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Components and Priorities of Industrial Policy in Azerbaijan

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Abstract

This article examines industrial policy in Azerbaijan and its link with the broader development agenda with respect to its periodization, priorities, and instruments. The article finds that despite the government’s attempts to diversify the economy and exports by promoting non-oil industries, the imbalance between the mining and manufacturing industries remains a challenging issue. Additionally, the high level of oil-gas dependence negatively affects the quality of policy formulation and implementation in industry.

Introduction

The oil and gas sector of the mining industry has been historically dominant in the economy of Azerbaijan. The national economy’s dependence on oil and gas remains high, with the hydrocarbon sector representing 44% of GDP, 90% of goods exports and at least 50% of fiscal revenue in 2018. As a consequence of the high dependence on hydrocarbon resources, Azerbaijan’s economy faced (i) negative implications of the “resource curse”, as reflected in a gradual slow-

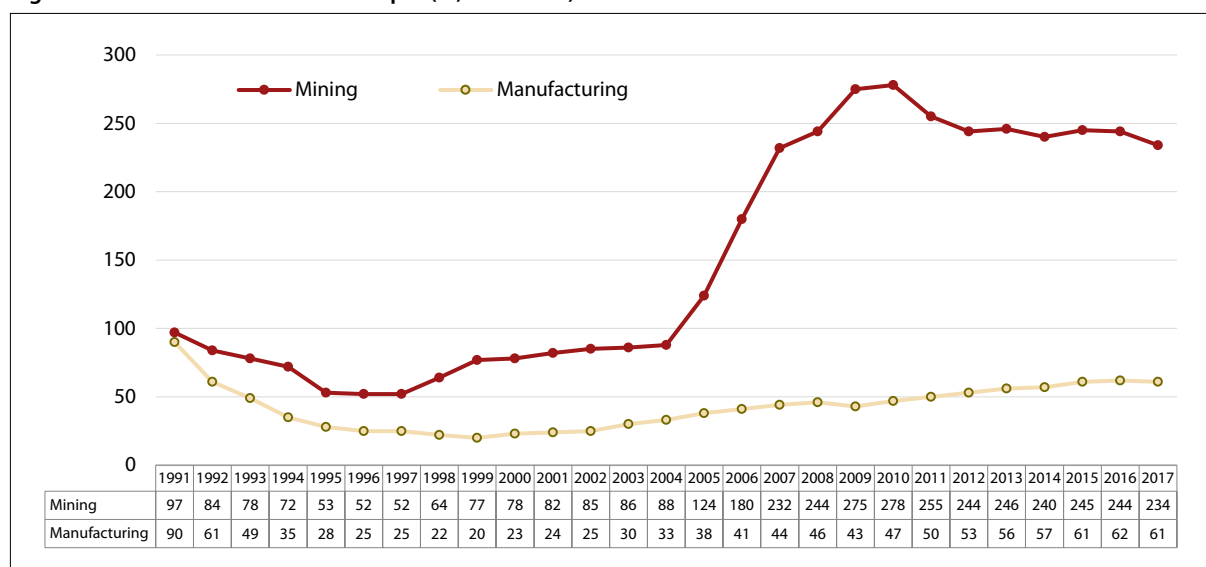
down of economic growth and (ii) deindustrialization in line with the “Dutch disease”, as indicated by the stagnant contribution of non-oil industries to the GDP. Total natural resource rents are associated with lower rates of government effectiveness, which affects the quality of policy formulation and implementation in industry¹. The oil and gas industry dominates both the national economy and total industrial production, yet it has very limited inter-industry linkages to contribute to the development of alternative sectors. The oil and gas sector in Azerbaijan developed only weak development transmission channels, such as a low employment multiplier and small-scale domestic contributions to the value chain, which minimizes the sector’s backward/forward linkages with other industrial sectors.

The main objective of the current industrial policy is to decrease the “double dependence” on the oil and gas sectors and on imports of non-oil products. Therefore, the government follows a mixed policy of combining import substitution with the promotion of non-oil exports. The officially declared diversification-led industrial policy is reflected in various state programmes and strategies aimed at supporting domestic industrial producers in traditional (e.g., petrochemical) and non-traditional (e.g., shipbuilding) fields and balancing the export orientation strategy with the import-substitution effects of industrial policy.

Periods of Industrial Development

The discovery and exploitation of the first oil fields in Baku in 1848 can be considered the beginning of industrialization in Azerbaijan. Industrialization spread to other regions of Azerbaijan, and new industrial cities (e.g., Sumgayit, Mingcevir, etc.) were constructed after the 1950s, and especially during the 1970–1980s. Industrial production dropped after the collapse of the Soviet Union in 1991 but started to improve again in the 2000s. Only in 2014 did the annual output in the mining industry exceed the level of production in 1990 (just before the collapse of the Soviet Union when all state-owned industrial enterprises actively produced a very broad range of products). The manufacturing sector, however, has not succeeded in reaching the production levels of 1990, falling short by almost 40% in 2017 (see Figure 1 below). The manufacturing industry mostly covers basic metals and non-metallic minerals; refined petroleum products, such as diesel fuel and jet fuel, and polyethylene; electricity production and supply; foods and beverages; and cement and construction materials.

Figure 1: Indexes of Industrial Output (%; 1990=100)



Source: <https://www.stat.gov.az/> (State Statistics Committee didn't specify currency or units that calculations on indexes of industrial output were based)

Large enterprises that were able to effectuate added industrial value have been restored to achieve industrial diversification and durable growth of the national economy since the beginning of the 2000s. Despite the attraction of billions of dollars of foreign investment in the oil-gas sector, private investors hesitated to invest in non-oil sectors because of the narrow scale of the domestic market and the fragile business environment. Therefore, the state’s industrialization

¹ Ahmadov, Ingilab and Mammadov, Jeyhun and Aslanli, Kenan, Assessment of Institutional Quality in Resource-Rich Caspian Basin Countries (June 5, 2013). (p. 25). Available at SSRN: <https://ssrn.com/abstract=2274813> or <http://dx.doi.org/10.2139/ssrn.2274813>

efforts encountered financial scarcity in non-oil industries until 2004–2005. However, the state has initiated large-scale investments in industrial development through public investment programmes since 2004–2005, as massive oil revenues enabled it to solve the infrastructure and energy supply problems for industrial enterprises. Given that oil revenues were a major source of fiscal resources, fluctuations in the market price of crude oil led to disruptions in the government's ability to finance industrial companies during the financial turmoil in 2008–2009 and after 2014. Particularly, the sudden collapse of oil prices in 2014 forced the government to take some measures for the development of the non-oil industry and that year was proclaimed “the year of industry” in Azerbaijan, during which government-financed industrial projects were implemented. The government adopted the “State Program of Industrial Development for 2015–2020 in Azerbaijan” in December 2014, which sets policy goals to help the industry achieve economic diversification in this period of falling oil prices and the lack of diversity in industrial production.

Objectives and Priorities of State Industrial Programmes

The diversification of the economy and exports through the development of the non-oil industry and the increase in non-oil GDP have been the main goals of economic policies in Azerbaijan since the early 2000s. The major tasks of industrial policy, as identified in official documents, are to ensure sustainable growth in industrial production and to enhance the structure and efficiency of industrial production². The government has officially focused on the heavy industry, food industry, construction materials, machine-building, and the chemical industry as priority fields outside of the oil and gas sector for achieving economic diversification³.

The government sets the following goals for industrial development:⁴ (i) modernization of the industry and improvement of the structure of the industry; (ii) increasing the export potential of non-oil industries; (iii) expanding energy-efficient and high value-added competitive industrial production; (iv) amplification of knowledge-based and innovative industrial production; (v) preparation of qualified human resources for new industrial production areas. Increasing competitiveness and capacity-building in industry, supporting industrial enterprises, constructing industrial zones and clusters, and enacting legislative improvements are the main directions of the State Program.

Instruments of Industrial Policy

Instruments of industrial policy indicated in the “State Program of Industrial Development for 2015–2020 in Azerbaijan” include the creating of new state-owned industrial enterprises, promoting exports, setting standards for industrial products, providing financial support for local production in specific fields with economic importance (aluminium, iron ore and steel production plants in the Ganja/Dashkesen regions, carbamide and polymers plants in the Sumgayit region), and establishing industrial zones, research & development activities, etc.

Doing Business and Tax Incentives

Improving the business environment has been highlighted as a cornerstone of enhancing the number of industrial enterprises and opening new modern processing facilities in the regions of Azerbaijan⁵. The procedures for doing business in industrial and non-industrial companies have been reformed recently: the number of procedures for the official registration of legal entities has been reduced from 3 to 1; the duration of the company registration process has been reduced to 20 minutes; and the amount of funds and documents required to start entrepreneurial activities has been reduced to zero⁶. Changes to the tax code, effective from January 1, 2019, are designed to affect small and medium industrial business entities through tax administration, tax breaks and an extended taxation base. Income tax exemptions are applied to individuals working in the non-oil sector by January 2019⁷. Small and medium-sized companies are exempt from corporate and income taxes for a period of 7 years. Due to recent changes in tax legislation, profits from the innovation activities of industrial companies are exempt from income tax for a period of 3 years from the

2 Aslanli, K. Ismayil, Z. Agayev, R. Mehtiyev, A. The Assessment of Economic and Export Diversification. Natural Resource Governance Institute & Free Economy Center. 2013 (p. 16) http://www.freeeconomy.az/site/assets/files/1188/iqtisadi_diversifikasiya_az.pdf

3 Strategic Roadmap on Perspectives of National Economy and Strategic Roadmap on Development of Heavy Industry and Machine-Building in Azerbaijan (2016). <http://www.president.az>

4 “State Program of Industrial Development for 2015–2020 in Azerbaijan”. 2014. https://azertag.az/xeber/Azerbaycan_Respublikasinda_senayenin_inkisafina_dair_2015_2020_ci_iller_uchun_dovlat_proqrami-821350

5 Musayev, V. Azerbaijan Economic Reforms Review. 2017. CAERC. https://ereforms.org/store//media/ekspert_yazilari/islahat%20icmalimart/strateji%20yol%20x%C9%99rit%C9%99si%20-eng1.pdf

6 Ministry of Taxes. 22/01/2018. State registration of legal entities will be carried out within 20 minutes with only 1 procedure. <http://taxes.gov.az/modul.php?name=metbuat&bolme=pressreliz&pid=1767&lang=>

7 Ministry of Taxes. 24/12/2018. Changes to Tax Code with questions and answers. <http://www.taxes.gov.az/VM2019/VM2019.pdf>

date of receipt of the “start-up” certificate. Tax incentives and doing business reforms can stimulate entrepreneurial activity in various sectors.

Regulation and Financing of Industrial Policy

The regulatory environment was managed by the Ministry of Energy and Industry until the 2010s. In 2013, the Ministry of Economy and Industry was established on the basis of the Ministry of Economic Development (it was renamed the Ministry of Economy in 2016), but later, it was renamed the Ministry of Economy and accumulated substantial responsibilities related to the formulation and implementation of industrial policy. The Ministry of Economy is responsible for the industrial policy including the development and implementation of state policy related to industry, the support of industrial enterprises and their domestic production, and the functioning of industrial parks and special industrial zones.

Industrial policies and programmes are funded by the following sources: the state budget, extra-budgetary funds, local budgets, domestic private and foreign direct investment, loans and grants, and technical and financial assistance from international and foreign organizations. More than 15% of the state’s centralized budget expenditures were allocated to industry-related public investment (construction) projects in 2017, which expenditures had reduced significantly after 2014⁸.

The government established various institutional mechanisms to finance industrial projects and production plants or to provide a guarantee to the investments: the Azerbaijan Investment Company, the National Fund for Entrepreneurial Development, AZPROMO, the Mortgage and Loan Guarantee Foundation, and the Small and Medium Business Development Agency⁹. The Azerbaijan Investment Company (AIC) functions as a co-investor representing the state and establishes joint funds to attract foreign investments. 82% of the current investment portfolio of AIC is allocated to heavy industry plants specializing in shipbuilding and cement production¹⁰. AIC has owned 21.28% of shares in Baku Shipyard Company LLC since 2013, which operates in the areas of vessels construction, ship repairs and conversions for domestic and foreign clients¹¹. The Azerbaijan Industrial Corporation (ASK) was established in 2017 to enhance the effective management of some state-owned industrial entities (which were transferred to the ASK as “toxic non-financial assets” from the largest state-owned commercial bank of Azerbaijan) and to contribute to non-oil industrial production¹². However, the ASK is a giant conglomerate without any industrial specialization or pre-existing experience, which creates risks related to the efficient management of the assets transferred to the balance of the corporation.

Industrial Clusters and Industrial Zones

The creation of industrial parks and industrial zones in certain regions to ensure the development of the non-oil sector, the creation of favourable conditions for the development of competitive industries, and the organization of industrial enterprises based on modern technologies were among top priorities of the government for establishing industrial infrastructure. To develop local industrial areas by utilizing resources efficiently through the expansion of small and medium-sized enterprises and increasing the industry’s specific weight in terms of employment, the government established a number of industrial parks and industrial zones. Industrial clustering through industrial parks and zones was a priority of the government.

Sumgayit Chemical Industrial Park was established in 2011 for the purpose of developing the chemical industry in the country. The 18 resident companies that operate in the Park produce steel and polyethylene pipes, hose and fittings, mechanical and hydraulic equipment, synthetic lubricants, electronic equipment, pesticides and agrochemicals, non-ferrous metals, ferroalloys, and polypropylene. SOCAR Polymer has a polypropylene plant in the Sumgayit Chemical Industrial Park in cooperation with Italian companies to produce 300,000 tons of products annually, and 70% of that will be exported to foreign markets. The total investment in SOCAR Polymer’s polypropylene and carbamide plants amount to USD 1.7 billion¹³.

8 Ministry of Finance. State Budget Revenues and Expenditures for 2017. <http://maliyye.gov.az/scripts/pdfs/web/viewer.html?file=/uploads/static-pages/files/5b1f722f85964.pdf>

9 Azerbaijan Export and Investment Promotion Foundation (AZPROMO). 2019 <http://www.azpromo.az/>

10 Azerbaijan Investment Company (AIC) Investment Portfolio. 2018. <https://aic.az/en/portfolio/sector:4>

11 AIC Investment Portfolio. 2018. Baku Shipyard Company. <https://aic.az/en/portfolio/sector:4/id:1>

12 Azerbaijan Industrial Corporation. 2019. <http://ask.gov.az/en/mission>

13 President of Azerbaijan Ilham Aliyev, Italian President Sergio Mattarella attended inauguration of polypropylene plant constructed in Sumgayit Chemical Industrial Park. 18/07/2018.

Mingachevir Industrial Park was established in 2015 to reduce the dependence on imports in the light industry and to create national textile brands in order to increase export potential. “Khazar” Car Factory was established in the *Neftchala Industrial Zone* (2015), where the “Azer mash” Company cooperates with the Iran Khodro Car Company to produce 10,000 cars annually for export mostly to the Middle East and the post-Soviet countries (e.g., to Ukraine beginning in 2019)¹⁴. The creation of industrial zones in various regions continues, with new additions including the Masalli Industrial Zone (2016, industrial products from metals, plastics, and woods), the Hajigabul Industrial Zone (production of buses for city transportation systems), and the Sabirabad Industrial Zone (processing of agricultural products). However, other industrial zones, such as the Balakhani Industrial Zone (2011, fertilizers and waste processing), the High-Tech Park (2012, no specific clustering), the Karadakh Industrial Park (2015, shipbuilding), and the Pirallahi Industrial Park (2016, production of medicines) are located close to Baku, the capital city and Azerbaijan’s main industrial and financial hub. Some steps have been taken to realize the law on free economic zones within the area of the newly established Baku International Sea Trade Port to combine industrial production with the logistical advantages of Baku. According to the World Bank’s country memorandum, “the government plans to develop several oil-gas related industries and sees its geographical position as an ideal to further develop transportation and other transit-related services”¹⁵.

Industrial Outputs and Its Structure

Over the course of 13 years (2005–2017), at least 75% of total foreign and domestic investment was directed to the oil and gas industry¹⁶. With the exception of the petrochemical sector, however, the oil and gas sector did not produce spillover effects that would stimulate growth in other industrial sectors. The petrochemical industry provides intermediate and final products for Azerbaijan’s economy, such as polyethylene, plastic products, fertilizers, packaging, and detergents. In 2017, the share of the chemical industry, including the manufacture of plastic products, in the structure of total industrial production was 2.1%, while the contribution of the extraction of crude petroleum and natural gas in total gross output stood at 61%¹⁷. The mining and manufacturing industries are greatly disproportionately represented in the economy. The ratio of mining and manufacturing to total industrial output was almost 70% to 30% in 2017. There is also a significant disparity in average wages: in the mining industry, this indicator stood ca. 1800 USD in 2017 compared to only 325 USD in the manufacturing industry. Despite the financial and material superiority of Azerbaijan (the share of the country’s strategic foreign exchange and gold reserves (40 billion USD) in the GDP is more than 85%—<http://www.oilfund.az>) over its resource-poor neighbours, the institutional and technological capacities to increase manufacturing value and exports per capita are relatively limited. Manufacturing value added per capita was USD 307 in 2015 (compared to USD 411 in Armenia and USD 428 in Georgia), and it increased by 10% in Azerbaijan between 2010–2015 (compared to 48% in Georgia and 36% in Armenia)¹⁸. Additionally, the level of manufactured exports per capita in Azerbaijan is lower than in neighbouring countries¹⁹.

Conclusion

The main objective of Azerbaijan’s current industrial policy is to decrease the “double dependence” on the oil and gas sectors and on the import of non-oil products. The government follows a mixed policy to combine import substitution and the promotion of non-oil exports. The diversification of the economy and exports through the development of the non-oil industry and the increase in non-oil GDP has been the unvarying goal of economic policies in Azerbaijan. For these purposes, industrial parks and industrial zones have been established to support industrial enterprises in Baku and other regions, including small and medium entrepreneurs. However, despite all the efforts to diversify the economy, the substantial disparity between the mining and manufacturing industries in Azerbaijan’s economy persists. The newly established tools of the government’s industrial policy, such as giving tax incentives, implement-

14 Khazar cars will be exported in Ukraine this year. Azertac İA. 09/02/2019 https://azertag.az/xeber/Khazar_avtomobilleri_bu_il_Ukraynaya_ixrac_edilecek-1243992

15 World Bank. 2009. Azerbaijan—Country economic memorandum: a new silk road—export-led diversification (English). Washington, DC: World Bank. <http://documents.worldbank.org/curated/en/531321468221991045/Azerbaijan-Country-economic-memorandum-a-new-silk-road-export-led-diversification> (p. 7)

16 State Statistical Committee of Azerbaijan. 2019. Industry of Azerbaijan. Investments directed to main capital of industry, <https://www.stat.gov.az/source/industry/?lang=en>

17 State Statistics Committee. 2018. Industry of Azerbaijan. Sectoral Structure of Industry (p. 32)

18 The Competitive Industrial Performance Index. 2018. UNIDO. <https://stat.unido.org/database/CIP%202018>

19 For more information see: Timm, Christian. 2019. Industrial Development in the Southern Caucasus—A Comparative Perspective in this issue, p. 21–28.

ing business reforms and establishing preferential conditions in the industrial zones could potentially stimulate entrepreneurial activity in various sectors.

About the Author

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The Elements of Industrial Policy in Georgia

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Abstract

Georgia does not have a national industrial policy strategy document to guide a long-term transformation of the country's economic structure. Officially, the Georgian state does not pursue an industrial policy. However, some of the state activities, such as the establishment of state agencies to facilitate investment by providing funding in promising sectors, overlap with the idea of industrial policy and its instruments. The present article addresses Georgia's socio-economic development strategy and the intervention tools of the state, with the aim of supporting industrial growth and diversification.

Introduction

The history of economic development shows that the transformation of a country's economy towards more productive sectors is crucial for economic development. A country's economic transformation has not always occurred autonomously but rather as an outcome of an effectively designed and implemented industrial policy (Buur et al., 2015). As Wade (2016) notes, in Georgia, since the collapse of the USSR, the term “industrial policy” has been avoided, except in the understanding that “the best industrial policy is no industrial policy,” as referenced by several economy ministers over the years. Given this background, it is no surprise that the administration of the government of Georgia has not come up with a national industrial policy strategy.

The definition of industrial policy (IP) has changed over time. According to Altenburg (2011), a goal of traditional IP used to be to enhance the productivity of land, capital, and labor. The states intervened in the markets by creating incentives (subsidies in the search process) to direct the flow of private capital into new sectors. In the 21st century, the task of IP is to provide a setting that allows the state and private sector to come together to learn about and discover the entrepreneurial opportunities and the constraints faced by the economic actors and to engage in strategic coordination (Rodrik, 2004, 2009). According to Pack and Saggi (2006), IP may refer to any selective intervention or policy that aims to modify the production structure in order to move it towards sectors that are expected to offer better chances for economic growth. Although the government of Georgia does not officially use the term industrial policy in reference to its intervention in economic activities, some of its economic policies do overlap with the idea of industrial policy.