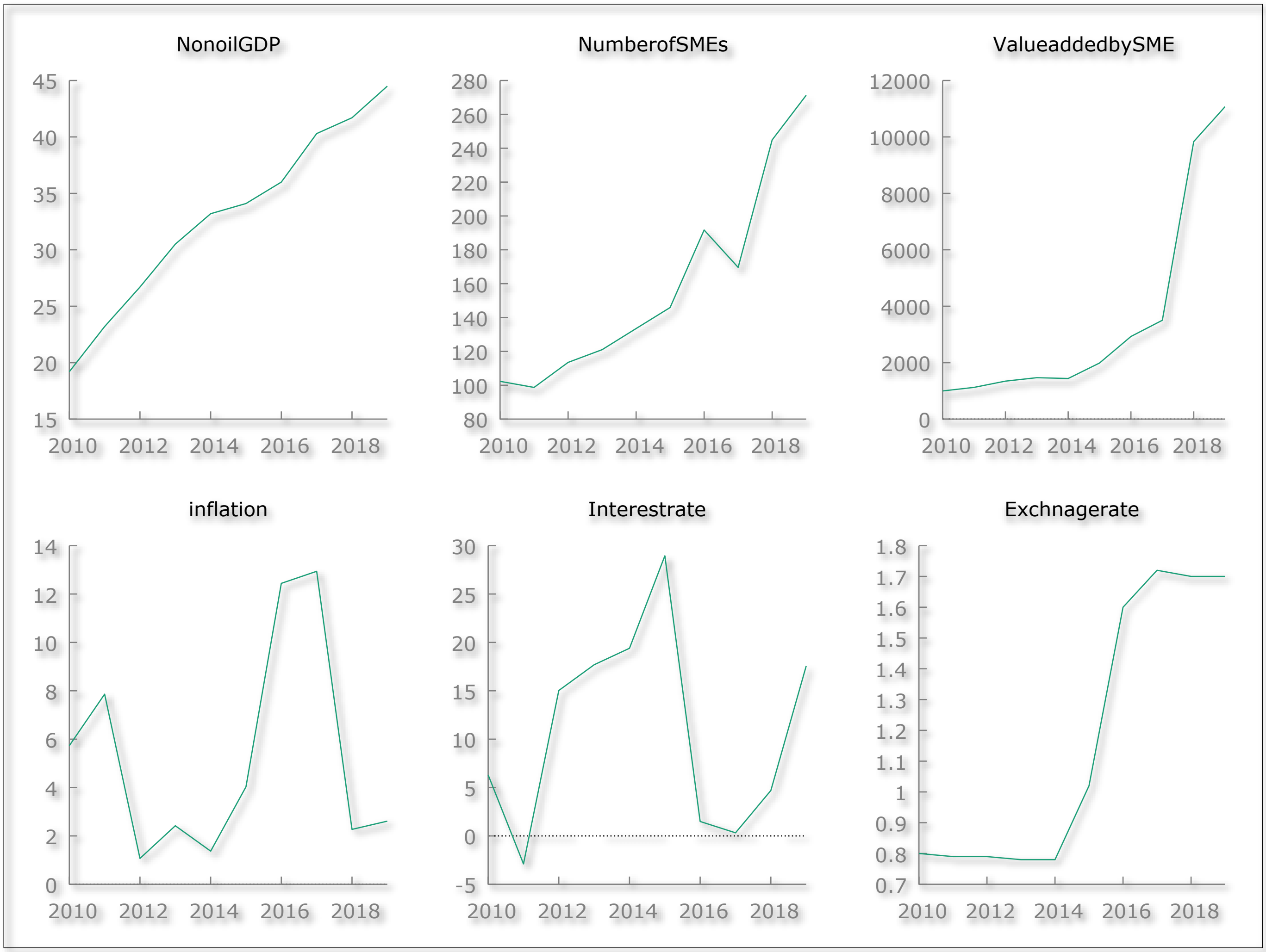
Figure 14. FDI inflow vs non-oil GDP



By carefully analyzing the statistics, we can see that the percentage of Azerbaijan's GDP that does not come from oil changed during the course of the time. 2019 marked the year that it achieved its all-time high, while 2010 was the year that it hit its all-time low. From 2010 to 2014, the non-oil portion of GDP had an overall rising trend, with a large growth of 72.9% throughout the period of time. Yet, it was lower in 2015 and then somewhat higher the following year (2016). After that, it had a substantial gain in 2017, followed by a minor rise in both 2018 and 2019.

The variation in non-oil GDP may be attributable to a number of causes, including shifts in the economic environment, shifting policies implemented by the government, and shifting economic conditions on a global scale. From 2010 to 2014, there was an increase in non-oil GDP, which may have been caused by the expansion of non-oil industries like as agriculture, construction, and manufacturing, as well as by favorable government policies and investments. It is possible that the reduction in oil prices, which had an effect on the economy as a whole, was the cause of the decrease in non-oil GDP in 2015. Nevertheless, the considerable rise in non-oil GDP in 2017 and beyond may be attributable to the efforts made by the government to diversify the economy, promote non-oil industries, and attract foreign direct investment (FDI).

Figure 15. Statistics of exchange, inflation and interest rates and non-oil GDP, value added by SMEs, Number of SMEs



Non-oil GDP has been on a steady upward trajectory throughout the decade, except for a slight dip in 2014. This growth is indicative of a healthy economy that that starts to rely increasingly on non-oil sector. The number of SMEs and value added by SMEs have both fluctuated over the years. In general, lower interest rates, a weaker currency, and low inflation rates have been beneficial for SME growth. For example, the decrease in interest rates in 2017 coincided with an increase in the number of SMEs, value added by SMEs, and non-oil GDP.

Conversely, high interest rates in 2015 led to a decrease in these economic indicators. Similarly, the increase in the exchange rate was associated with an increase in the value added by SMEs and non-oil GDP, while the decrease in the exchange rate in 2011 and 2012 was associated with a decrease in the number of SMEs and value added by SMEs. The same trends can be observed for inflation rates, which fluctuated between a low of 1.07% in 2012 and a high of 12.94% in 2017. It is worth noting that the highest inflation rate in 2017 coincided with a decrease in the number of SMEs and value added by SMEs, indicating that high inflation can be a barrier to SME growth. Additionally, the high interest rates in 2015 may have been a barrier to economic growth.

Conclusion

According to the findings of a study on foreign direct investment (FDI) in Azerbaijan's non-oil sector, there are a number of opportunities and obstacles that need to be addressed in order to maximize the potential benefits of FDI for small and medium-sized organizations (SMEs) in the country. These issues need to be addressed in order to ensure that the potential benefits of FDI are realized. Foreign direct investment (FDI) can bring in much-needed capital, technology, and knowledge. However, it also generates competition for local small and medium-sized enterprises (SMEs), who may not have the resources to effectively compete with larger and more established global firms. It is imperative that the government of Azerbaijan, in conjunction with the private sector, takes a proactive approach to attracting and supporting foreign direct investment (FDI) in the non-oil sector in order to overcome these challenges and fully realize the potential benefits of FDI. This will allow Azerbaijan to fully realize the benefits of FDI.

This can be accomplished through the establishment of an encouraging regulatory environment, the provision of financial and technical assistance to small and medium-sized businesses, and the promotion of conditions that are conducive to investment. In addition, there should be efforts made to promote openness and accountability in the process of investment, and there should also be efforts made to guarantee that the advantages of foreign direct investment are dispersed widely and fairly throughout the economy.

The findings of the study suggest that FDI inflows have a positive impact on the value added by SMEs and non-oil GDP creation in Azerbaijan. The study highlights the importance of FDI in promoting economic growth and development in Azerbaijan. FDI has the potential to create new jobs, increase competition, improve productivity, and transfer technology and knowledge. This can benefit SMEs by creating new opportunities for growth and development.

Overall, this thesis has provided important insights into the impact of FDI on the non-oil sector in Azerbaijan and its potential to promote SME growth and development. The findings suggest that policy-makers should continue to encourage FDI inflows and implement policies to mitigate the negative impact of interest rates while maximizing the positive impact of exchange and inflation rates.

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