In 2016, the Government of Azerbaijan adopted the Strategic Road Map on Production of Consumer Goods at the Level of Small and Medium Enterprises in the Republic of Azerbaijan (SME Roadmap) to promote SME development and stimulate economic diversification. In this context, the Ministry of Economy requested the OECD’s support for implementing the SME Roadmap.

This Policy Insights report focuses on identifying and assessing policies that enhance MNE-SME linkages and their impacts on SME outcomes.

Building on ongoing work conducted by the OECD Investment Division for ASEAN jointly with UNIDO, the report makes use of primary data collected through an enterprise survey, fact-finding missions and qualitative interviews with businesses, government agencies and chambers of commerce, as well as desk research.

The main beneficiaries of this project are the Ministry of Economy, the Centre for Analysis of Economic Reforms and Communication, and the Agency for the Development of Small- and Medium-Sized Enterprises, as well as other SME stakeholders involved in the implementation and monitoring of Azerbaijan’s SME Roadmap.

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Azerbaijan: Linking Domestic Suppliers with Foreign Investors
Foreword

In 2016, the Government of Azerbaijan adopted its Strategic Roadmap for the Production of Consumer Goods at the Level of Small and Medium Enterprises in the Republic of Azerbaijan (SME Roadmap) to promote SME development and stimulate diversification of the economy. The Ministry of Economy has requested the OECD’s assistance in supporting the implementation of the SME Roadmap.

This assistance is being provided in the context of the multi-country project EU4Business: From Policies to Action, implemented by the OECD in the countries of the European Union’s Eastern Partnership, with the financial support of the Union under its EU4Business initiative.

The overall objective of the project is to build capacity in Azerbaijan's institutions to implement and monitor the SME Roadmap. In order to meet this objective, the project focuses on the following activities:

- strengthening public-private dialogue through regular Working Group meetings involving international experts, Azerbaijani stakeholders and the OECD;
- developing recommendations for a better implementation of the SME Roadmap and design of SME support measures; and
- providing support in establishing a results-based monitoring system for the SME Roadmap.

The main beneficiaries of this project are the Ministry of Economy, the SME agency and Centre for Analysis and Communication of Economic Reforms, as well as other SME stakeholders involved in the implementation and monitoring of Azerbaijan's SME Roadmap.

This note, which summarises project findings, served a basis for discussion during the peer review of Azerbaijan at the OECD Eurasia Competitiveness Roundtable in Paris in November 2018, with a focus on identifying and assessing policies that enhance MNE-SME linkages and their impacts on SME outcomes.

The work has involved regular meetings of a public-private working group to determine priorities and identify gaps for the implementation of the SME Roadmap. The report builds on ongoing work conducted by the OECD Investment Division for ASEAN jointly with UNIDO, in terms of the conceptual framework, data collection methodology, and analysis. It makes use of primary data collected through an enterprise survey, fact-finding missions and qualitative interviews with businesses, government agencies, and chambers of commerce, as well as desk research.
Acknowledgements

This report summarises the work carried out by the OECD Eurasia Competitiveness Programme (ECP) under the authority of the OECD Eastern Europe and South Caucasus Initiative Steering Committee, in consultation with the government of Azerbaijan and with the participation of the private sector and international organisations in Azerbaijan.

Representatives from several Azerbaijani ministries, government agencies, private sector organisations, and other stakeholders should be acknowledged for their active participation in the Working Group meetings and their availability to meet with the OECD team and share valuable insights for the development of this note.

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## Acronyms and Abbreviations

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<tr>
<th>Acronym</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>ADR</td>
<td>alternative dispute resolution</td>
</tr>
<tr>
<td>ASK</td>
<td>National Confederation of Entrepreneurs</td>
</tr>
<tr>
<td>AZN</td>
<td>Azerbaijan manat (currency)</td>
</tr>
<tr>
<td>AZPROMO</td>
<td>Azerbaijan Export and Investment Promotion Foundation</td>
</tr>
<tr>
<td>BBTC</td>
<td>Baku Business Training Centre</td>
</tr>
<tr>
<td>CESD</td>
<td>Center for Economic and Social Development</td>
</tr>
<tr>
<td>CIS</td>
<td>Commonwealth of Independent States</td>
</tr>
<tr>
<td>CSR</td>
<td>Corporate Social Responsibility</td>
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<tr>
<td>DTF</td>
<td>distance to frontier</td>
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<tr>
<td>EaP</td>
<td>Eastern Partnership</td>
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<tr>
<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
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<tr>
<td>EU</td>
<td>European Union</td>
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<tr>
<td>FDI</td>
<td>foreign direct investment</td>
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<tr>
<td>GDP</td>
<td>gross domestic product</td>
</tr>
<tr>
<td>GLC</td>
<td>government-linked company</td>
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<td>GVC</td>
<td>global value chain</td>
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<tr>
<td>KPI</td>
<td>key performance indicator</td>
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<tr>
<td>ICT</td>
<td>information and communications technologies</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>IO</td>
<td>input-output</td>
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<tr>
<td>IPA</td>
<td>investment promotion agency</td>
</tr>
<tr>
<td>IPR</td>
<td>Investment Policy Review</td>
</tr>
<tr>
<td>M&amp;A</td>
<td>mergers and acquisitions</td>
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<tr>
<td>JV</td>
<td>joint venture</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>ISO</td>
<td>International Organization for Standardization</td>
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<tr>
<td>MNE</td>
<td>multinational enterprise</td>
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<tr>
<td>NGO</td>
<td>non-governmental organisation</td>
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<tr>
<td>NPO</td>
<td>non-profit organisation</td>
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<tr>
<td>PFI</td>
<td>Policy Framework for Investment (OECD)</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>research and development</td>
</tr>
<tr>
<td>RBC</td>
<td>responsible business conduct</td>
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<tr>
<td>SFF</td>
<td>Supplier Finance Facility</td>
</tr>
<tr>
<td>SMEs</td>
<td>small and medium-sized enterprises</td>
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<tr>
<td>SOE</td>
<td>state-owned enterprise</td>
</tr>
<tr>
<td>UN</td>
<td>United Nations</td>
</tr>
<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
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<tr>
<td>UNIDO</td>
<td>United Nations Industrial Development Organization</td>
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<tr>
<td>USAID</td>
<td>United States Agency for International Development</td>
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<tr>
<td>USD</td>
<td>United States dollar</td>
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<tr>
<td>VAT</td>
<td>value-added tax</td>
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<tr>
<td>WB</td>
<td>World Bank</td>
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<tr>
<td>WBES</td>
<td>World Bank Enterprise Survey</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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Executive Summary

Progress in information and communications technologies (ICT), the growth of the Internet, and lower transport costs have made it possible for firms to establish production chains that are geographically dispersed across the world. Firms participate in global value chains (GVCs) in various ways – imports, exports, foreign direct investment (FDI), movement of business personnel, and data transfer – to optimise their international business strategies and increase productivity.

Leveraging FDI to enhance MNE-SME linkages is a policy opportunity

Small and medium-sized enterprises (SMEs) account for over 95% of all established companies in Azerbaijan, but only 10% of value added and 19% of total employment, in the non-oil sector. Leveraging FDI to further the development of SMEs in Azerbaijan and enhance their economic importance represents an opportunity to foster greater economic diversification, create quality jobs, and achieve sustainable and inclusive growth. SME development and integration into GVCs is a strategic objective outlined in the 2016 Strategic Roadmap for the Production of Consumer Goods at the Level of Small and Medium Enterprises in the Republic of Azerbaijan (SME Roadmap).

A 2018 OECD survey of Azerbaijani firms finds that GVC linkages are associated with above-average firm productivity. Supplying multinational enterprises (MNEs) is also perceived as a benefit in terms of improved product quality, adoption of new technologies and practices, and better working conditions for employees. The observed improvement in working conditions suggests that foreign MNEs compel domestic firms to raise their standards, thus improving not only their efficiency but also their conduct.

Linkages are constrained by limited FDI in non-oil sectors and domestic firm capabilities

FDI in Azerbaijan has grown over the past two decades, with the stock of inward FDI reaching 70% of GDP in 2016, though it is dominated by investments in oil-related activities. Domestic firms with adequate capabilities are increasing their GVC participation, but mostly through trade rather than through linkages with foreign investors, likely due to the still-underdeveloped FDI activities in the non-oil sector. A significant proportion of the foreign investors interviewed for this project find that the inputs they require, including specialist skills, are not available locally, and physical inputs often fail to meet their product quality standards. Thus, from the investors’ point of view, linkages are in some respects limited by the capabilities of domestic firms.

Economic reforms are viewed as successful and will require long-term commitment

Azerbaijan has taken a number of steps to strengthen the institutional, regulatory and operational environment for SMEs, particularly by easing company registration and developing e-government services. Other reforms targeted at stimulating local production, simplifying customs procedures, and supporting internationalisation are also expected to promote SME participation in GVCs. Interviews with businesses indicate a general perception that the reform programme is a serious effort to develop industry and to improve
the country’s international image, though it is noted that consistency and long-term commitment across the programme is necessary for it to be effective.

**A strong judiciary supports business linkages and technology transfer**

Evidence from the latest World Bank Enterprise Survey for Azerbaijan (2013) suggests that good enforcement procedures are associated with higher levels of local sourcing by foreign investors. Over the last decade, Azerbaijan has introduced a number of measures to enhance the efficiency and transparency of the judiciary, most notably the “e-court” information system, which considerably improved case management and court proceedings. There remains, however, scope for further strengthening the judiciary by providing alternative mechanisms for resolving commercial and investment disputes, according to World Bank *Doing Business* scores. Alternative dispute settlement beyond courtroom litigation is expected to further encourage local linkages of foreign investors.

**SME support initiatives can be improved by adding elements of aftercare**

Policy interventions designed to increase SME presence in global value chains often focus on tax incentives, export financing facilities, training, marketing portals, business matchmaking services, support for acquiring certifications, support for attending international trade fairs, and e-commerce platforms on which SMEs can list. Although awareness of SME support initiatives is very high in Azerbaijan, the use of more intensive forms of support like training is still low, and the effectiveness of available support is variable. Moreover, much emphasis is given to export promotion, export portals and trade fairs, although many domestic firms still struggle to meet domestic demand, and few have the capabilities to meet large orders from foreign buyers.

**Targeted tax incentives may be helpful in promoting SME linkages**

In Azerbaijan, significant incentives are provided to residents of industrial parks, which are typically large firms. However, it may be more desirable to incentivise large producers to undertake vendor development programmes, secondments of personnel to mentor SME suppliers, or other forms of linkage programmes. In fact, there is evidence that corporate investors have played an important role in supporting SME development and business linkages. Government incentives for corporate initiatives may be warranted.

**Industrial estates are well-placed to foster SME linkages**

Azerbaijan has organised both industrial parks and industrial estates with distinct roles and constituencies. Industrial parks are sector-specific manufacturing compounds designed for large conglomerates, while industrial estates are cross-sectoral special manufacturing compounds that provide preferential terms for SMEs, where applicants are chosen on the basis of how likely they are to engage with other residents. As industrial parks aim to develop industry through large, state-financed conglomerates, they in some ways inhibit competition and perhaps deter foreign investment. Industrial estates, on the other hand, aim to provide favourable conditions for the development of business clusters, including specifically SMEs. They are well-placed to achieve this objective and facilitate SME linkages if combined with adequate local capacity building.

**Developing the food processing sector requires modernising farming practices**

A case study of food processing suggests that the shortcomings of the agricultural sector – outdated farming practices and equipment, lack of knowledge and skills, lack of finance, and distortionary incentives – adversely affect food processors, which cannot rely on a stable supply of agricultural products of unvarying quality. Inadequate contract
enforcement, poor local packing options and lack of finance for new equipment also reduce their competitiveness.
1. MNE-SME linkages: Rationale and conceptual framework

This chapter highlights the importance of foreign investment in supporting SME integration in global value chains (GVCs), based on a conceptual framework developed in the context of a joint OECD-UNIDO study on Southeast Asian SMEs. It argues that SME participation in GVCs has predominately been viewed through the lens of trade and presents a simple framework to explain the investment channels through which SMEs can participate in GVCs – namely, through supply chain linkages with foreign MNEs.

This report is not intended as an exhaustive analysis of policies to improve the investment climate in Azerbaijan. Rather, the objective of this report is to examine how foreign direct investment (FDI) can be leveraged to create opportunities for domestic small and medium-sized enterprises (SMEs), in the context of Azerbaijan’s efforts to diversify its economy, and specifically of its implementation of the 2016 Strategic Roadmap for the Production of Consumer Goods at the Level of Small and Medium Enterprises in the Republic of Azerbaijan (SME Roadmap).

The focus of this report is on manufacturing investments because they represent more complex value chains that offer greater opportunities for supply chain linkages (also in terms of pre- and post-production services), exports, and integration in global value chains (GVCs). Within manufacturing, the food processing sector is used as a case study as it is found to currently hold the greatest potential for Azerbaijani SMEs in terms of growth and exports. Nevertheless, other sectors – such as chemicals, textiles, furniture, ceramics, plastic, and metal products – are also covered in this study: information on firms operating in these industries is collected through an original business survey and analysed in the report.

GVCs offer an important opportunity for SME development

Advances in information and communication technologies (ICT) and reduced transport costs have enabled firms to establish production chains that are geographically dispersed across the globe, so as to meet market demands and reap efficiency gains. Firms combine multiple channels – imports, exports, direct investment, movement of personnel, and data flows – to optimise international business strategies, resulting in a network of interconnected global value chains (GVCs).

Leveraging FDI to further the development of SMEs in Azerbaijan and enhance their participation in GVCs offers an opportunity to foster greater economic diversification, create quality jobs, reduce import dependence and achieve sustainable and inclusive growth. SME development and integration into GVCs is a strategic objective outlined in the SME Roadmap.

SMEs account for over 95% of all established companies in Azerbaijan, but only 10% of value added and 19% of total employment in the non-oil sector (Statistical Yearbook,
2017), according to the recently redefined criteria (Box 1). Despite significant variation (and differences in the definition of SMEs) across countries, in other Eastern Partnership countries, SMEs are on average responsible for 40% of value added and 60% of employment, suggesting that there is significant scope for relaxing constraints related to size and access to strategic resources that prevent SMEs from developing. Moreover, the relatively low weight of medium-sized enterprises within the SME sector (2%, compared to 9% in Georgia) suggests that small businesses are struggling to scale up their operations (EU4Business, 2017).

**Box 1. What are SMEs?**

There is no universal definition of SMEs. They can defined in terms of number of employees, annual turnover, value of fixed assets, or some combination of these measures. The definition can also vary by industry (as was the case in Azerbaijan until it was standardised in 2015). Until 2016, the State Statistical Committee of Azerbaijan did not distinguish between medium-sized and large enterprises. In 2016, the government confirmed a new definition of SMEs:

<table>
<thead>
<tr>
<th>Category</th>
<th>Employees</th>
<th>Annual revenue (AZN)</th>
<th>Annual revenue (USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>≤ 25</td>
<td>≤ 200,000</td>
<td>≤ 118,000</td>
</tr>
<tr>
<td>Medium</td>
<td>26-125</td>
<td>200,000-1,250,000</td>
<td>118,000-737,000</td>
</tr>
<tr>
<td>Large</td>
<td>&gt;125</td>
<td>&gt;1,250,000</td>
<td>&gt;737,000</td>
</tr>
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The Law on Entrepreneurship was later amended and micro-enterprises were introduced into the classification. There is a plan to revise the criteria and increase the limits for micro, small and medium-sized firms by taking into account the European Union (EU) and World Bank definitions.

For the purpose of this report, a company is considered an SME if it employs up to 125 full-time workers.

Not all SMEs have the potential to integrate in GVCs

It is important to bear in mind that not all SMEs have the potential to become highly productive firms that contribute to long-term growth and competitiveness or that are able to substantially integrate into GVCs. Simply put, the bulk of SMEs (e.g. corner shops, hairdressers, small restaurants) may never integrate into GVCs. Moreover, an exclusive focus on smaller firms overlooks the experience of firms that have been small in the past but have overcome barriers to growth and internationalisation.

In order to account for these concerns and to identify policies and programmes that can enable GVC integration for SMEs with adequate capabilities, this report includes analysis of both large firms and SMEs. In this context, it is important to reflect on whether and how policies can be developed to support SME development. This requires a delicate balance: SME-specific policies and support programmes can have distortionary effects as they may create disincentives for firms to grow (Cusmano, 2016).

---

1 The contribution of SMEs to GDP was 6.4% in 2016 (State Statistical Committee).
MNE-SME linkages in GVCs can involve multiple mechanisms

This review follows a simple conceptual framework, developed in the context of a recent OECD-UNIDO study of Southeast Asian SMEs (2019), to show how SMEs participate in GVCs through trade and investment channels, and how inward and outward investment and strategic partnerships may support SME upgrading in GVCs (Figure 1). The conceptual framework focuses exclusively on the collaborative linkages between foreign multinational enterprises (MNEs) and local SMEs. MNE activity in foreign markets, however, also affects the competitive environment of SMEs in complementary activities. The main focus of this report is the investment channel (i.e. supply chain linkages with multinationals), though barriers to international trade are also important for SME participation in GVCs.

Figure 1. Conceptual framework: SME participation in GVCs via investment

SMEs access GVCs through supply chain linkages

SMEs typically access GVCs through supply chain linkages, involving the purchase and sale of intermediate goods and services. Trade linkages arise when SMEs import or export goods and services directly or indirectly, via larger firms. Domestic linkages with foreign investors arise when SMEs buy from or sell to MNEs that operate domestically.

SMEs strengthen participation in GVCs through deeper linkages and FDI

Deeper linkages between MNEs and SMEs – which involve repeated interactions and some form of transfer of knowledge, technology or skills – can result in greater SME participation in GVCs. These deep linkages (which will be referred to interchangeably as partnerships) can take many forms, including joint ventures, strategic alliances, contract manufacturing, technology licenses, franchises, research collaborations, and informal arrangements. Alternatively, deep linkages can arise when SMEs receive direct equity investments from foreign firms (inward FDI). Strengthened GVC participation through deep trade or FDI linkages can in some cases result in upgrading, including getting better
at producing goods, moving to different tasks within the value chain, or changing activity altogether.

**SMEs can become main actors in GVCs through outward investment**

As SMEs grow and develop, and as domestic markets grow, what SMEs produce at home may also evolve. Relative cost differentials, access to knowledge technology and skills, or access to new markets may push SMEs that are at a more advanced stage of development to invest abroad, become multinational and grow into larger corporations. Although this is more relevant at a later stage of economic development, it is important to have the full potential growth trajectory of an SME in mind and to enable policies that support firm growth and long-term competitiveness.

**The policy framework for MNE-SME linkages matters**

Existing evidence shows that host country policies, including those on trade, investment, labour, government spending, and education, affect the extent to which MNE-SME linkages materialise, and whether they enhance SME outcomes (Farole and Winkler, 2014). The OECD’s *Policy Framework for Investment* (2015), which provides policy guidance for governments to improve the investment climate in general, also includes a particular focus on policies that both a) enable SME participation in GVCs through linkages with MNEs and b) reduce the constraints preventing SMEs from becoming investors themselves (Box 2).

Less explored, however, are the channels through which different polices are combined to enable the types of linkages that improve specific SME outcomes. Moreover, while many governments recognise the potential benefits of MNE-SME linkages and have put in place programmes targeting linkages and their associated benefits (e.g. through fiscal incentives), there is limited evidence on the degree to which, or the conditions under which, these programmes are effective.² This report attempts to fill some of these information gaps in the context of Azerbaijan, focusing on how policies can enable FDI that produces inclusive and sustainable opportunities for SMEs in GVCs.

Box 2. The OECD Policy Framework for Investment

The OECD’s *Policy Framework for Investment* (PFI) helps governments mobilise private investment in support of sustainable development, thus contributing to the prosperity of countries and their citizens and to the fight against poverty. It offers a list of key questions to be examined by any government seeking to create a favourable investment climate.

The PFI was first developed in 2006 by representatives of 60 OECD and non-OECD governments in association with business, labour, civil society and other international organisations and endorsed by OECD ministers that same year. Designed to support international investment policy dialogue, co-operation, and reform, it has been extensively used by over 25 countries and regional bodies to assess and reform the investment climate. The PFI was updated in 2015 to take this experience and changes in the global economic landscape into account.

The PFI is a flexible instrument that allows countries to evaluate their progress and to identify priorities for action in 12 policy areas: investment policy; investment promotion and facilitation; trade; competition; tax; corporate governance; promoting responsible business conduct; human resource development; infrastructure; financing investment; public governance; and investment in support of green growth. Three principles apply throughout the PFI: policy coherence, transparency in policy formulation and implementation, and regular evaluation of the impact of existing and proposed policies.

The PFI’s value lies in the way it brings together the different policy strands while stressing the overarching issue of governance. The aim is not to break new ground in individual policy areas but to tie them together to ensure policy coherence. It does not provide ready-made reform agendas, but rather helps to improve the effectiveness of any reforms that are ultimately undertaken. By encouraging a structured process for formulating and implementing policies at all levels of government, the PFI can be used in various ways and for various purposes by different constituencies – including for self-evaluation and reform design by governments and for peer reviews in regional or multilateral discussions (such as *Investment Policy Reviews*).

The PFI looks at the investment climate from a broad perspective. It is not just about increasing investment but about maximising the economic and social returns; quality matters as much as quantity as far as investment in concerned. It also recognises that a good investment climate should be good for all firms – foreign and domestic, large and small. The objective of a good investment climate is also to improve the flexibility of the economy to respond to new opportunities as they arise – allowing productive firms to expand and uncompetitive ones (including state-owned enterprises) to close. The government needs to be nimble: responsive to the needs of firms and other stakeholders through systematic public consultation and able to change course quickly when a given policy fails to meet its objectives. It should also create a champion for reform within the government itself. Most importantly, it needs to ensure that the investment climate supports sustainable and inclusive development.

The PFI was created in response to this complexity, fostering a flexible, whole-of-government approach which recognises that investment climate improvements require not just policy reform but also changes in the way governments go about their business.

2. Foreign investment and SME linkages in Azerbaijan

This chapter gives an overview of investment trends in Azerbaijan in comparison with Eastern Partnership countries. It further provides a snapshot of the extent of supply chain linkages of Azerbaijani firms through trade and investment channels, using secondary firm-level data from a World Bank Enterprise Survey, as well as new survey data collected by the OECD. Attracting more investment in the non-oil sector – and leveraging these investments to enhance supply chain linkages with SMEs in GVCs – is important for inclusive development.

There is significant potential for greater FDI attraction in the non-oil sector

Foreign direct investment (FDI) in Azerbaijan has grown over the past two decades, with the inward stock reaching 70% of GDP in 2016 (UNCTAD, 2018), though its contribution to the overall expansion in inward FDI in Eastern Partnership countries (driven primarily by Ukraine and Georgia) has remained roughly constant over 2001-2016, at around 20% (Figure 2, Panel A). The oil and gas sector is responsible for the great bulk of FDI entering Azerbaijan. Non-oil FDI flows have risen steadily (Figure 2, Panel B), though they are still under one-third of overall FDI flows.

A closer look at the types of activities of foreign investors that operate in Azerbaijan reveals that the majority of new investment projects (as opposed to mergers or acquisitions) are in the services sector, particularly in retail and business services (Figure 3, Panel A). In terms of value, the bulk of new investment projects remain in extraction; manufacturing accounts for only 10% of the combined value of greenfield investments since 2003 (Figure 3, Panel B). Thus, while non-oil investments are on the rise, there is significant scope for greater FDI attraction in manufacturing activities that support participation in global production networks.

In order to leverage FDI as a means to support SME development and participation in GVCs, it is necessary for Azerbaijan to attract more FDI that helps diversify its economy and link it to global and regional production networks. This means attracting foreign investment in manufacturing activities and production-related services, which to date remains limited.

3 The focus of this report nonetheless remains manufacturing investments, because they present more-complex value chains with greater opportunities for supply chain linkages, exports, and integration in GVCs.
Figure 2. Non-oil FDI in Azerbaijan is growing, albeit moderately

Note: Figures are in USD millions at current prices. EaP = Eastern Partnership.

Figure 3. New investments are concentrated in services and extraction


Linkages with foreign investors are constrained by non-oil FDI

Until 2013, manufacturing firms in Azerbaijan performed relatively poorly in terms of GVC participation. Data from a 2013 World Bank Enterprise Survey indicate that only 15% of manufacturing SMEs in Azerbaijan (of which 26% produce food products, 16% wearing apparel, 12% machinery and equipment, and 11% non-metallic mineral products) used intermediate inputs of foreign origin. Only 3% of these SMEs exported their products (Figure 4). This contrasts with selected other Eurasian economies, where the share of importers was on average 50%, and where the share of exporters was on average 15%.

New data from a 2018 OECD survey of enterprises in Azerbaijan (see Box 3) provide evidence that domestic firms with adequate capabilities are increasing their GVC participation. The survey of 201 companies, which was designed to give more weight to companies with some likelihood of participating in GVCs, focuses on manufacturing sectors that are of greatest potential in terms of growth and exports. It is therefore likely
that the surveyed firms are above the economy-wide norm in terms of firm capabilities (Box 3). Given that the majority of firms were sampled from a database of companies with some demonstrated potential for exporting, trade linkages are particularly widespread: close to 80% of firms source inputs from abroad and almost 50% supply foreign firms abroad (Figure 5). However, even these firms display limited linkages with multinationals: fewer than 10% of surveyed firms report that they supply or buy from foreign affiliates of MNEs that operate in the country. This is likely to reflect the still-limited level of FDI in the non-oil sector.

A potentially important channel of participation in GVCs for domestic companies is linkages with other more internationalised domestic companies: 15% of respondents manufacture goods that are further processed by third companies and eventually exported.4 In a country where there is relatively little foreign investment in GVCs, value chains in which multiple stages occur within national borders may offer more viable opportunities for SMEs to plug into GVCs.

Over 50% of the surveyed companies report some form of deep linkages, such as contractual arrangements or strategic alliances, with foreign companies located domestically or abroad. As noted in the previous chapter, such deep linkages are expected to involve greater transfer of knowledge and to provide opportunities for domestic firms to upgrade their positioning in GVCs. Once again, cross-border partnerships (reported by 19-31% of firms) are significantly more prevalent than partnerships with MNEs established locally (5-9% of firms). This implies, however, that almost all of the observed linkages with MNEs (6-10% of firms) are in fact deep linkages, and suggests that, where present, such relationships produce significant benefits.

Finally, 4% of respondents (eight companies in the sample) engage in outward FDI activities. Interestingly, only three of them are large firms, while the other are SMEs, which suggests that there is some scope for greater outward activity for successful Azerbaijani SMEs.

**Figure 4. In 2013, trade linkages were relatively modest**

4 It is not specified whether these third companies are foreign- or domestic-owned, but given the low reported forward linkages with foreign affiliates of MNEs (5%), it can be assumed that these are in large part domestic firms.
Figure 5. Even for top performing firms, linkages with foreign MNEs remain modest

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>46%</td>
<td>Direct and indirect trade linkages</td>
</tr>
<tr>
<td>15%</td>
<td>Linkages with foreign investors</td>
</tr>
<tr>
<td>10%</td>
<td>Deep trade linkages</td>
</tr>
<tr>
<td>5%</td>
<td>Deep linkages with foreign investors</td>
</tr>
<tr>
<td>9%</td>
<td>Outward FDI</td>
</tr>
<tr>
<td>5%</td>
<td>Sources from foreign suppliers abroad</td>
</tr>
<tr>
<td>4%</td>
<td>Sells output to firms abroad (exports)</td>
</tr>
<tr>
<td>31%</td>
<td>Sells processed goods for further processing and export</td>
</tr>
<tr>
<td>5%</td>
<td>Sells to foreign suppliers in Azerbaijan</td>
</tr>
<tr>
<td>19%</td>
<td>Partners with foreign suppliers abroad</td>
</tr>
<tr>
<td>15%</td>
<td>Partners with foreign buyers abroad</td>
</tr>
<tr>
<td>10%</td>
<td>Sources from foreign suppliers in Azerbaijan</td>
</tr>
</tbody>
</table>

Note: The figure is based on responses from 201 enterprises. “Partnering with” is defined as engaging in a long-term contract, alliance or partnership which each category of supplier or buyer. The survey is likely to be biased towards better top performing firms, with greater potential for GVC integration (see Box 3).

Box 3. Brief methodological note

OECD Azerbaijani Enterprise Survey 2018

The enterprise survey was launched in March 2018 after a pilot phase of one month. It was administered face-to-face by a survey management company based in Baku, to 201 participants, over a period of three months. It is important to stress that the survey sample is not intended to be representative of the general population of firms, and sampling was not random. Sectors presenting greater opportunities for SME linkages were deliberately over-sampled, while many sectors were left out. Company details were in large part retrieved from a database of enterprises branded and promoted as part of the “Made in Azerbaijan” initiative and published on the Ministry of Economy’s website (http://www.economy.gov.az/media/pdf/katalog_ru.pdf). This means that the survey’s findings cannot be generalised to the population of firms. As discussed in Chapter 1, not all SMEs have the potential to integrate into GVCs. Given limited resources, government efforts to support linkages should focus on the areas of greatest opportunity and SMEs with adequate capabilities. For this reason, greater weight is given to medium-sized enterprises that have signalled some potential to forge linkages with MNEs. The sectors of focus are processed foods, furniture, and chemical and related products that are downstream of oil. See Annex B for a full description of the sample.

EU Business Climate Survey of Azerbaijan 2018

While some foreign-owned enterprises participated in the OECD survey, the vast majority of respondents were domestic enterprises, reflecting the population of firms in the non-oil sector. In order to gain deeper insights on some questions designed specifically for foreign investors, the OECD partnered with the German-Azerbaijan Chamber of Commerce (AHK) to insert three additional questions relevant to our study in their annual survey of EU investors. The survey incorporated 20 questions in total and was administered online in the first quarter of 2018. A total of 131 foreign investors completed the survey. See Annex C for details of the questions and sample.

Semi-structured interviews and focus group

Beyond surveys, the data collection approach involved multiple fact-finding missions to complement the quantitative data with qualitative perspectives on the main challenges obstructing linkages and potential areas of opportunity, across a range of different stakeholders. Specifically, 33 semi-structured face-to-face interviews were held with business associations (7); foreign investors (4); domestic companies (8), including SMEs (6); government agencies (5); industrial parks/estates (2); industry experts (3); NGOs (3); and international organisations (1). Moreover, a focus group was held in December 2017, organised and chaired by the National Confederation of Entrepreneurs (ASK), with the additional objective of piloting the enterprise survey and collecting the views of SMEs. The 13 participants included 10 SMEs, one large firm and two industry associations. A summary of the findings from the interviews and focus group is provided in Annex A.

Secondary data sources

This study also uses a variety of secondary data sources at different levels of aggregation; namely, country-level FDI statistics (UNCTAD, IMF) and regulatory climate indicators (World Bank Doing Business); sector-level statistics (Central Bank of Azerbaijan, State Statistical Committee of Azerbaijan); firm-level information (World Bank Enterprise Surveys); and project-level information on cross-border investments (Financial Times).
3. Benefits and determinants of MNE-SME linkages

This chapter provides evidence of the benefits of participating in GVCs through linkages for firms in Azerbaijan, in terms of productivity and other measures of performance. The analysis is based on primary quantitative evidence collected for this study. The chapter then addresses the issue of what drives linkages from a market perspective, focusing on investor motives and domestic firms’ absorptive capacities.

GVC linkages are associated with improved firm performance

Supply chain linkages with foreign MNEs can benefit SMEs in a variety of ways. Linkages may enable firms to develop managerial skills, improve the quality of products, develop new products, acquire new technologies, reduce costs, improve working conditions, or reduce their environmental footprints. However, as suggested by the conceptual framework in Chapter 1 (Figure 1), these linkages are likely to generate different impacts for SMEs depending on their depth: the benefits for SMEs depend to some extent on the degree to which MNEs exert control over them (e.g. through alliances, contractual arrangements or direct investment). Benefits are also likely to vary depending on the sector and on whether linkages are upstream (with suppliers) or downstream (with buyers).

Several approaches are used in the literature to estimate the effects of linkages on firm outcomes, and their conclusions tend to be incomplete and often contradictory. The mainstream approach is the estimation of FDI spillovers using an industry-level measure of FDI presence and estimating its effect on a given performance indicator at the firm level (Aitken and Harrison, 1999; Javorcik, 2004; Blalock and Gertler, 2008; Damijan et al., 2013). The issue with trying to estimate FDI spillovers at the firm level by measuring FDI presence at the industry level is that it assumes that all domestic firms are affected by FDI to the same degree, whereas firms in fact differ greatly in terms of the linkages they are able to develop with foreign firms. Emerging research tries to account for this by explicitly controlling for linkages using survey data, although limited evidence is available for Eastern Partner economies. This chapter contributes to this literature by analysing original firm-level data on Azerbaijani firms to examine the relationship between different forms of linkages (trade, FDI, partnerships) and reported firm outcomes.

Linkages are associated with above-average firm productivity in Azerbaijan (Figure 6). According to primary data collected in the OECD Enterprise Survey of Azerbaijan, firms that enjoy some form of trade, investment or contractual linkage experience a productivity premium, measured as the ratio of their average productivity relative to firms that have no links. The highest productivity premium (of a factor of 12.5) is observed for companies.

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5 Productivity is measured here as turnover per employee. Though we acknowledge that this does not take into account costs of production, it serves as a rough approximation.
that produce processed goods that are used as intermediate inputs by firms that eventually export their output – a measure that is intended to capture indirect participation in global value chains, through domestic linkages. As can be expected, companies that engage in outward investment activities are also ten times more productive, on average, than firms with no linkages. In all cases, however, the direction of causality is unclear, and further empirical analysis is needed to shed more light on this question. Causality might, indeed, run both ways: better-performing firms might be more attractive to MNEs, and GVC integration might then further enhance their productivity edge.

Figure 6. GVC linkages are associated with higher productivity

![Bar chart showing GVC linkages vs productivity](chart)

Average productivity normalised by the average productivity of firms with no GVC linkages

*Note: The figure is based on responses from 201 enterprises. Productivity is measured as turnover per employee. Respondents are not representative of the overall population of SMEs in Azerbaijan; the survey is likely to be biased towards better, top-performing firms with greater potential for GVC integration (see Box 3). “Partnering with” is defined as engaging in a long-term contract, alliance or partnership with each category of supplier or buyer.

Source: OECD Azerbaijani Enterprise Survey (2018).*

In addition to objective measures of above-average productivity, firms also perceive significant benefits from trade and investment linkages (Figure 7). These benefits take the form of improvements in the firms’ operations and products, more so than direct cost reductions, suggesting that they are indeed the result of knowledge transfers rather than access to cheaper substitutes for domestic resources.

Specifically, more than 80% of firms report improvements in the quality of their products or services, and adoption of new technologies, processes and practices, as a result of sourcing from foreign suppliers (Figure 7, Panel A). Likewise, over 80% of firms report improved working conditions of staff, production processes and skills as a result of supplying foreign companies (Figure 7, Panel B).

The observed improvements in working conditions could imply that domestic firms raised their standards in order to comply with the requirements of foreign buyers, as multinationals are held to high international labour standards, and are in many countries accountable for the conduct of their suppliers. In other words, supply chain linkages are associated with improvements in conduct as well as efficiency, and promoting responsible business conduct (RBC) can be a means to provide domestic companies with greater access to GVCs. Through its *Guidelines on Multinational Enterprises*, the OECD is supporting countries to improve conduct of their business sector (OECD, 2011).
Figure 7. Linkages are associated with better products and processes

Panel A: Benefits of backward linkages

- Improved quality of products' services: 87%
- Adopted new technologies, processes or management practices: 83%
- Increased capacity for existing products' services: 77%
- Developed managerial or technical skills: 75%
- Started offering new products/services: 61%
- Hired more workers to meet increased production/service delivery: 57%
- Reduced energy or resource use: 49%
- Reduced volatility (e.g. through long-term contracts with suppliers): 43%
- Reduced costs: 27%

Panel B: Benefits of forward linkages

- Improved working conditions of staff: 83%
- Adopted new technologies, processes or management practices: 81%
- Developed managerial or technical skills: 80%
- Improved products/services to meet international standards: 79%
- Increased capacity for existing products/services: 77%
- Started offering new products/services: 65%
- Hired more workers to meet increased production/service delivery: 62%
- Reduced energy or resource use: 60%
- Reduced volatility (e.g. through long-term contracts with buyers): 49%

Note: Forward linkages are linkages with buyers (e.g. retailers) while backward linkages are linkages with suppliers. Panel A is based on responses from responses from 150 companies; and Panel B is based on responses from 111 companies. Respondents are not representative of the overall population of SMEs in Azerbaijan (see Box 3). Source: OECD Azerbaijani Enterprise Survey (2018).

Foreign investors come to Azerbaijan predominantly to sell

The motives for FDI are typically grouped into three categories: resource-seeking, market-seeking and efficiency-seeking (Dunning, 1993). The search for natural resources motivates resource-seeking FDI. Market-seeking FDI instead follows demand factors like a host country’s market size, per capita income and market growth. New markets give MNEs the opportunity to grow by achieving economies of scale and scope. Traditionally, market-seeking FDI has been associated with the incentive for a firm to move to a foreign location and thereby circumvent import tariffs or quotas (tariff-jumping” FDI). Efficiency-seeking FDI instead aims to maximise the gains from geographically dispersed resources and activities, by taking advantage of different factor endowments, institutional and cultural factors, economic systems and policies, and market structures, while supplying multiple markets. As such, it underlies the formation of global value chains.

Conceptually, the materialisation of linkages between MNEs and domestic firms is related to the motives of foreign investors. Resource-seeking investors may bring little value added to the domestic economy, as their primary purpose is extraction. Market-seeking investors are often viewed as competitors by domestic producers, though they may forge linkages with upstream suppliers and downstream distributors. Efficiency-seeking investors, by definition, enter the market to exploit local production advantages. Thus, efficiency-
seeking FDI is expected to be the most conducive to linkages and knowledge transfers to domestic producers. In practice, investors are rarely driven by just one motive, and the resulting benefits for domestic firms are not so clear-cut. Nevertheless, examining primary motives as reported by investors can shed light on the likelihood of the realisation of linkages.

According to the 2018 EU Business Climate Survey, EU investors in Azerbaijan are driven primarily by market-seeking motives (33%). Strategic partnerships and alliances are also cited as among the most important factors by over a quarter of respondents; though this is likely a means to enter and serve the market (i.e. by partnering with local knowledge) rather than an end in itself (Figure 8). This is not surprising as respondents to the survey are concentrated in services (73%) and construction (8%), which are typically non-tradable. Qualitative interviews with selected foreign investors in food processing and production of construction materials corroborate this evidence, indicating that the investors’ decisions to enter the market were mainly demand-driven.

**Figure 8. Foreign investors come to Azerbaijan to sell rather than produce**

*What are the most important factors that drove your company to invest in Azerbaijan? (Select 2 that apply)*

![Survey Results](image)

*Note: Figures are based on 131 survey responses.*

*Source: OECD based on EU Business Climate Survey Azerbaijan 2018.*

When asked what deters them from sourcing locally (Figure 9), the most common response among EU firms was that needed inputs are not available locally (22%). Almost 20% of EU investors report that domestic suppliers do not meet their product quality standards, and another 16% maintain that they lack the relevant skills or capabilities. Thus, from the investors’ point of view, linkages are to a great extent limited by the capabilities of domestic firms, which are assessed in greater detail in the next section. Once again this was corroborated by qualitative interviews with a manufacturer of beverages, who remarked that the bottles produced domestically do not meet their standards, and by a technology service provider, who noted the difficulty in retaining skilled labour. A summary of the main challenges and areas of opportunity identified by interviewed stakeholders is provided in Annex A.

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6 Refer to Box 3 for a brief description of the methodology and to Annex C for the sampling.
Absorptive capacity can be increased by providing training opportunities

FDI offers SMEs in developing economies like Azerbaijan an opportunity to acquire knowledge. Transfer of knowledge from foreign to domestic firms necessitates capabilities on the part of the domestic firms (known as absorptive capacity) or the ability of the firms to assimilate information acquired through interaction with other firms (Cohen and Levinthal, 1990). Absorptive capacity is a function of domestic firms’ characteristics and of the technology gap between domestic and foreign firms. Empirical evidence shows that domestic suppliers with better technical capabilities tend to develop more knowledge-intensive types of linkages with foreign firms (Saliola and Zanfei, 2009).

This section considers measures of absorptive capacity that have been studied in the literature and are associated with supply chain linkages and FDI spillovers (OECD-UNIDO, 2019). It then provides an assessment of the performance of Azerbaijani SMEs with respect to these measures based on data from the World Bank Enterprise Surveys, and from the 2018 OECD enterprise survey of Azerbaijan.

Azerbaijani firms demonstrate significant capacity to absorb technology

The productivity gap between domestic and foreign firms has served as a proxy for absorptive capacity. However, given that differences in productivity (measured as turnover per employee) may be the result of different sectors and cost structures across foreign and domestic firms, and that the samples are too small to undertake a sector analysis, other performance gaps are considered that relate to the firm’s likelihood of engaging with foreign investors. For instance, the extent to which firms are located in an industrial park or estate is likely to be related, on the one hand, to the firm’s productive and innovation capabilities, as there is an application and screening process for admission to these parks; and on the other hand, to the likelihood of forging linkages with foreign investors, which are often invited to reside in these parks. Adherence to international quality standards is a basic requirement for most multinationals in their sourcing decisions and directly relates to the firm’s ability to participate in GVCs. Use of technologies licensed by foreign companies is an indication of the capacity to absorb knowledge and technology transfers.
To summarise, the measures considered in this study are: (1) the share of firms that operate in an industrial park or estate; (2) the share of firms that have internationally-recognised product-quality certifications; and (3) the share of firms that use technologies licensed by a foreign firm (Figure 10).

Figure 10. Surveyed firms demonstrate significant capacity to access GVCs

Note: The figure is based on responses from 201 enterprises.

As expected, foreign firms that participated in the OECD survey outperform domestic firms across all measures in Azerbaijan, particularly in adherence to standards and in use of foreign-licensed technologies. Nevertheless, over 50% of domestic firms respond positively to both of these questions, and the gap in performance is very small for residency in industrial parks. Thus, the Azerbaijani SMEs that participated in this study demonstrate high capabilities in terms of accessing global supply chains (though this cannot be generalised to the overall population of SMEs).

A comparison with WBES data on domestic manufacturing firms\(^7\) shows that, in fact, the capabilities of Azerbaijani SMEs in 2013 were on average significantly lower than in our sample, particularly as regards certification (Figure 11). While the absorptive capacity of Azerbaijani firms is very likely to have grown over the past five years (not least thanks to the extensive programme of economic reform), the performance of our sampled companies is certainly much above average, and the overall improvement in performance is likely to lie somewhere in the middle. This being said, it is noteworthy that domestic manufacturing firms in Azerbaijan were among the top performers in terms of use of foreign technologies, across all considered countries.

\(^7\) Foreign companies are not represented in the figure because no data on foreign companies is available for Azerbaijan (and fewer than 10 observations are available for most other EaP countries).
Figure 11. On average, certification appears to be limited

![Certification Chart]

*Note*: Figures are based on data from 2013, on manufacturing firms only.

**Investment in human capital and skills can be improved**

Absorptive capacity is also determined by the level of human capital and skills in domestic firms (Meyer and Sinani, 2005). Several studies highlight positive FDI spillovers in companies that invest in human capital as opposed to companies that do not (Ben Hamida and Gugler, 2009; Girma et al., 2008), suggesting that offering training opportunities to employees can be crucial to access GVCs.

According to the WBES, firm investment in training was low in manufacturing in 2013: fewer than 10% of manufacturing SMEs offered formal training programmes to their employees (Figure 12). In contrast, a significantly higher share of SME service providers reported offering formal training (23%), suggesting that the manufacturing sector is lagging behind in this respect and there is scope for greater investment in human capital by manufacturing SMEs.

Figure 12. Few manufacturing SMEs offered formal training to their employees

![Training Chart]

*Note*: Figures are based on data from 2013.

The 2018 EU Business Climate Survey of foreign investors in Azerbaijan reinforces this impression to some extent: 16% of investors (predominantly in service sectors) view the
lack of relevant skills of local suppliers as one of the main reasons for not sourcing locally; when asked about the overall business environment, 37% rated the availability of skilled workers as unsatisfactory. A foreign ICT service provider also noted in an interview that the level of vocational training in the country is inadequate, and that there is a shortage of specialist and technical skills. It thus appears that there is significant room for improving vocational and technical skills. From an employee perspective, this could potentially be addressed by providing incentives for companies to offer formal training to their employees. However, this issue goes beyond company training and should be addressed in coordination with educational institutions.

The government has already taken steps to address challenges related to education and skills. A draft proposal for the creation of a “Certification Centre” of the Ministry of Labour and Social Protection and the Ministry of Education has recently been submitted to the government in order to identify areas of priority for human capital development and certification of formally and informally-acquired skills. Advancing this agenda is of key importance for strengthening the domestic business landscape and supporting SME development.
4. An enabling policy environment

The policy environment is a crucial ingredient for attracting investment, boosting the competitiveness and growth of local SMEs, and anchoring investors through deep linkages with the local economy. This chapter reviews existing policies designed to improve the investment climate, build SME capacity, and encourage investors to forge linkages with local SMEs in Azerbaijan. The chapter draws on the experience of successful policies in other countries to provide lessons for Azerbaijan—focusing on regulatory reforms, contract enforcement, industrial zones, and linkage policies.

The development of a policy environment designed to encourage business linkages between foreign investors and local firms is affected by a variety of factors (Figure 13). FDI trends and the sourcing decisions of multinationals reflect the global context, including macroeconomic factors (related to the business cycle and long-term growth) and geographic and cultural factors, among others. Additionally, investor business models and SME capacities (discussed at length in the previous chapters) determine the extent to which foreign MNEs are likely to forge deep linkages with local SMEs.

Figure 13. A policy framework for investment and linkage

Source: Adapted from UNCTAD (2010).

Policy can play a pivotal role in attracting and anchoring investors through deep linkages with the local economy. The first step to supporting linkages is implementing measures to improve the overall investment climate. A healthy investment climate can by itself help to

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8 The OECD Policy Framework for Investment (PFI) addresses questions pertaining to 12 policy fields that are critically important for improving the quality of a country’s enabling environment for
create an environment that encourages foreign firms to invest in and link with local firms. Governments may nevertheless decide to implement additional targeted measures to enhance linkages; however, without an underlying policy environment that fosters and facilitates private investment, these proactive policies are likely to prove ineffective.

Targeted linkage policies integrate complementary elements aimed at foreign investors and domestic SMEs. On the investor side, it is necessary to attract a critical mass of targeted FDI to form an industrial cluster that can create real opportunities for business. On the domestic side, putting in place a supporting mechanism to help local firms overcome supply-side constraints and achieve the standards required to become suppliers to multinationals (quality, delivery, performance, compliance, etc.) is necessary to create a pool of qualified local firms capable of supplying goods and services that meet FDI requirements. Having attracted foreign investors and developed local capabilities, policy can then serve to build an effective selection and matching mechanism to link potential FDI and local firms.

This chapter first examines selected areas of the investment climate in Azerbaijan that may have particular influence on the development of linkages, including the recent wave of economic reforms aimed at creating a basis for sustainable economic growth that is led by the private sector and not driven by the oil sector. It then focuses on specific policies for linkage promotion and local capacity building, the extent of their implementation in Azerbaijan, and the related experiences of other countries.

**Improving the investment climate**

*Economic reforms have been successful and will require long-term commitment*

Azerbaijan has taken a number of steps to strengthen the institutional, regulatory and operational environment for SMEs, particularly by easing company registration and developing e-government services. This has resulted in a significant improvement in the country’s overall ease of doing business, and is reflected in one of the highest annual increases in the World Bank’s “ease of doing business” score observed across 190 economies (World Bank, 2019a). Reforms aimed at stimulating local production, simplifying customs procedures, and supporting internationalisation have also been implemented and are expected to contribute considerably to facilitating SME participation in GVCs through supply chain linkages.9

Business perceptions of the reforms in Azerbaijan have been positive, with over 50% of businesses that participated in the OECD survey considering almost all reforms “good” or “very good” (Figure 14). The suspension of business inspections has been particularly well received (86% good or very good), as have online licensing and visa services (82% and 77%, respectively). Measures to simplify the tax system (see Box 4), stimulate local production and simplify and amend the customs system are also perceived as successful by over 60% of firms, and perceived negatively by around 10% of firms.

Interviews with foreign and local businesses, and foreign chambers of commerce, indicate that the reforms and programmes implemented by the government are generally perceived as a serious effort to develop industry in Azerbaijan and to improve the country’s

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9 See also OECD (2018c) for details of the reform programme.
international image. At the same time, it is noted that more can be done in terms of developing skills, promoting competition, and reducing uncertainty. Some companies report that there is volatility in the sectors targeted by the government for growth, which creates uncertainty for businesses and hampers the effectiveness of the initiatives.\footnote{See Annex A for a summary of findings from qualitative interviews with businesses, private-public agencies and chambers of commerce.} Such companies would welcome greater consistency and long-term commitment across the reform programme.

**Figure 14. Businesses perceive most reforms as successful**

<table>
<thead>
<tr>
<th>Reform</th>
<th>Poor</th>
<th>Very poor</th>
<th>Good</th>
<th>Very good</th>
</tr>
</thead>
<tbody>
<tr>
<td>Suspension of inspections related to entrepreneurial activities</td>
<td>1%</td>
<td>3%</td>
<td>95%</td>
<td>5%</td>
</tr>
<tr>
<td>Simplification of the licensing procedure through ASAN services</td>
<td>2%</td>
<td>2%</td>
<td>77%</td>
<td>11%</td>
</tr>
<tr>
<td>Launch of ASAN Visa portal</td>
<td>18%</td>
<td>7%</td>
<td>67%</td>
<td>5%</td>
</tr>
<tr>
<td>Simplification of the tax system</td>
<td>7%</td>
<td></td>
<td>93%</td>
<td>4%</td>
</tr>
<tr>
<td>Measures to stimulate the local production</td>
<td>13%</td>
<td></td>
<td>87%</td>
<td>6%</td>
</tr>
<tr>
<td>Simplification of the customs system</td>
<td>12%</td>
<td></td>
<td>61%</td>
<td>7%</td>
</tr>
<tr>
<td>Amendments to the law on customs tariffs</td>
<td>12%</td>
<td></td>
<td>61%</td>
<td>7%</td>
</tr>
<tr>
<td>Establishment of the Board of Appeal under the President of Azerbaijan</td>
<td>16%</td>
<td>5%</td>
<td>60%</td>
<td>5%</td>
</tr>
<tr>
<td>Establishment of the State Agency for Vocational Education and Training</td>
<td>16%</td>
<td>5%</td>
<td>60%</td>
<td>5%</td>
</tr>
<tr>
<td>Adoption of export-oriented economic model by providing export incentives</td>
<td>17%</td>
<td>3%</td>
<td>35%</td>
<td>1%</td>
</tr>
<tr>
<td>Establishment of the Financial Market Supervisory Authority</td>
<td>17%</td>
<td>3%</td>
<td>35%</td>
<td>1%</td>
</tr>
</tbody>
</table>

*Note: Figures are based on 201 survey responses.*

*Source: OECD Azerbaijani Enterprise Survey (2018).*
Box 4. Key reforms in the tax system affecting the investment environment

In 2013 Azerbaijan became a member of the OECD’s Global Tax and Transparency Forum (http://www.oecd.org/tax/transparency). It has since taken action to improve information exchange with other countries on tax issues and to align itself with international standards. Drawing on international experience, important reforms to the tax system have been made in recent years, so as to create favourable conditions for business and enhance mutual trust and transparency among tax payers and tax authorities. The Ministry of Taxes was charged with simplifying tax administration, expanding the scope of electronic audit, toughening requirements for tax audits, and adjusting anti-avoidance rules in line with international best practice.

Tax code reforms:

- Provisions related to transfer pricing, voluntary tax disclosure, advance tax ruling, e-invoices, taxation of e-commerce, limitation of cash settlements, value-added tax (VAT) for agricultural products, and tax monitoring of financial institutions, were appended to the tax code.
- A law on the regulation of taxpayer debt was enacted, and a portion of the taxpayer interest accrued and financial sanctions incurred prior to January 2017 were waived.
- Legal entities and individuals involved in entrepreneurial activities in industrial or technological parks are exempt from income tax, property tax, land tax, and VAT on imported machinery and equipment, for the duration of seven years from the year in which they were registered in those parks, since 2013.
- Since 2016, legal entities and individual entrepreneurs that obtain an investment promotion certificate are exempt from income tax, property tax, land tax and VAT on imported equipment, for a period of seven years, conditional on the amount and location of investment.
- Legal entities and individuals engaged in export of non-oil products receive an export promotion incentive proportional to the customs value of exported goods.

Tax administration reforms:

- As part of the e-government project, an electronic tax declaration form was introduced in 2007 that currently accounts for 95% of submitted tax declarations; a single VAT deposit account was introduced in 2008 to increase the efficiency of VAT transaction verification; electronic tax invoices were introduced in 2010; and an online clerical system was introduced in 2010 to provide a channel for electronic correspondence between tax authorities and taxpayers.
- A Call Centre covering many state agencies was set up in 2015. One of its functions is to assist taxpayers with questions related to tax compliance. The Call Centre was certified for compliance with EU standards in 2011. Service Centres were also set up in several regions of the country to facilitate access to tax services; 57 such centres currently exist.
- A manual was developed for tax authorities to support newly registered businesses, providing all necessary information on tax compliance.
- The Twinning project on e-audit (2012-13) was implemented together with the Netherlands Tax and Customs Administration, enabling the improvement of the Ministry’s capabilities in the fields of large-scale enterprise auditing, e-declarations, electronic accounting, and e-audits of large and medium enterprises.
- A “Tax Friends” initiative for tax literacy in rural areas was rolled out in 2012, in collaboration with school teachers.
- A “Single Risk Management Centre” tool was introduced to improve the quality and effectiveness of tax inspections.
- A Tax Appeal Board was established under the Ministry of Taxes, charged with carefully examining appeals from taxpayers and taking appropriate measures as stipulated by legislation.

Good enforcement procedures support domestic sourcing
The ability to make and enforce contracts and resolve disputes efficiently is fundamental for markets to function properly. Good enforcement procedures enhance predictability in commercial relationships by assuring investors that their contractual rights will be upheld promptly by local courts. When procedures for enforcing contracts are overly bureaucratic and cumbersome or when contract disputes cannot be resolved in a timely and cost-effective manner, foreign investors may restrict their activities or refrain from engaging with local companies. As a result, guaranteeing good enforcement procedures or alternative dispute resolution mechanisms can serve to not only promote linkages between foreign investors and domestic SMEs, but also to make technology transfers more likely.

Because the court system plays a fundamental role in enforcing contracts, a number of judicial reforms are considered good practices in responding to the need of modern societies for efficient and high-quality judiciary systems. They include such measures as: producing and monitoring statistics on the efficiency and costs of the judicial system; adopting e-justice systems to facilitate the management of cases by both judges and lawyers; and organising the judicial system along key areas of specialisation. Alternative dispute resolution mechanisms – including arbitration, mediation and conciliation – are also available and increasingly used for resolving commercial and investment disputes. International investment agreements, although varying in scope and content, also provide relevant standards of treatment of investors and their investments. As such, they may offer an additional layer of security to covered investors, including sometimes by offering recourse to international investment arbitration to resolve investor-state disputes (OECD, 2015).

In 2009, with assistance from the World Bank, Azerbaijan took major steps towards the development of an efficient and transparent e-Justice system. This transformation was initiated through the development and implementation of an “e-Court” information system covering automation of court proceedings and enforcement of court decisions. The e-Court system aims to deliver on the principles of access to justice, efficiency and transparency through components such as e-Filing, automated random case distribution for impartiality, and an automated e-Fast-Track System for non-litigious civil cases. To further enhance court management within the system, a performance-measurement component was developed (Court Pulse), based on a set of key performance indicators (KPIs). The e-Fast-Track System significantly decreased the workload for judges and courts, and resulted in a remarkable reduction in the time required for case proceedings. At present, over 60% of the legal entities and entrepreneurs apply electronically to courts of general jurisdiction over disputes arising out of non-fulfilment of contractual obligations. As a result, the efficiency of contract enforcement with regard to time, cost and procedural complexity has been significantly improved.

Country performance in terms of contract enforcement and judicial processes can be assessed using indicators covered in the World Bank’s Doing Business exercise. Figure 16 illustrates the ease of enforcing contracts in selected Eurasian countries based on two indices. The “ease of enforcing contracts” index measures the distance of each country from the frontier (or best performance since 2005), where performance is based on: days to resolve a commercial dispute; enforcement costs as a share of claim value; and use of good practices promoting quality and efficiency. The “quality of judicial processes” index

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11 https://www.coe.int/en/web/cepej/events/crystal-scales-of-justice-prize/2017
is constructed on a scale from 0 to 18 using scores that cover: court structure and proceedings; case management; court automation; and alternative dispute resolution.\textsuperscript{12}

As shown in the figure, there is wide variation across indices and among the selected countries. With respect to the time and costs associated with enforcing contracts (Figure 15, Panel A), Azerbaijan scores at average OECD levels. This reflects the recent introduction of measures to improve the efficiency of the court system, such as online submission of appeals and payment of court costs. At the same time, there is scope for further reform and improvement in the quality of judicial processes, as measured by the World Bank Doing Business score (Figure 15, Panel B). A closer look at the breakdown of the “quality of judicial processes” index suggests that significant gains can be made from the perspective of doing business by offering alternative dispute resolution mechanisms beyond litigation (Figure 16). This means recognising arbitration, mediation and conciliation as ways to resolve commercial and investment disputes.

**Figure 15. The quality of judicial processes can be improved**

<table>
<thead>
<tr>
<th>Panel A: Ease of enforcing contracts (DTF)</th>
<th>Panel B: Quality of judicial processes (0-18)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kazakhstan</td>
<td>Georgia</td>
</tr>
<tr>
<td>70</td>
<td>60</td>
</tr>
</tbody>
</table>

*Note:* The “distance to frontier” (DTF) measures the distance of an economy from the best performance observed in all years and all economies since 2005. The distance is measured on a scale from 0 (lowest performance) to 100 (frontier). The DTF score for enforcing contracts is a simple average of the distance to frontier scores for (1) days to resolve a commercial dispute through the courts; (2) attorney, court and enforcement costs as a share of claim value; and (3) use of good practices promoting quality and efficiency. The quality of judicial processes index (0-18) measures whether each economy has adopted a series of good practices in its court system in four areas: court structure and proceedings (0-5), case management (0-6), court automation (0-4), and alternative dispute resolution (0-3).


\textsuperscript{12} For more details on the World Bank’s *Doing Business* methodology, see: http://www.doingbusiness.org/Methodology/enforcing-contracts.
Figure 16. Alternative dispute resolution is important to business

Note: The “quality of judicial processes” index (0-18) measures whether each economy has adopted a series of good practices in its court system in four areas: court structure and proceedings (0-5), case management (0-6), court automation (0-4), and alternative dispute resolution (0-3).


Responsible business conduct signals safe local sourcing opportunities

Responsible business conduct (RBC)\(^\text{13}\) principles and standards set out an expectation that all businesses – regardless of their legal status, size, ownership structure or sector – should avoid and address negative impacts of their operations, while contributing to the sustainable development of the countries where they operate. These expectations are prevalent throughout GVCs and are affirmed in the main international instruments on RBC – notably the OECD Guidelines for Multinational Enterprises (2011), the UN Guiding Principles on Business and Human Rights (2011), and the Fundamental Conventions of the International Labour Organization (ILO)\(^\text{14}\) – and increasingly in international trade and investment agreements and national development strategies, laws, and regulations all over the world.

Many businesses also find that “responsible business is good business”, beyond ensuring that they respect human rights and comply with relevant laws and regulations. Understanding, addressing, and avoiding risks material to business operations in a more comprehensive way – that is, beyond financial risks – often leads to a competitive advantage. A market in which internationally accepted environmental and social principles and standards are not respected faces an increased risk of being excluded from value chain

\(^{13}\) Although RBC is often referred to as “corporate social responsibility” (CSR), the two are not exactly equivalent. Responsible business conduct means that businesses should make a positive contribution to economic, environmental and social progress with a view to achieving sustainable development, and that they have a responsibility to avoid and address the adverse impacts of their operations. While the concept of CSR is often associated with philanthropic corporate conduct external to business operations, RBC goes beyond this to emphasise the integration of responsible practices within internal operations and throughout business relationships and supply chains. For more information see https://www.oecd.org/investment/toolkit/policyareas/responsiblebusinessconduct.

activity. This is supported by the survey evidence (presented in Chapter 3) showing that businesses that are more integrated in GVCs also report better working conditions of staff.

RBC expectations could be included in FDI attraction efforts and may help attract MNEs that are more inclined to source locally. The current “Invest in Azerbaijan” website (www.azpromo.az/investments) does not mention environmental and social issues or corporate social responsibility. This is a missed opportunity to connect with investors that are keen on doing business responsibly and to brand Azerbaijan as a responsible business destination. Making an explicit link between RBC and investment promotion efforts can help fill the information gap for foreign investors, who may otherwise perceive the risk of operating in Azerbaijan to be higher than it otherwise is.

RBC could also be incorporated into supplier databases and matchmaking events. Governments could include RBC principles and standards in industry-specific training programmes as a way to build the absorptive capacity of domestic companies and encourage business linkages with foreign investors. This could encompass everything from promotion to capacity-building exercises to supporting cross-sectoral learning efforts (for example, supporting cost-sharing efforts within and among industries for specific due diligence tasks, participation in initiatives on responsible supply chain management, and cooperation between industry members who share suppliers).

Additionally, training and awareness-raising for business leaders could also be useful in promoting a wider understanding and recognition of the importance of RBC. Educational institutions such as business schools can be important platforms in this regard. The authorities could make educational and training programmes more market-driven by increasingly involving the private sector in human resource development policies and encouraging internal and external training by employers.

Building capacity and facilitating linkages

As described at the beginning of this chapter, governments can play a role in increasing the attractiveness of SMEs as business partners for foreign investors, through specific policies and programmes. The evidence suggests that SMEs are less likely than larger firms to participate in global value chains because their limited size, resources, managerial structure and geographic location can result in informational, technical and administrative barriers that make it difficult to access finance, comply with quality standards, bridge connectivity and infrastructure constraints, innovate, or find and develop suitable human capital.

Policy interventions designed to increase SME presence in global value chains thus often focus on incentives, export financing facilities, training programmes, marketing portals, business matchmaking activities, support for acquiring internationally-recognised certifications, support for attending international trade fairs, and the creation of e-commerce platforms on which SMEs can list. Such measures can be a complement to – but should not be viewed as a substitute for – the kind of business environment improvements discussed above. These programmes are often implemented by investment promotion agencies in coordination with other government agencies (see Thailand’s strategic approach to linkage policy in Box 5). An example of a successful supplier development programme in the context of the Czech Republic is provided in Box 6.
In Thailand, the Board of Investment (BOI) and the Ministry of Industry (MOI) are the main official actors responsible for designing and implementing the core elements of linkage policies. They flexibly and informally coordinate the activities of related agencies and units, private sector bodies such as the Alliance for Supporting Industries Association (ASIA), and academic institutions and non-profit organisations that provide technical support and business consulting (e.g. the Technology Promotion Association). The resulting network is neither dominated by a single organisation nor governed by explicit rules: each member performs its functions separately, and refers customers to other organisations wherever they can fill required functions better.

As an investment promotion agency, the BOI is the first point of contact for foreign investors, and is charged with attracting FDI strategically (based on the published list of priority activities and products) and linking it with local companies, through its BOI Unit for Industrial Linkage (BUILD). BUILD receives inquiries from foreign investors through various channels (including the One Start One Stop Investment Centre and BOI’s overseas offices), announces the specification and volume requirements of foreign buyers in its website, and solicits expressions of interest from Thai suppliers. It also subsidises Thai firm participation in overseas trade exhibitions (Vendor-Meet-Customer Roadshows).

The MOI’s Department of Industrial Promotion (DIP) is responsible for local capacity building directly and indirectly through various bodies such as the Bureau of Supporting Industry Development (BSID), sector-specific institutions, industry associations, and the Industrial Estate Authority of Thailand (IEAT). BSID is the unit that was originally charged with delivering local capacity building through the provision of technical and managerial support to companies in “supporting industries” (SIs). As the number of SI companies grew to over a thousand, thematic forums were established and BSID’s role shifted from technical support to advisory and financial support. Gradually, the forums gained experience and developed into 12 privately-run industrial associations, under the summit organisation ASIA.

While direct evidence of the effectiveness of this strategy is not currently available, Thailand excels among ASEAN countries in terms of GVC integration through linkages, as reflected by its achieving the highest level of local sourcing by foreign MNEs in manufacturing (exceeding 95% of total inputs in 2016). This is an example of a model that could be adapted to the case of Azerbaijan, particularly as regards the delivery of local capacity building.
Box 6. Czech Invest Supplier Development Programme

The Investment and Business Development Agency, or CzechInvest, was established in 1992 by the Ministry of Industry and Trade and underpinned the country’s deep socio-economic transformation in the 1990s.

CzechInvest’s strategy was to attract FDI with positive externalities and spillovers. Spillovers from MNEs to SMEs can be better absorbed domestically when the gap between local and foreign technologies is reduced; however, the Czech suppliers were uncompetitive. Another issue facing the agency was how to improve communication between local companies and MNEs.

In response, in 1999 the agency launched the Supplier Development Programme with a focus on electronics, the country’s fastest-growing sector and its second largest FDI sector after automotive. The Programme included the following pillars:

- **Target specific local companies to participate in training and technical assistance programs** to heighten the quality of local producers and improve their absorptive capacity.

- **Run an online database of local suppliers to ease communication between foreign investors and local suppliers.** The database serves as an effective tool for identifying and categorising suppliers in the Czech Republic and as a means of clearly presenting individual industrial sectors (electronics, IT, aeronautic, automotive). The database is intended primarily for foreign investors entering the Czech Republic and those that are already operating there, as well as for other foreign and domestic companies that are interested in obtaining supplies from the Czech Republic. It also allows users to search for first-, second-, and third-tier suppliers.

- **Provide matchmaking services.** The agency helps foreign investors set up meetings with selected producers, then assists during negotiations, thus facilitating the establishment of business relationships.

- **Provide financial intermediation for businesses expansion.** CzechInvest provides an affidavit to a lending bank or when the MNE as a partner can guarantee the contract for supplies.

By 2015, at which time CzechInvest had 263 employees, the agency had arranged 1,628 investments worth nearly CZK 896 billion (USD 40 billion). Its freely available sector database of Czech suppliers contains approximately 3,400 suppliers and is an efficient tool for searching and ranking partners and suppliers in the Czech Republic by sector characteristics, modules, key technologies and locations.

*Source: OECD (2018b) and Benáček (2010).*

Targeted SME support initiatives are being put in place

Within the country’s economic reform programme, Azerbaijan has devised a specific range of initiatives to build local capacity and support SME participation in global value chains, including:

- marketing and match-making support through Azerbaijan’s Export and Investment Promotion Agency (AZPROMO);
- information on export-related events through the online portal export.az; and
- training through the Baku Business Training Centre (BBTC).

Overall, awareness of support initiatives is very high, reaching above 90% of survey respondents (Figure 17). The use of these services, on the other hand, is more limited, with AZPROMO services being used by around 30% of respondents and BBTC training by under 20% of respondents. To better understand the scope and effectiveness of these initiatives, a closer examination of these services was undertaken through desk research and discussions with the relevant agencies and selected beneficiaries.

**Figure 17. Azerbaijani firms are aware of selected government support services**

![Bar chart showing awareness and use of support services](chart.png)

*Note: Figures are based on 201 survey responses.*

*Source: OECD Azerbaijani Enterprise Survey (2018).*

The BBTC and its regional offices host over 120 training sessions, workshops, roundtables, conferences and other events per year, with both local and foreign participants. Training services offered by the BBTC cover topics related to developing a business plan, starting and managing a business, branding and marketing, and exporting, among others, and have benefitted over 30,000 entrepreneurs to date. Training sessions conclude with a beneficiary survey that informs future curricula and activities. Interviewed recipients report that they would welcome more in-depth coverage of specific topics, rather than broad but more superficial curricula. Moreover, the services are described as seminars with limited follow-up activities to monitor the progress of trainees. Future training programmes devised by the Agency for the Development of Small- and Medium-Sized Enterprises (SME Agency) could envisage more in-depth coverage of selected topics and systematic delivery aftercare with a suitable lag after delivery of the training.

AZPROMO employs 11 different support mechanisms to stimulate exports and promote the “Made in Azerbaijan” brand abroad. These include international trade fairs, trade missions, promotion and negotiation of shelf space with foreign retailers, and the export.az portal, which lists domestic suppliers, and trade-related events. While it is too early to assess the full impact of most of these support initiatives, it is noteworthy that export.az facilitated exports of USD 475 million worth of goods to 100 countries in 2017, and USD 284.4.8 million worth of goods to 100 countries in the first half of 2018. A second portal initially intended as an e-commerce platform for SMEs to sell products abroad (azexport.az) was created in 2017 and is managed by the Centre for Analysis and Communication of Economic Reforms. The portal has already received 10,000 quotation requests from 150 countries and issued over 200 Free Sale Certificates. In addition to this, the portal offers complex services for Azerbaijani exporters, including consultancy services.

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15 For more information on this portal see also OECD (2018c).
and the issuance of certificates necessary for export and customs clearance. The Centre for Analysis and Communication of Economic Reforms has also recently launched an ambitious new matching portal (enterpriseazerbaijan.com), which features a variety of business-to-business searching, localisation and matching functions. The portal aims to stimulate investments in the SME sector and increase options for alternative sources of funding. Once fully operational, this portal is expected to provide a valuable new tool for internationalisation, and business linkages, more generally.

While there is consensus that export promotion efforts are important and are going in the right direction, continued emphasis should be given to promoting local SME linkages with both domestic and foreign MNEs that are already plugged into global value chains, through initiatives like Enterprise Azerbaijan. In fact, some interviewed SMEs noted that they have difficulty serving the local market and lack the ability to fulfil large orders from foreign buyers. Deeper linkages with local buyers may help increase their capabilities and prepare them for exporting.

**Corporate investors also play a role in promoting business linkages**

Beyond public policies and programmes to support SME linkages with large firms, foreign investors also have incentives to develop and engage with local business communities. Potential benefits for foreign investors include enhanced reputation and local license to operate, improved integration in new markets, reduced foreign exchange needs and increased flexibility due to proximity of local suppliers. Accordingly, corporate actors have also played a role in promoting business linkages, including in Azerbaijan.

For instance, the Azeri-Chirag-Gunashli (ACG) oil field and Baku-Tbilisi-Ceyhan (BTC) pipeline are BP’s massive projects in Azerbaijan. The ACG/BTC Linkages Program was designed to address the lack of opportunity and financing sources for local businesses. As part of the programme, the Baku Enterprise Centre was set up to support the development of local companies as potential suppliers to BP. The programme provides a supplier database and job board; training in technology and basic business disciplines; and technical assistance to help businesses bid for and win contracts with BP. Simultaneously, BP has implemented a number of procurement policy changes that have made it easier for local SMEs to compete. In 2006 BP spent approximately USD 77 million per year on procurement from local SMEs and worked with 444 SMEs. Thirty-five new fee-based small business management courses were developed in Russian and Azeri with demand quickly outpacing availability.

For an oil-exporting country like Azerbaijan, the oil sector is a natural starting point for developing other supporting industries, as in the example of BP. However, it is important to expand this kind of initiative to non-oil industries in order to support further diversification of the economy.

**Targeted tax incentives may be useful to promote SME linkages**

Evidence of successful corporate initiatives to promote business linkages raises the question of whether the government has a role to play in creating incentives for larger corporations to develop such programmes.

Given that incentives can significantly erode the tax base, international organisations and other institutions generally agree that targeted incentives – in terms of both sectors and activities – should be preferred to profit-based tax holidays and tax reductions (OECD, 2018a). Targeted tax incentives and their effectiveness are under-researched, but some
Evidence supporting targeted approaches is emerging. In fact, targeted incentives for SME and supplier engagement, for example, have been demonstrated to be effective in Malaysia, Singapore and Thailand (UNCTAD, 2011).

The programmes in Malaysia, for instance, influenced Intel in its decision to develop local SMEs as suppliers. Intel developed a two-stage model for supporting supplier development and upgrading. First, potential suppliers are selected based on the quality of their management; human resources; technical, materials and process capabilities; and cost competitiveness. They are then provided with training and opportunities to supply the affiliate and, ultimately, the global Intel network. Intel estimates benefits amounting to USD 50 million per year from participating in these programmes (Christiansen and Thomsen, 2005).

In Azerbaijan, significant incentives are provided to residents of industrial parks. However, in order to achieve greater linkages between these large conglomerates and local SMEs, it may be more desirable to incentivise large producers to undertake vendor development programmes, secondments of personnel to provide mentorship to SME suppliers, or other forms of linkage programmes (see Box 6 earlier in this chapter).

**Industrial estates are a work-in-progress but hold promise**

The critical feature distinguishing industrial zones from the rest of the economy is the distinct incentives offered to companies operating in the zones. These incentives are generally grouped into two broad categories: tax and non-tax incentives. Tax incentives reduce investors’ tax liabilities, typically for a predetermined period of time. Non-tax incentives range from streamlined administrative procedures (e.g. one-stop shops for government services, fast-track customs procedures) to the provision of infrastructure and equipment, or simplified legal and regulatory requirements.

Under the right conditions, industrial zones can serve to create linkages with local suppliers, and specifically SMEs. Foreign investors in industrial zones may have an interest in finding low-cost reliable suppliers in the host economy: a study of FDI spillovers in Romania and Czech Republic found evidence of multinationals helping Czech suppliers set up production lines, providing training in quality control and coaching in management strategy and financial planning, offering advance payment and other kinds of financing, and introducing suppliers to export markets (Javorcik and Spatareanu, 2005).

But attraction of foreign investors and the spread of backward linkages are by no means assured. The extent of investment and local procurement by foreign investors depends, in the first instance, upon a host country offering a business-friendly climate that allows local firms to grow and prosper. Local SMEs need contract enforcement, reliable infrastructure, lack of red tape, and access to duty-free inputs no less than foreign investors if they are to become certified as suppliers to foreign and domestic exporters in the zones. Moreover, as discussed in the previous chapter, a more robust local private sector translates to a greater probability of linkages and of successful supplier development.

In other words, a zone-based strategy may be effective in attracting investors in the short run, by offering adequate infrastructure services and duty-free access to capital goods and other inputs. Yet economic activities within the zones tend to have weak linkages with the rest of the economy if not firmly embedded in a wider development agenda. Moreover, zones may be seen as a way of forcing the pace of a given sector’s development by, for example, facilitating faster provision of needed infrastructure, streamlining regulations and/or providing financial incentives to investors. The risk is that political priorities may
effectively override the commercial case for the zones, leading to attempts to force the development of sectors and activities in which a country has little or no comparative advantage. Policy makers should bear this in mind as they consider possible zones and industrial parks, particularly when regions seek to formulate “smart specialisation” strategies. An example of a successful zone-based strategy implemented in Malaysia is illustrated in Box 7.
Box 7. Penang’s success in promoting SME linkages (Malaysia)

Amidst fierce national debates on the relative virtues of export-led versus import-substitution growth strategies, the Penang Special Economic Zone (SEZ) became known in the 1980s as the site in Malaysia where multinational investors engaged in basic consumer electronic assembly and export. In combination with vigorous investment promotion policies, the Penang state government established the Penang Skills Development Centre (PSDC), which was later recognized as a world-class model for partnerships between government, academia, and industry. The PSDC initially concentrated on vocational training in electrical engineering and electronics, as part of Malaysia’s advance into standardized component production (such as printed circuit boards). It subsequently focused on higher value-added components and products in the semiconductor, information technology, audio visual, and digital camera sectors.

Beginning in 2000, Penang added life sciences, biotechnology, pharmaceuticals, and medical devices to its repertoire for FDI-SEZ-export expansion. Penang’s particular niche combines advanced electronics with life sciences, including, for example, precision and tooling-based medical devices, electrical and electronic-based medical devices, automation-based medical devices, and diagnostic tools. In an effort to ensure that its vocational training programs kept pace with FDI promotion efforts, The PSDC created a Micro-Electronics Centre of Excellence at Universiti Sains Malaysia, which relies on support from international corporations for specialization in mechanical engineering (e.g. robotics, micro- and nano-assembly), chemical engineering (e.g. gasses and chemical delivery techniques), materials sciences (e.g. packing R&D), and supply chain management. More recently, Universiti Sains Malaysia has begun to cultivate similar government-industry-academic partnerships in the pharmaceutical and nutraceutical sectors.

Penang’s use of FDI-SEZ-export strategy has created a virtuous cycle for Malaysia by integrating attraction of foreign investors, skill-building initiatives, and infrastructure upgrades. In 2005, the Malaysian central government chose Penang to roll out the Multimedia Super Corridor (MSC) IT platform for industries and businesses. At the onset of the international financial crisis in 2008 there were more than 700 companies operating in Penang’s eight SEZs (four free-trade zones and four industrial estates) with a total of 775 factories employing more than 170,000 workers. At the same time Penang – and Malaysia overall – have generated one of the world’s more successful records in generating backward linkages and supply chains within the host economy, from complex packaging to a broad array of contract engineering services.


In Azerbaijan, there are two types of industrial zones: industrial parks and industrial estates (Table 1). Industrial parks are manufacturing compounds intended for medium-to-large manufacturers within specific sectors. All residents of industrial parks, high-tech parks, and agro parks are exempted from property tax, land tax, corporate income tax, value-added tax (VAT) and customs duties on imported equipment for seven years. To date there are seven

16 https://www.azernews.az/business/123548.html
industrial parks, of which six are active, covering chemicals and construction materials, shipbuilding, textiles, pharmaceuticals and high-tech equipment. Most of the residents of these industrial parks are large domestic MNEs that are partially controlled by the state (joint-stock companies). Some are joint ventures with foreign investors (notably with Iranian and Russian pharmaceutical companies), though they are not yet operational. With the exception of the start-ups residing in the High-Tech Park, SMEs (particularly the smaller ones) do not generally reside in industrial parks as they cannot meet the scale of production for which the parks are intended. This means that while in theory the tax holidays applied to residents of industrial parks apply also to SMEs, in practice they are enjoyed almost exclusively by large firms.

Industrial estates are instead special zones in the regions that provide preferential terms for SMEs, including all utilities, roads, facilities and machinery necessary for their entrepreneurial activities. Applicants are chosen on the basis of the socio-economic significance of their proposed projects (e.g. jobs, value added, environmental impact) and whether they are likely to engage with other residents (i.e. relevance to supply chains of existing residents), favouring those that will provide the greatest combined value added. In other words, industrial estates are designed to foster supply chain linkages and to create favourable conditions for SME development. Large producers are also invited to reside in the estates, so as to create demand for SME residents, though they are not provided with fully-equipped facilities as are SMEs. The estates are managed by the Azerbaijan Investment Company, a state-owned holding company that also provides partial equity financing for large investment projects in non-oil sectors that are hosted in the industrial parks. There is only one fully functioning industrial estate, though three more are expected in 2019. The clusters that are being developed in these estates cross a variety of manufacturing sectors, including food processing, packaging, textiles, furniture and construction materials, as well as engineering, logistics and other business services.

As industrial parks aim to develop industry through large government-linked conglomerates, they can inhibit competition and perhaps deter foreign investment. Moreover, the provision of tax holidays that are not tied to specific targets (e.g. job creation, supplier development, R&D) may impose significant fiscal costs without achieving the desired industrial development objectives. Industrial estates, on the other hand, aim to create cross-sectoral business with a specific focus on SME participation, and are well-placed to achieve this objective – so long as the other policy issues discussed in this chapter are also addressed. In both cases, it is advisable to undertake a comprehensive cost-benefit analysis to assess whether the fiscal costs associated with the zones are justified.
### Table 1. Summary of industrial zones in Azerbaijan

<table>
<thead>
<tr>
<th>Name/Location</th>
<th>Created</th>
<th>Industry</th>
<th>Operational</th>
<th>Residents</th>
<th>Active residents</th>
<th>Total employment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Industrial parks</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sumgait</td>
<td>2011</td>
<td>chemicals, construction materials, machinery and equipment</td>
<td>yes</td>
<td>15 (12 GLCs and 3 foreign MNEs)</td>
<td>8</td>
<td>1 022 (10 000 expected by 2020)</td>
</tr>
<tr>
<td>Garadagh</td>
<td>2015</td>
<td>shipyard and ship repair</td>
<td>yes</td>
<td>1 JV (Singapore)</td>
<td>1</td>
<td>2 000</td>
</tr>
<tr>
<td>Pirallahi</td>
<td>2016</td>
<td>pharmaceuticals, medicinal product packaging</td>
<td>no</td>
<td>2 JVs (Russia and Iran)</td>
<td>none</td>
<td>350 expected by 2020</td>
</tr>
<tr>
<td>Balakhani</td>
<td>2011</td>
<td>recycling (motor oils, plastic, paper and cardboard products)</td>
<td>yes</td>
<td>10 medium-to-large firms</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Ganja</td>
<td></td>
<td>aluminium and steel</td>
<td>yes</td>
<td>2 GLCs</td>
<td>2</td>
<td>2 000+</td>
</tr>
<tr>
<td>Mingachevir</td>
<td>2015</td>
<td>light industry (textiles, leather, cotton products)</td>
<td>yes</td>
<td>1 large firm with 2 plants</td>
<td>1</td>
<td>628 expected</td>
</tr>
<tr>
<td>High-Tech Park</td>
<td>2012</td>
<td>ICT, biotechnologies, medical software, robotics</td>
<td>yes</td>
<td>8 (6 start-ups, 1 GLC, 1 foreign MNE)</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>Industrial estates</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Neftchala</td>
<td>2016</td>
<td>automobiles, fish feeds, plastic goods, pipes, paper products, mobile schools</td>
<td>Yes</td>
<td>9 (1 large auto firm, 8 SMEs)</td>
<td>6</td>
<td>500 expected by 2018</td>
</tr>
<tr>
<td>Masalli</td>
<td>2016</td>
<td>furniture, mattresses, construction materials, woodwork, metal products</td>
<td>No</td>
<td>9</td>
<td>none</td>
<td>200 expected</td>
</tr>
<tr>
<td>Hajigabul</td>
<td>2017</td>
<td>heavy engineering, special vans, composite materials, plastic products</td>
<td>No</td>
<td>several applicants</td>
<td>none</td>
<td>n/a</td>
</tr>
<tr>
<td>Sabirabad</td>
<td>2017</td>
<td>wool, construction materials, car parts</td>
<td>No</td>
<td>n/a</td>
<td>none</td>
<td>n/a</td>
</tr>
</tbody>
</table>

*Note: GLC signifies “government-linked company”, meaning it is partially controlled by the state. JV signifies a “joint venture” that in this case is partially controlled by a foreign investor (but may also be a GLC).*

*Source: OECD elaboration.*
5. Case study: Food processing

This chapter provides a concrete example of how policy makers can support SME linkages in global value chains in the context of a specific sector – food processing – and its value chain. The chapter draws on the general policy discussion in Chapter 4 to provide concrete measures to support SME linkages in food processing that could be considered and refined with relevant stakeholders.

Food processing is constrained by agricultural practices

Accounting for over one-third of total manufacturing output and 30% of manufacturing enterprises, food processing constitutes an important sector for Azerbaijan’s economy, including small businesses (Figure 18). The main products it offers include dairy, meat, fish, wine, infusions, juices and mineral waters. Dairy is the largest food processing segment and, because local dairy products are significantly more affordable than imported brands, local producers maintain high shares of the market. Canned food is a relatively new segment, and there is a demand for modern technologies to improve the quality and value of canned goods. Overall, domestic production of processed foods meets around 70% of domestic demand, while the remainder is imported (ITE, 2016a).

Figure 18. Food processing is a large part of manufacturing in Azerbaijan


In order to better understand the environment in which food processors operate, a stylised illustration of the food value chain and the different actors in the value chain is provided in Figure 19. The main domestic actors include primary producers (farmers), processors, and distributors (including retailers and caterers). In fact, both upstream producers of agricultural products and downstream distributors of processed foods have a profound
impact on food processors. For instance, the development of modern grocery retailing has significantly boosted the food processing sector (ITE, 2016b). Conversely, adverse conditions faced by farmers translate to losses for food processors.

Figure 19. The food value chain

Note: Trading companies may act as intermediaries between smaller primary producers and foreign buyers. Source: OECD elaboration.

Survey evidence suggests that, while companies in food processing demonstrate somewhat less absorptive capacity in terms of certifications, use of technologies, clustering, and linkages with foreign MNEs, they tend to be more export-oriented (Figure 20). Moreover, they exhibit significantly stronger productivity gains from direct and indirect trade linkages (Figure 21). On the selling side, this may be expected as access to foreign markets allows companies to scale up. On the sourcing side, it could imply that firms that are able to import advanced processing equipment and technologies from abroad enjoy significant efficiency gains. Moreover, it may suggest that domestically produced inputs (such as agricultural products and packaging) are less competitive or of lower quality than imported ones. A closer examination of these segments of the value chain is necessary to understand what policies can enable greater development and linkages for SMEs in food processing.

Figure 20. Surveyed food processors have lower absorptive capacities, but export more

Note: The figure is based on responses from 108 enterprises. Source: OECD Azerbaijani Enterprise Survey (2018).
Interviews with selected food processors, industry experts and non-governmental organisations (NGOs)\(^\text{17}\) provide some insight in the major constraints faced by the two segments of the value chain, and how they affect the food processing industry (Table 5.1). Farmers employ outdated farming practices and equipment, and lack the knowledge and skills needed to improve the quality and consistency of their yield. They are further constrained by lack of finance for new equipment, small and parcelled land plots that are not clearly delineated, and an inability to co-ordinate with other farmers and processors so as to enhance efficiency and minimise waste.

On the policy side, state orders that assign targets to specific crops combined with subsidies that encourage extensive (rather than intensive) farming distort farmer incentives. Thus, a farmer faces incentives to cultivate as much land as possible in an effort to get more state subsidies and also to concentrate that cultivation on the crops subsidised by the state. This perpetuates subsistence farming and can lead to degradation and salinisation of arable land (Sadigov, 2018). A proposed “Specialisation of Regions” policy that would provide incentives for region-specific crops is expected to exacerbate this distortion and also to reduce farmers’ bargaining power as it increases their dependence on few large buyers (i.e., a handful of sugar beet, cotton and tobacco producers).

Food processors, in turn, are affected by the shortcomings of the farming sector, in that they cannot rely on a stable supply of agricultural products of unvarying quality. Difficulty enforcing contracts also inhibits the predictability of their sales, as retailers may switch to alternative cheaper suppliers (or imports) without facing penalties after having contracted orders at pre-negotiated prices. Local packaging that fails to meet international quality standards (e.g. glass jars and bottles) forces processors to rely on expensive imports, which may be inaccessible to SMEs. Similarly, lack of finance prevents smaller processors from upgrading equipment and processing techniques. Given these barriers it is very hard for

\(^{17}\) Of the 33 interviews undertaken, 14 involved stakeholders related to the food value chain. Refer to Table A.2 in Annex A for more details.
SMEs to compete with the few large conglomerates that dominate the processing sector (e.g. Azersun, Gilan Holding, Veyseloglu Group).

Table 2. Summary of perceived barriers affecting food processing sector

<table>
<thead>
<tr>
<th>Farmers</th>
<th>Food processors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small parcelled land plots, inadequate record keeping, and unclear delineation of plots</td>
<td>Variable quality and quantity of agricultural produce as a result of poor farming practices</td>
</tr>
<tr>
<td>Lack of knowledge and skills, outdated farming practices and equipment, inadequate irrigation system</td>
<td>Inadequate contract enforcement causing unpredictable supply of inputs and purchase of outputs</td>
</tr>
<tr>
<td>Limited number of processing facilities and access to direct distribution channels, causing losses from wasted produce</td>
<td>Poor packaging (e.g. low-quality glass jars and bottles), causing reliance on expensive imports</td>
</tr>
<tr>
<td>Lack of testing facilities where the new crops can be tested for quality before introduced to the market</td>
<td>No formal mechanisms for cooperation between farmers and distributors or processors</td>
</tr>
<tr>
<td>Specialisation of regions policy, crop targets and subsidies per hectare of farmed land can lead to land degradation</td>
<td>Lack of competition, dominance of few large processors</td>
</tr>
<tr>
<td>Lack of financing for new equipment</td>
<td>Lack of financing for new equipment</td>
</tr>
</tbody>
</table>

Source: Interviews with 14 stakeholders including farmers, processors, business associations, NGOs and agricultural experts. See Table A.2 in Annex A for more details.

Linkage promotion requires developing capabilities of farmers, processors and packagers

Supporting linkages in the processed foods sector requires addressing the barriers discussed above, which can be mapped onto the framework for creating an enabling environment for supply chain linkages (Figure 22).

First, three aspects affecting the investment climate can be addressed to support synergies and linkages along the food value chain: (1) improved contract enforcement; (2) strengthened competition; and (3) market-friendly incentives. Improving contract enforcement mechanisms and the quality of judicial processes allows farmers and processors to have more stable inflows of revenues, as buyers of their products are held liable for breaching contractual agreements. Lifting direct subsidies that perpetuate small-scale subsistence farming, and perhaps replacing them with indirect forms of support that allow farmers more discretion based on market incentives, can help increase the scale and reduce the costs of primary production and provide a more stable source of unprocessed agricultural inputs for processors. Promoting competition in food processing can allow SME processors to grow in scale and become more competitive in domestic and foreign markets.

Linkage promotion requires first attracting a critical mass of foreign investors and then matching them to domestic processors with adequate capabilities. Given the idiosyncrasies of this value chain in the context of Azerbaijan, the linkages that should be nurtured are not just foreign-domestic and MNE-SME, but also domestic-domestic and SME-SME. In other words, it is important both (1) to create a mechanism through which SME processors can co-ordinate with small-scale farmers, and (2) to support linkages between SME processors and foreign producers of processing equipment or foreign buyers of processed foods. In all cases, the first step is building the capabilities of domestic firms along the food value chain.

Local capacity building should, in the first instance, target the modernisation of the agricultural sector and the adoption of agricultural innovations and best practices. In practical terms, this involves providing technical assistance to farmers, supporting financing of modern farming equipment, and encouraging small-scale farmers to engage in
co-operatives that allow them to enjoy economies of scale when purchasing equipment and inputs such as fertilisers. The absorptive capacity of processors can also be further developed by supporting knowledge transfers from larger processors, for instance by incentivising secondments. This may be combined with financial and technical support for upgrading processing facilities and obtaining internationally recognised certification. As local packaging options often fail to meet international standards, specific measures to improve the quality of packaging to meet international requirements are also advisable.

Responsibility for local capacity building related to the food value chain may be assigned to a joint task force combining the Ministry of Agriculture, the Food Safety Agency, and the Ministry of Economy (including the newly established SME Agency). This would ensure a broader value chain rather than sectoral approach to capacity building. As in the case of Thailand (see Box 5 in Chapter 4), close co-operation with industry associations would allow the government agencies to eventually take on a more advisory role, while the technical assistance is entrusted to the private sector.

Areas that should be prioritised in terms of FDI attraction for supporting the processed foods sector include facilities and equipment related to crop testing, cold storage, green-housing, processing and packaging (Figure 22). One way could be to target tax incentives to companies that invest in developing such facilities, in designated regional areas. Business linkages can then be facilitated through match-making services, trade fairs and exhibitions, and publicly-available supplier databases. Both FDI attraction and linkage promotion would fall under the responsibilities of the investment promotion agency (AZPROMO), though close co-ordination with the SME Agency and industry associations should be encouraged.

Figure 22. Supporting linkages in Azerbaijan’s processed foods sector
Action plan for pilot linkages programme: food processing value chain

A suggested action plan is proposed for the development of a pilot linkages programme. Although the plan was developed with the food processing sector in mind, it may be adapted also to other sectors.

Programme set-up

The following actions should take place before implementation of the pilot, so as to put in place the necessary information and support structures.

1. *Linkage strategy team:* The first step is to establish a linkage strategy team that is focused in a specific institution and coordinated with FDI promotion related to agro-processing. It is likely that the newly established SME Agency will be seen as the most logical choice. However, it is suggested that the Ministry of Economy establishes a working group of relevant stakeholders to come to a final decision. The team of professionals appointed to manage the linkage programme should be experienced in SME capacity building, supply chain development and business networking, and have a good understanding of SMEs and FDI in the country. It is likely that the leader of the team will come from a private sector background and have the credibility to talk to senior managers from FDI companies. It will be necessary to provide training, consultancy and staff exchange opportunities to the team to develop capabilities in linkage programme management.

2. *Information on the SME sector:* Conduct a survey to collect data on and create a database of regional SMEs in the food value chain. The survey team should interact closely with regional SMEs (through company visits and focus groups) and identify basic needs, strengths and weaknesses. The survey should ask questions relating to business/sector development and required skills, so as to promote demand-driven skills development over the next 3-5 years. The following actors should be involved in survey procedures and implementation: the newly established SME Agency; the Centre for Analysis and Communication of Economic Reforms; and a private or public consultancy authorised to support questionnaire design, survey implementation and evaluation, so as to guarantee objectivity. Using the data collected, the survey team should produce clear instructions on how to improve skills development and prepare a list of SMEs with the highest potential for engaging with foreign investors; these SMEs should subsequently be included in the programme design process.

3. *Information on existing FDI:* Seek to identify and motivate at least one foreign investor to participate in the programme. The active involvement of corporate investors can play a crucial role in the success of a linkage programme. A memorandum of understanding (MoU) should be prepared and signed with the investor(s) involved in the programme. At this stage, as many foreign investors as possible should be engaged, regardless of the sector or the degree to which linkages are a priority. An immediate action is to identify the needs and expectations of investor(s) and specify their skills. It is recommended to conduct a survey of large privately-owned domestic companies as well as foreign investors (aiming if possible for at least 50) within the next 12 months. The survey should ask questions relating to business/sector development and required skills.

4. *Financial resources:* Allocate funds to finance SMEs involved in the programme. Make sure that the programme funds are easily accessible and used by SMEs. In 2007 BP, together with the Micro-Finance Bank of Azerbaijan and IFC, launched
the Supplier Finance Facility (SFF) as an initiative aimed at supporting local business development by providing transparent sources of funding for SMEs. A similar approach could be applied to the food processing sector.

5. **Local consultants and trainers**: Identify SME trainers and ensure that there is an adequate supply of high-calibre local consultants. Engage consultants who are already trained on the subject through other programmes, such as EBRD Business Advisory Services. Organise meetings with the consultants and facilitate the exchange of knowledge and experience among them. Consider the needs and means to upgrade their capacities.

6. **Communication**: Develop and maintain a robust system for the provision and dissemination of information related to the programme. For this purpose, prepare and disseminate brochures and handouts; set up websites that offer quick and easy access to comprehensive, current and reliable business information with an English language option; and set up a web portal promoting FDI-SME linkages and the programme itself (the portal should also be capable of providing virtual matchmaking services). Communicate the results of the food processing sector and skills analysis to start-ups, entrepreneurs and SMEs through media and business associations. These findings should inform private-sector actors on where to invest and on whom to hire. Communication should make use of all available channels (web, TV, newspapers, social media).

7. **Organising skills provision**: Establish a skills training council as coordinator between educational and vocational institutions, SMEs, large companies, foreign investors, and regional development organisations. Such an organisation should be directly supported by an existing non-governmental, strong regional actor promoting SME and farmer interests such as sector associations. The leading managers of the council should be appointed by the Ministry of Education, the Ministry of Agriculture, and the Ministry of Economy after having been approved by the Chamber of Commerce and selected business associations (e.g. the National Confederation of Entrepreneurs, the Association of Fruit and Vegetables Producers and Exporters, the Association of Packaging Industry, etc.). It is essential that professional, full-time staff manage the council.

8. **Monitoring and evaluation**: Develop and implement a robust monitoring and evaluation system for the programme. Regularly monitor the programme to immediately identify and address any problems and changes in market conditions. Set specific, quantifiable targets and performance indicators for the programme on the short-, medium- and long-term achievements. Collect baseline data from participating and comparable non-participating SMEs so that the programme’s outcomes and impacts can be evaluated.

**Programme implementation**

9. **A clear and transparent system**: Ensure that the linkage programme is implemented in a transparent manner, including a competitive tender process to become a beneficiary. Sign service agreements with the SMEs involved in the programme. Conduct a detailed gap analysis for SMEs to understand precisely their deficiencies and needs, so that critical areas for improvement can be identified and addressed.

10. **Business development services for SMEs**: Based on the individual needs and requirements of each SME as identified in its action plan, provide advice, training or financial support to upgrade products/services and processes through the identification, selection and acquisition/transfer of new technologies. Provide training services to upgrade technical and management capabilities (e.g. health,
safety and environment requirements, quality management, business process streamlining; accounting and finance management, human resource management; marketing and sales, strategic planning, project management; management of intellectual property, energy efficiency, and risk management). Engage competent consultants (potentially from abroad) for the delivery of training services. Enforce biannual meetings and workshops between the skills training council, the departments responsible for skills development, the directors of higher education and vocational training institutes, and representatives of local business associations, selected SMEs, large companies and foreign investors that stand out in the region as assessed through the above described survey.

11. **Promotion and networking with foreign investors**: Biannually organise ‘meet-the-buyer’ events and facilitate close interaction between potential suppliers and buyers during these events. Work closely with foreign investors to facilitate the access of SMEs to tenders and contract opportunities. Organise quarterly study visits for SMEs to interact with specific departments of the investors to provide social, professional and technical insights, and create a learning platform for key participants of the programme. Encourage SMEs to diversify their customer bases by actively promoting their products and services to a wider range of potential buyers in the country and abroad through various means (exhibitions and fairs, trade missions, e-business portals, newsletters, magazines, visits to potential customers). Organise exhibitions, information days, meetings and site visits between investor(s) and SMEs. Include SME consultants in all events so that they better understand the cultural issues, needs and requirements of both potential buyers and suppliers.

12. **Developing the research base**: Strengthen R&D in technology parks to facilitate spin-offs, entrepreneurial activities and forms of cooperation between academia and innovative SMEs and large companies.

13. **Promoting entrepreneurship**: Strengthen programmes on entrepreneurship in vocational training institutes and universities, (e.g. to include modules on entrepreneurial thought and action, creativity and idea generation, opportunity evaluation and business planning, entrepreneurial marketing, technology entrepreneurship or entrepreneurial finance). Involve local business consultancies and successful local entrepreneurs in developing curricula.

**Programme evaluation**

14. An effective pilot programme requires *carrying out monitoring and evaluation regularly*, based on the evaluation system devised in the preparatory phase, through contracted independent third parties. Monitoring should be based on measurable indicators of activity and beneficiary satisfaction. Annual evaluations should assess improvements in beneficiary performance along key business indicators (e.g. turnover, employment, export) and in relation to a suitable control group.
6. Implementation Roadmap

This report examines the overall policy landscape that affects and has the potential to enable SME linkages in global value chains, in the context of Azerbaijan. Given the still underdeveloped FDI activities in the non-oil sector in Azerbaijan, emphasis should also be given to supporting local linkages of SMEs with domestic MNEs that are already plugged into global value chains, which can prepare them to export or be suppliers of foreign investors. The policy implications that emerge are the following:

**Improve the investment climate**

**Ensure coherence and consistency across the reform programme.** Keeping up the reform momentum, while ensuring coherence and long-term commitment across the reform programme and SME strategy will ensure that initiatives continue to be effective by reducing business uncertainty. All key government and private stakeholders should be involved in the process of monitoring the implementation and updating the reform plan.

**Strengthen institutions involved in judicial processes.** Despite significant improvements in the efficiency of the judiciary, there remains room for increasing the quality of judicial proceedings. Guaranteeing good enforcement procedures and alternative dispute resolution mechanisms can serve not only to promote linkages between foreign investors and domestic SMEs but also to make technology transfers more likely.

**Raise awareness of the benefits of responsible business conduct.** The observed improvement in working conditions in firms that supply foreign MNEs suggests that promoting responsible business conduct (RBC) can be a means of providing domestic companies with greater access to GVCs. The government plays a pivotal role in raising awareness about how adhering to responsible business conduct principles can benefit businesses. Making an explicit link between RBC and investment promotion efforts can also help fill the information gap for foreign investors and brand Azerbaijan as a responsible business destination.

**Support supplier development and the establishment of business linkages**

**Target incentives to supplier development.** Given the vast incentives provided to large conglomerates that reside in industrial parks, it might be desirable to make these incentives more targeted toward linkages with domestic SMEs, potentially by making them conditional on the provision of vendor development programmes. Corporate initiatives to support SME development through training and vendor development programmes have been found to be successful in Azerbaijan. As foreign investment and linkages with foreign investors are constrained by a lack of specialist skills, there is significant room for improving vocational and technical skills, potentially by providing incentives for companies to offer formal training to their employees.

**Facilitate SME access to supplier development opportunities.** Policymakers can play a role not just in delivering training and matching services, but also in raising awareness
among businesses about existing initiatives, both public and corporate. Work closely with foreign investors and large domestic firms to facilitate SME access to supplier development programmes.

**Operationalise supplier matching portals.** An ambitious new portal has recently been launched (enterpriseazerbaijan.com) that is expected, when operational, to provide a valuable tool to support business linkages. Ensure that it is kept up-to-date, relevant and user-friendly, working closely with business to evaluate its effectiveness. One element of the supplier database could be responsible business conduct so as to signal safe local sourcing options.

**Follow up on training initiatives.** Publicly-funded training initiatives exist and cover a broad range of topics. Including responsible business conduct principles and standards in industry-specific training programmes can be a way to further encourage business linkages with foreign investors. Guide businesses to more-tailored assistance on specific topics where necessary, and ensure that adequate aftercare is offered. Follow-up should be provided with a lag of 9-12 months to assist beneficiaries in applying what they have learned.

**Advance the operationalisation of industrial estates.** As industrial estates are well-placed to foster the development of industrial clusters and supply-chain linkages specifically with SMEs, but are still for the most part not operational, resources should continue to be allocated to the operationalisation and expansion of such estates. In addition to enabling domestic-domestic linkages, attracting foreign investors to reside in proximity to these estates should also be considered.

**Food processing sector pilot linkages programme**

The main takeaways from the case study of the food processing sector and corresponding action plan for a pilot linkages programme are the following:

**Support financing of modern farming and processing equipment.** Modernise the agricultural sector. Replace crop subsidies that perpetuate subsistence farming with less distortionary forms of support. Attract foreign investment in crop-testing facilities, cold storage infrastructure and modern farming equipment.

**Encourage the adoption of agricultural innovations and best practices.** Support financing for modern farming equipment and provide technical assistance to farmers on the use of equipment and on agricultural best practices. Encourage small-scale farmers to engage in cooperatives.

**Build capacity for quality certification.** Support knowledge transfers from large food processors to food processing SMEs by incentivising secondments. This may be combined with financial and technical support for upgrading processing facilities and obtaining internationally-recognised certification.

**Provide matchmaking services for processors and retailers.** Organise regular ‘meet-the-buyer’ events and facilitate close interaction between potential suppliers and buyers during these events. Work closely with foreign investors to facilitate the access of SMEs to tenders and contract opportunities.

Based on the above recommendations, a suggested implementation roadmap is provided in Figure 23.
## Figure 23. Suggested implementation roadmap

<table>
<thead>
<tr>
<th>Recommendations</th>
<th>Indicative implementation timing</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1 Improve the investment climate</strong></td>
<td>Short term</td>
</tr>
<tr>
<td>• Ensure coherence and consistency across reform programme</td>
<td>&lt; 1 year</td>
</tr>
<tr>
<td>• Strengthen institutions involved in judicial process</td>
<td></td>
</tr>
<tr>
<td>• Raise awareness on the benefits of responsible business conduct</td>
<td></td>
</tr>
<tr>
<td><strong>2 Build capacity and facilitate linkages</strong></td>
<td></td>
</tr>
<tr>
<td>• Target incentives to supplier development</td>
<td></td>
</tr>
<tr>
<td>• Facilitate SME access to supplier development initiatives</td>
<td></td>
</tr>
<tr>
<td>• Operationalise and maintain supplier matching portals</td>
<td></td>
</tr>
<tr>
<td>• Follow-up on training initiatives</td>
<td></td>
</tr>
<tr>
<td>• Advance the operationalisation of industrial estates</td>
<td></td>
</tr>
<tr>
<td><strong>3 Implement food processing pilot linkages programme</strong></td>
<td></td>
</tr>
<tr>
<td>• Support financing of modern farming/processing equipment</td>
<td></td>
</tr>
<tr>
<td>• Encourage adoption of agricultural best practices</td>
<td></td>
</tr>
<tr>
<td>• Build capacity for quality certification</td>
<td></td>
</tr>
<tr>
<td>• Provide business match making services for processors and retailers</td>
<td></td>
</tr>
</tbody>
</table>
References


Financial Times (2017), FDI Markets (database)


UNCTAD (2018), FDI Statistics.


Annex A. Semi-structured interviews and focus group

Table A.1. Challenges and opportunities for business linkages: summary of interviews

<table>
<thead>
<tr>
<th>Type of organisation</th>
<th>Main challenges</th>
<th>Areas of opportunity/ priority</th>
</tr>
</thead>
</table>
| Business associations/chambers of commerce (7) | - Low financial literacy  
- Limited mentality of paying taxes  
- Limited culture of business associations, all recently set up by government, top-down  
- Low capacity of local SMEs  
- SMEs don't have a place to go to for advice  
- Dysfunctional banking sector  
- High inflation, high cost of loans, and absence of alternative financing mechanisms for SMEs  
- Inefficient/unreliable court system  
- Lack of competition; few holding companies that hold majority of business, owned by ruling elite  
- Perception that reforms are temporary, to fill state budget until oil prices rise again  
- Lack of professionalism or commitment  
- Lack of trust in judicial/legal system discourages foreign investment  
- The financial market is dominated by bank financing, main target of government support  
- Cumbersome regulations and lack of government support are key barriers for the development of micro-finance instruments (e.g. strict rules for the provision of subsidised financing, VAT)  
- Access to finance  
- Lack of specialist skills  
- Lack of local accreditation bodies to certify compliance to ISO standards | - Create an SME agency on the model of Singapore  
- Private sector has adequate training capabilities (e.g. bank training centre)  
- Empower the private sector by outsourcing more business training and capacity building activities  
- Improve financial literacy of households and small business owners  
- Develop agro-processing capabilities  
- Construction, chemicals  
- Improve banks  
- Improve universities and technical skills  
- Create an environment where people can start something without being restricted or persecuted  
- TAP (Trans-Adriatic Pipeline) may really make a difference in terms of volume of production of oil, so economy might pick up  
- Agriculture, ICT and small manufacturing (e.g. furniture)  
- Support for micro-finance institutions, often the only source of external financing for micro enterprises and sole entrepreneurs |
| Foreign investors (4) | - Standards, product quality (e.g. glass bottles do not meet requirements and have to be imported)  
- Scale of production is too limited to invest in local production of inputs  
- High exposure to exchange rate fluctuations: 60% of costs are in foreign currency (imports)  
- Corruption, bribery, unofficial avenues of compliance; companies operate in a different ethical environment  
- Unpredictability of tariff rates; change overnight  
- Education and skills shortage: inadequate vocational training; not enough specialist skills (e.g. IT)  
- Working conditions: hard to retain skilled staff  
- Access to finance: venture capital not clearly defined in law, standard financing mechanisms too expensive for start-ups/SMEs  
- Intellectual property rights: piracy rate is 80% in country and 40% in government; loopholes in law limit sales but not usage of pirate software  
- Courts: Lack of transparency and independence | - Capitalise on Azerbaijani diaspora for investing in export markets: e.g. plans to export local brands to Russia, negotiating with Kazakhstan and Georgia, had talks with Canada  
- Medium-term commitment: need to improve time for planning if want to attract investment; investors need predictability  
- Big potential in IT services sector; market for IT solutions is huge  
- Geographically at a crossroads; high-speed connection thanks to fibre optic infrastructure  
- Develop IT usage among government agencies  
- Improve IP protection and eliminate loopholes  
- Create an ecosystem of IT start-ups  
- Increase capacity for vocational training  
- Processed food, furniture, value-added products based on oil, and pharmaceuticals if can build up trust in local manufacturing |
• small size of market and lack of trust toward ‘Made in Azerbaijan’
• Changing nature and unpredictability of policy priorities, and poor infrastructure connecting to key markets like Iran

<table>
<thead>
<tr>
<th>Domestic companies (8)</th>
<th>Financing new machinery to scale up production to meet local demand, and keep up with new technologies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Imports all materials and packaging because Azerbaijan either doesn’t produce materials, or doesn’t charge competitive prices, and scale of local production is not high enough</td>
</tr>
<tr>
<td></td>
<td>Financing (expansion financed entirely through retained earnings, no bank loans approved)</td>
</tr>
<tr>
<td></td>
<td>Power cuts affecting productivity</td>
</tr>
<tr>
<td></td>
<td>Logistics (scale is too small to fill containers), certification (lab tests are very costly) and financing (private funds and retained earnings only)</td>
</tr>
<tr>
<td></td>
<td>Certification</td>
</tr>
<tr>
<td></td>
<td>Lack of equipment or know-how to scale up</td>
</tr>
<tr>
<td></td>
<td>Lack of high-quality local packaging material imported from Turkey and Iran, which makes production very costly</td>
</tr>
<tr>
<td></td>
<td>Liquidity constraints are aggravated by delayed payments by large retailers</td>
</tr>
<tr>
<td></td>
<td>Maintaining equipment due to lack of sufficient capital and overly cumbersome procedures for certification</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Focus group (13)</th>
<th>Access to finance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Compliance with food safety standards</td>
</tr>
<tr>
<td></td>
<td>Compliance with ISO standards for IT security</td>
</tr>
<tr>
<td></td>
<td>Lack of local accreditation body, obtaining certification from foreign body is expensive</td>
</tr>
<tr>
<td></td>
<td>Lack of skilled specialists (e.g. IT)</td>
</tr>
<tr>
<td></td>
<td>Lack of management capabilities</td>
</tr>
<tr>
<td></td>
<td>Limited domestic demand</td>
</tr>
<tr>
<td></td>
<td>Rule of law, no trust in justice system</td>
</tr>
<tr>
<td></td>
<td>Poor quality of education, lack of skilled labour</td>
</tr>
<tr>
<td></td>
<td>Lack of communication</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>International organisations (1)</th>
<th>Implication of devaluation and banking crisis is that lending is down, people don’t want to borrow because too expensive given central bank’s rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Many industrial parks being created at high speed; some ground work should be done to make sure they are effective</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Government agencies (5)</th>
<th>Limited access to export markets given the country’s lack of free-trade agreements and membership in the WTO</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Paralysed banking sector</td>
</tr>
<tr>
<td></td>
<td>Inability to forecast how GDP affects tax collection; advance requests made to private sector</td>
</tr>
</tbody>
</table>

- Participation in trade fairs and trade missions through the support of AZPROMO, very useful, main channel for finding exporters abroad
- 6-month secondment of experts from foreign suppliers of machinery was very useful in training employees
- Large domestic retailers can play an important role in helping build SME brand name by providing prime shelf space
- The government could relax SME liquidity constraints by requiring retailers to pay SMEs without delay
- Participation in trade fairs and trade missions through the support of AZPROMO, very useful, main channel for finding exporters abroad

Note: The majority of these interviews were carried out between December 2017 and February 2018. Reforms that have since been implemented may have already addressed or be in the process of addressing some of the challenges raised by businesses (particularly as regards price and stability and court procedures).
<table>
<thead>
<tr>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Farmer (1)</strong></td>
</tr>
<tr>
<td>Dairy, fruit and vegetables</td>
</tr>
<tr>
<td><strong>Processor (4)</strong></td>
</tr>
<tr>
<td>Jams, pastes and sauces</td>
</tr>
<tr>
<td>Honey</td>
</tr>
<tr>
<td>Jam</td>
</tr>
<tr>
<td>Confectionary</td>
</tr>
<tr>
<td><strong>Trading company (1)</strong></td>
</tr>
<tr>
<td>Exporter of agricultural products (to CIS countries)</td>
</tr>
<tr>
<td><strong>Association (2)</strong></td>
</tr>
<tr>
<td>Fruit and Vegetable Producers and Exporters Association</td>
</tr>
<tr>
<td>Network of Young Entrepreneurs</td>
</tr>
<tr>
<td><strong>Agriculture expert (3)</strong></td>
</tr>
<tr>
<td>Azerbaijan State Agricultural University</td>
</tr>
<tr>
<td>Agricultural Expert based in Ganja-Gazakh region</td>
</tr>
<tr>
<td>Hazelnut industry expert</td>
</tr>
<tr>
<td><strong>NPO/NGO (3)</strong></td>
</tr>
<tr>
<td>EU Technical Assistance Project for the Implementation of the ‘Support to</td>
</tr>
<tr>
<td>Rural and Regional Development’ (SRRD) Program</td>
</tr>
<tr>
<td>USAID Socio-Economic Development Activity (SEDA) project</td>
</tr>
<tr>
<td>Center for Economic and Social Development (CESD)</td>
</tr>
</tbody>
</table>
Annex B. OECD Azerbaijani Enterprise Survey 2018

Sampling

Table B.1. Size distribution

<table>
<thead>
<tr>
<th>Size class</th>
<th>Number of employees</th>
<th>Population distribution</th>
<th>Sampling distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>1-25</td>
<td>65%</td>
<td>45%</td>
</tr>
<tr>
<td>Medium</td>
<td>26-125</td>
<td>31%</td>
<td>35%</td>
</tr>
<tr>
<td>Large</td>
<td>&gt;125</td>
<td>3%</td>
<td>20%</td>
</tr>
</tbody>
</table>

Note: Medium-sized firms are intentionally oversampled. Figures are based on 201 survey responses. Source: OECD Azerbaijani Enterprise Survey (2018).

Table B.2. Sector distribution

<table>
<thead>
<tr>
<th>Sector</th>
<th>Number of companies</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food products</td>
<td>95</td>
<td>47.3%</td>
</tr>
<tr>
<td>Beverages</td>
<td>13</td>
<td>6.5%</td>
</tr>
<tr>
<td>Textiles</td>
<td>4</td>
<td>2.0%</td>
</tr>
<tr>
<td>Wearing apparel</td>
<td>11</td>
<td>5.5%</td>
</tr>
<tr>
<td>Leather and related products</td>
<td>1</td>
<td>0.5%</td>
</tr>
<tr>
<td>Wood and woodwork</td>
<td>2</td>
<td>1.0%</td>
</tr>
<tr>
<td>Paper and paper products</td>
<td>3</td>
<td>1.5%</td>
</tr>
<tr>
<td>Printing production</td>
<td>5</td>
<td>2.5%</td>
</tr>
<tr>
<td>Chemicals</td>
<td>11</td>
<td>5.5%</td>
</tr>
<tr>
<td>Rubber and plastic products</td>
<td>6</td>
<td>3.0%</td>
</tr>
<tr>
<td>Other non-metallic mineral products</td>
<td>17</td>
<td>8.5%</td>
</tr>
<tr>
<td>Basic metals</td>
<td>3</td>
<td>1.5%</td>
</tr>
<tr>
<td>Fabricated metal products (excl. machinery and equipment)</td>
<td>5</td>
<td>2.5%</td>
</tr>
<tr>
<td>Electrical equipment</td>
<td>2</td>
<td>1.0%</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>1</td>
<td>0.5%</td>
</tr>
<tr>
<td>Motor vehicles and transport equipment</td>
<td>1</td>
<td>0.5%</td>
</tr>
<tr>
<td>Furniture</td>
<td>18</td>
<td>9.0%</td>
</tr>
<tr>
<td>Information and technology services</td>
<td>1</td>
<td>0.5%</td>
</tr>
<tr>
<td>Architectural, engineering and other technical services</td>
<td>2</td>
<td>1.0%</td>
</tr>
<tr>
<td>Total</td>
<td>201</td>
<td>100%</td>
</tr>
</tbody>
</table>

Summary statistics

Figure B.1. Age, location, and ownership

Panel A: Years in operation

- >25 years: 15%
- 1.5-5 years: 20%
- 6-10 years: 20%
- 11.25 years: 41%

Panel B: Location

- Bulu: 61%
- Regions: 39%

Panel C: Ownerships

- Domestic: 94%
- Foreign: 5%
- State-owned: 1%

Note: Figures are based on 201 survey responses.

Figure B.2. Firm absorptive capacities and GVC linkages

Note: Figures are based on 201 survey responses.
The survey

Azerbaijan Enterprise Survey 2018: Supply chain and investment linkages

INTRODUCTION

In collaboration with the Ministry of Economy of Azerbaijan, the OECD is conducting an enterprise survey to understand: (a) barriers to doing business in Azerbaijan; (b) how firms connect with suppliers, customers and investors in Azerbaijan; and, (c) how the policy environment could facilitate these connections. This survey is an opportunity for your firm to highlight factors that impede the expansion of your operations or the smooth functioning of your supply chain. This survey is part of a wider project funded by the European Union on ‘Supporting the Implementation and Monitoring of Azerbaijan’s SME Roadmap’, and its results will inform policy advice and capacity-building initiatives in Azerbaijan.

In our appreciation of the information you share through this survey, your company is eligible to participate in a capacity-building workshop on improving your firm’s internationalisation and investment opportunities, involving international experts, policymakers and the private sector. You will also receive a free report on the main findings from the survey.

- This survey includes 44 questions in total, primarily multiple choice, and should take approximately 25 minutes of your time.
- The information you provide in this questionnaire is strictly confidential. Responses will be aggregated and no enterprise or personal information will be disclosed.

Thank you for sharing your views and experience with us. If you have any questions or comments on the survey, please do not hesitate to contact Iris Mantovani (Iris.MANTOVANI@oecd.org).

INSTRUCTIONS

Please answer the questions in this survey to the best of your ability. If you are not sure about your answer, please still select the answer that you think is most appropriate.

This questionnaire refers to local firms and foreign firms:

- **Local firms** are firms that are wholly owned by Azerbaijan investors or firms with a foreign ownership share of less than 10%.
- **Foreign firms** are firms that operate in Azerbaijan with a foreign ownership share of 10% or more.

A) GENERAL INFORMATION (14 Questions)

1. In which sectors does your firm operate? *(Select all that apply)*
   - Extraction
   - Agriculture
   - Manufacturing
   - Services
   - Sales

   If you ticked more than one option in Q1, please focus on your firm’s core activities in Azerbaijan. Please keep this in mind for all subsequent questions.

2. Please specify the main activities of your firm in Azerbaijan: *(Select one option)*
   - Manufacture of food products
   - Manufacture of beverages
   - Manufacture of tobacco products
   - Manufacture of textiles
   - Manufacture of wearing apparel
   - Manufacture of rubber and related products
### 3. How many years has your firm been in operation?
- [ ] <1 year
- [ ] 1-5 years
- [ ] 6-10 years
- [ ] 11-25 years
- [ ] >25 years

### 4. How many permanent, full-time employees are in your firm? (Enter number)

### 5. Over the last five years, has the number of employees in your firm changed?
- [ ] Yes, it increased
- [ ] Yes, it decreased
- [ ] No, it stayed roughly the same

### 6. Approximately, what were your firm's total sales last year, in Manat? (Enter number)

### 7. Which of the following best describes the ownership structure of your firm? (Select one option)
- [ ] Local firm (<10% foreign ownership)
- [ ] Foreign firm: 10-49% foreign ownership
- [ ] Foreign firm: 50-100% foreign ownership
8. Does your firm have any affiliates, i.e. firms of which it owns a share of at least 10%? (Select all that apply)
   - Yes, affiliates in Azerbaijan
   - Yes, affiliates abroad
   - No

9. Over the past 5 years, has the firm engaged in any of the following activities? (Select all that apply)
   - Importing inputs
   - Exporting outputs
   - Selling outputs to foreign firms in Azerbaijan
   - None of the above

10. Do you have a long-term contract, alliance or partnership with any of the following types of firms? (Select all that apply)
    - Yes, with local suppliers
    - Yes, with foreign suppliers in Azerbaijan
    - Yes, with foreign suppliers abroad
    - Yes, with local buyers
    - Yes, with foreign buyers in Azerbaijan
    - Yes, with foreign buyers abroad
    - No, mostly short-term contracts

11. Is your firm located in an industrial park or industrial estate?
    - Yes
    - No

12. Does your firm adhere to any internationally recognised quality certification (e.g., ISO 9000, ISO 14001)?
    - Yes
    - No

13. Does your firm at present use technology licensed from a foreign firm excluding office software?
    - Yes
    - No

14. Are any of the top managers in your firm female?
    - Yes
    - No

**B) LINKAGES WITH SUPPLIERS (6 Questions)**

15. Where does your firm source its inputs? (Select all that apply)
    - Local firms in Azerbaijan
    - Foreign firms in Azerbaijan
    - Firms abroad (Imports)

   If you ticked 'FIRMS ABROAD (IMPORTS)' in Q15, please continue to Q16. Otherwise please skip to Q18.

16. What do you import from abroad? (Select all that apply)
    - Raw materials/ semi-processed goods (e.g. cotton, fish, fruit, basic metals)
    - Processed or manufactured goods (e.g. machinery, textiles, glass products)
    - Services (e.g. legal, accounting, IT services)

17. What percent of your firm's inputs are imported? (Please provide an approximation to the best of your ability)
    - <1%
    - 1-5%
    - 5-10%
    - 10-49%
    - 50-89%
    - 90-100%
18. What discourages your company from importing inputs (or importing more of its inputs)?

<table>
<thead>
<tr>
<th>Local suppliers produce cheaper inputs</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local suppliers produce better quality inputs</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Local suppliers are more reliable</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Local inputs are cheaper because of government interventions (e.g., subsidies)</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Imported inputs are more costly or not available because of high transport costs</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Imported inputs are more costly because of customs procedures</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Other, please specify:</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
</tbody>
</table>

19. What discourages your company from sourcing inputs locally (or sourcing more of its inputs locally)?

<table>
<thead>
<tr>
<th>The inputs we use are not produced locally</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local suppliers lack the relevant skills or capabilities</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Local suppliers lack professionalism, or are unreliable</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Local suppliers do not meet our product quality standards</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Local suppliers do not meet our ethical standards</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Local suppliers do not meet our environmental standards</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Local suppliers do not respect intellectual property rights</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Other, please specify:</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
</tbody>
</table>

If your firm only sources locally please skip to the next section.

20. How and to what extent has your firm benefited from sourcing inputs from foreign suppliers, both in Azerbaijan and abroad?

<table>
<thead>
<tr>
<th>1 Strongly disagree</th>
<th>2 Disagree</th>
<th>3 Neutral</th>
<th>4 Agree</th>
<th>5 Strongly agree</th>
</tr>
</thead>
</table>

4
### C) LINKAGES WITH CUSTOMERS (9 Questions)

21. To whom does your firm sell? [Select all that apply]
   - [ ] Firms
   - [ ] Consumers
   - [ ] Government
   - [ ] Other: __________________________

   If you ticked 'Firms' in Q21, please proceed to Q22. Otherwise please skip to SECTION D.

22. Which companies does your firm sell to? [Select all that apply]
   - [ ] Local firms in Azerbaijan
   - [ ] Foreign firms in Azerbaijan
   - [ ] Firms abroad (exports)

23. Do you sell processed goods to firms in Azerbaijan for further processing and eventual export?
   - [ ] Yes
   - [ ] No
   - [ ] I don’t know

   If you supply local firms only please skip to Q25.

24. If you supply foreign firms (both in Azerbaijan and abroad), what do you supply to them?
   - [ ] Raw material, unprocessed goods
   - [ ] Processed manufactured goods (e.g. textiles, canned fruits, glass products)
   - [ ] Services (e.g. legal, accounting, IT services)

25. What percentage of total sales is exported abroad? [Please provide an approximation to the best of your knowledge]
   - [ ] <1%
   - [ ] 1-5%
   - [ ] 10-49%
   - [ ] 50-89%
   - [ ] 90-100%
26. How and to what extent has your firm benefited from selling its products/services to foreign firms, both in Azerbaijan and abroad?

<table>
<thead>
<tr>
<th>Developed managerial or technical skills (e.g. through training)</th>
<th>Strongly disagree</th>
<th>Disagree</th>
<th>Neutral</th>
<th>Agree</th>
<th>Strongly agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adopted new technologies, processes or management practices</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Increased capacity for existing products/services</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Started offering new products/services</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Hired more workers to meet increased production/service delivery</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Improved products/services to meet international standards (e.g. food safety)</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Improved working conditions of staff</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Reduced energy or resource use</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Reduced volatility (e.g. through long-term contracts with buyers)</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Other, please specify</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
</tbody>
</table>

27. What are your firm’s main channels for establishing contact with its customers? [Select max. 2 options]

☐ Your firm’s website
☐ Other web platforms
☐ Government-sponsored programme
☐ Business associations (e.g. Chambers of Commerce)
☐ Trade shows, wholesale showrooms or conventions
☐ Headquarters or parent company contacts
☐ Industry or personal contacts (e.g. diaspora)
☐ Other, please specify: ____________________________
26. To what degree do the following factors prevent your firm from exporting (or exporting more)?

<table>
<thead>
<tr>
<th>Factor</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Difficulty finding partners or establishing distribution channels abroad</td>
<td></td>
<td></td>
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<tr>
<td>Lack of skills, technology, knowledge or knowhow to compete abroad</td>
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<tr>
<td>Complicated border procedures required to export</td>
<td></td>
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<tr>
<td>Import tariffs in foreign markets decrease competitiveness of your firm</td>
<td></td>
<td></td>
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<tr>
<td>Import quotas in foreign markets</td>
<td></td>
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<tr>
<td>Product standards or certification requirements in foreign markets</td>
<td></td>
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<tr>
<td>Export restrictions and export taxes in Azerbaijan</td>
<td></td>
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<tr>
<td>Foreign exchange rate volatility</td>
<td></td>
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<tr>
<td>Concerns about intellectual property rights and contract enforcement in Azerbaijan</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Other, please specify</td>
<td></td>
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</tr>
</tbody>
</table>

29. To what degree do the following factors limit your firm’s ability to sell to foreign firms in Azerbaijan?

<table>
<thead>
<tr>
<th>Factor</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lack of foreign firms in Azerbaijan</td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>Difficulty establishing contact with foreign firms in Azerbaijan</td>
<td></td>
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</tr>
<tr>
<td>Lack of scale to meet demands of foreign firms in Azerbaijan</td>
<td></td>
<td></td>
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<tr>
<td>Lack of skills, technology, knowledge or knowhow to compete with foreign suppliers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lack of skills to manage relationships with foreign firms in Azerbaijan</td>
<td></td>
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</tr>
<tr>
<td>Difficulty adapting products/services to demands of foreign firms in Azerbaijan</td>
<td></td>
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<tr>
<td>Difficulty complying with international standards (e.g., labour, environmental)</td>
<td></td>
<td></td>
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<tr>
<td>Other, please specify</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>
### D) BUSINESS ENVIRONMENT (9 Questions)

#### 30. To what degree do you consider the following factors obstacles to the current operations of this firm?

<table>
<thead>
<tr>
<th>Factor</th>
<th>1 - Strongly disagree</th>
<th>2 - Disagree</th>
<th>3 - Neutral</th>
<th>4 - Agree</th>
<th>5 - Strongly agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>Access to finance</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Business licensing and permits</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Corruption</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Courts</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Crime, theft and disorder</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Customs and trade regulations</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Electricity</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Inadequately educated workforce</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Labour regulations</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Political instability</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Practices of competitors in the informal sector</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Tax administration</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Tariffs</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Transport</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
</tbody>
</table>

#### 31. Is your firm member of any of the following business associations in Azerbaijan? [Please select all that apply]

- National Confederation of Entrepreneurs
- Chamber of Commerce
- Azerbaijan Woman Entrepreneurs Union
- Bookkeepers Association of Azerbaijan
- Association of vegetable & fruit producers and exporters
- Textile Producers and Exporters Association
- Tea Producer & Exporter Association
- Wine Importers and Producer Association
- Association of hazelnut producers and exporters
- Azerbaijan Pomegranate Producers and Exporters Association
- Foreign Chamber of Commerce; please specify nationality: __________________________

#### 32. Are you aware of any of the following government support services, and has your firm made use of any of them?

- Baku Business Training Centre
- ASAN e-government services
- APPROMO
- export.az
- National Fund for Entrepreneurship Support
- Other, please specify: __________________________

[Yes, I am aware of this] [Yes, my firm has used this]
33. The year 2015 witnessed a number of structural reforms aiming to mitigate the effects of the economic distress in Azerbaijan. How effective do you think the following government reforms have been in improving the business climate?

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Launch of ASAN Visa portal</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>2. Simplification of the licensing procedure through ASAN services</td>
<td></td>
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<td></td>
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<tr>
<td>3. Suspension of inspections related to entrepreneurial activities</td>
<td></td>
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<tr>
<td>4. Simplification of the customs system</td>
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<tr>
<td>5. Establishment of the Board of Appeal under the President of Azerbaijan</td>
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<tr>
<td>6. Measures to stimulate the local production</td>
<td></td>
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<tr>
<td>7. Amendments to the law on customs tariffs</td>
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<tr>
<td>8. Establishment of the State Agency for Vocational Education and Training</td>
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<td></td>
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<tr>
<td>9. Simplification of the taxation system</td>
<td></td>
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<tr>
<td>10. Adoption of export-oriented economic model by providing export incentives</td>
<td></td>
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<tr>
<td>11. Establishment of the Financial Market Supervisory Authority</td>
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</tr>
</tbody>
</table>

34. Please rank this firm’s sources of financing from most important to least important. (Enter numbers from 1 (most important) to 5 (least important))

- Internal funds or retained earnings
- Loans from banks
- Loans from non-bank financial institutions (e.g. microfinance, credit unions, cooperatives)
- Purchases on credit from suppliers/ advances from customers
- Money lenders, friends, relatives

35. In the last 12 months, what share of spending was financed through internal funds or retained earnings?

- 0%
- 1-5%
- 6-10%
- 11-24%
- 25-49%
- 50-74%
- 75-89%
- 90-99%
- 100%

36. In the last 12 months, has your firm applied for bank financing?

- Yes
- No

If you ticked ‘YES’ in Q36, please proceed to Q37 and skip Q38. If you ticked ‘NO’ please skip to Q38.

37. Did your firm receive the amount applied for? (Select all that apply)

- Yes
- No, we received less than we applied for
- No, we didn’t receive any loan
38. What is the main reason your firm did not apply for bank financing? [Select one option]

- [ ] No need for external financing
- [ ] Application procedures too complex
- [ ] Collateral requirements too high
- [ ] Interest rates too high
- [ ] Size of loan and maturity were insufficient
- [ ] It is necessary to make informal payments to get bank loans
- [ ] Did not think it would be approved
- [ ] Other, please specify: 

F) CONTACT DETAILS (6 Questions)

Details you provide below will remain strictly confidential. No enterprise-specific or personal information will be disclosed.

39. Please enter the name of your firm: 

40. Please provide the 4-digit postal code of your firm’s head office in Azerbaijan:

41. What is your position within the firm? [Select one category]

- [ ] Chairman, Managing Director or Owner
- [ ] Director, Company Secretary
- [ ] Senior Manager (except financial), e.g. Marketing Manager, Supply Chain Manager
- [ ] Chief Accountant, Financial Manager
- [ ] Other, please specify:

42. How did you find this survey? [Select one category]

- [ ] Very easy to answer
- [ ] Easy to answer
- [ ] Difficult to answer
- [ ] Very difficult to answer

43. Do you have any other comments?

44. Please enter your email address if you would like a chance to be invited to future trainings or to be informed of the main findings from this project:

THANK YOU!

Thank you for filling out the survey. Should you have any questions or comments, please contact Iris Mantovani (Iris.MANTOVANI@oe.cd) or Patrik Prazinsky (Patrik.PRAZINSKY@oe.cd).
Annex C. EU Business Climate Survey of Azerbaijan 2018

Sampling

Figure C.1. Size distribution

Note: Figures are based on 131 survey responses.
Source: EU Business Climate Survey Azerbaijan 2018.
Table C.1. Sector distribution

<table>
<thead>
<tr>
<th>Q12. What is the main area of your operations?</th>
<th>Count</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accommodation and Food Service Activities</td>
<td>3</td>
<td>2%</td>
</tr>
<tr>
<td>Administrative and Support Service Activities</td>
<td>6</td>
<td>5%</td>
</tr>
<tr>
<td>Agriculture, Forestry and Fishing</td>
<td>3</td>
<td>2%</td>
</tr>
<tr>
<td>Arts, Entertainment and Recreation</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Construction</td>
<td>10</td>
<td>8%</td>
</tr>
<tr>
<td>Education</td>
<td>1</td>
<td>1%</td>
</tr>
<tr>
<td>Electricity, Gas, Steam and Air Conditioning Supply</td>
<td>6</td>
<td>5%</td>
</tr>
<tr>
<td>Financial and Insurance Activities</td>
<td>8</td>
<td>6%</td>
</tr>
<tr>
<td>Human Health and Social Work Activities</td>
<td>6</td>
<td>5%</td>
</tr>
<tr>
<td>Information and Communication</td>
<td>7</td>
<td>5%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>4</td>
<td>3%</td>
</tr>
<tr>
<td>Mining, Oil and Gas</td>
<td>18</td>
<td>14%</td>
</tr>
<tr>
<td>Professional, Scientific and Technical Activities</td>
<td>22</td>
<td>17%</td>
</tr>
<tr>
<td>Public Administration and Defence; Compulsory Social Security</td>
<td>1</td>
<td>1%</td>
</tr>
<tr>
<td>Transportation and Storage</td>
<td>11</td>
<td>8%</td>
</tr>
<tr>
<td>Water supply; Sewerage, Waste Management and Remediation Activities</td>
<td>8</td>
<td>6%</td>
</tr>
<tr>
<td>Wholesale and Retail Trade</td>
<td>17</td>
<td>13%</td>
</tr>
<tr>
<td>Total</td>
<td>131</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: EU Business Climate Survey Azerbaijan 2018.

Selected questions

In order to gain deeper insights on some questions designed specifically for foreign investors, the OECD partnered with the German-Azerbaijan Chamber of Commerce (AHK) to insert the following three additional questions relevant to our study in their annual survey of EU investors:

Q3.1 What percent of your company’s inputs are imported?
   a. <1 %
   b. 1-9 %
   c. 10-49 %
   d. 50-89 %
   e. 90-100 %

Q5. What discourages your company from sourcing from local suppliers? [Select max. 3 that apply]
   a. The inputs we rely on are not produced locally
   b. Local suppliers do not meet our product quality standards
   c. Local suppliers lack the relevant skills or capabilities
   d. Local suppliers lack professionalism
   e. Local suppliers are unreliable
   f. Local suppliers do not meet our ethical standards
   g. Local suppliers do not respect intellectual property rights
   h. Local suppliers do not meet our environmental standards
   i. Other, please Specify: ___________________________________________

Q9. What are the most important factors that drove your company to invest/to do business in Azerbaijan? [Select max. 2 that apply]
a. Access to domestic market
b. Strategic partnerships/alliances
c. Access to technology or knowledge
d. Access to natural resources
e. Access to export markets
f. Low costs of production
g. Investment incentives (e.g. tax incentives)
h. Other, please specify
i. Diversifying supply chain risk
j. Access to intermediate inputs and suppliers
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The OECD is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to coordinate domestic and international policies. The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The European Union takes part in the work of the OECD.

www.oecd.org

OECD EURASIA COMPETITIVENESS PROGRAMME

The OECD Eurasia Competitiveness Programme, launched in 2008, helps accelerate economic reforms and improve the business climate to achieve sustainable economic growth and employment in two regions: Central Asia (Afghanistan, Kazakhstan, Kyrgyzstan, Mongolia, Tajikistan, Turkmenistan and Uzbekistan), and Eastern Europe and South Caucasus (Armenia, Azerbaijan, Belarus, Georgia, the Republic of Moldova and Ukraine). The Programme contributes to the OECD outreach strategy implemented by the Global Relations Secretariat.

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EU4BUSINESS

The EU4Business Initiative covers all EU support for small and medium-sized enterprises (SMEs) in the region of the Eastern Partnership, which brings together the EU, its member states and six partner countries: Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine.

www.eu4business.eu
In 2016, the Government of Azerbaijan adopted the Strategic Road Map on Production of Consumer Goods at the Level of Small and Medium Enterprises in the Republic of Azerbaijan (SME Roadmap) to promote SME development and stimulate economic diversification. In this context, the Ministry of Economy requested the OECD’s support for implementing the SME Roadmap.

This Policy Insights report focuses on identifying and assessing policies that enhance MNE-SME linkages and their impacts on SME outcomes.

Building on ongoing work conducted by the OECD Investment Division for ASEAN jointly with UNIDO, the report makes use of primary data collected through an enterprise survey, fact-finding missions and qualitative interviews with businesses, government agencies and chambers of commerce, as well as desk research.

The main beneficiaries of this project are the Ministry of Economy, the Centre for Analysis of Economic Reforms and Communication, and the Agency for the Development of Small- and Medium-Sized Enterprises, as well as other SME stakeholders involved in the implementation and monitoring of Azerbaijan’s SME Roadmap.

www.oecd.org/eurasia