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## INVESTMENT CLIMATE IN AZERBAIJAN

### Executive summary

Azerbaijan is a country rich in natural and human resources. Apart from abundant reserves of oil, gas and minerals, it has untapped potential in a number of sectors for the development of new business. The workforce is well educated and the labor costs are highly competitive. The country's strategic geographic location at the gateway of east and west provides access to the large markets of the Newly Independent States (NIS), Iran, Turkey and the European Union (EU).

Azerbaijan's political environment is stable. Domestically, the country has made steady progress in the arena of political and social reforms. Internationally, Azerbaijan has maintained harmonious relations with Russia as well as with the United States, EU, Turkey and Iran, strengthening not only political but commercial ties with these countries.

The country has achieved impressive macroeconomic stabilization since independence. The government has taken effective measures to ensure price stability and currency convertibility. Gross Domestic Product (GDP) has grown steadily. The country is also making noteworthy progress towards a market economy. The government's commitment to this goal is attested to by its enthusiastic promotion of private sector development and the ongoing privatization process that it launched in 1995.

The Azerbaijani government welcomes foreign direct investment (FDI) in Azerbaijan. In the relatively short period since independence, it has made continuous efforts to open up the economy and establish laws and regulations that are favorable to foreign investors. The foreign exchange regime and currency transfer policies are liberal and there are no major constraints on commercial activity. The law permits foreigners to wholly own companies, and protects them from nationalization and expropriation of assets. Special efforts are currently being made to improve the transparency of the regulatory system, further reduce bureaucracy and corruption, and develop additional incentives for attracting foreign investors.

There are a number of non-oil sectors that present interesting foreign investment opportunities. Agriculture, a currently under-developed sector, has good potential for development in the areas of food processing and packaging. Activities of this kind can bring added value to the rich array of fruits and vegetables that grow in the country for the purpose of exporting abroad and as a substitution for high-priced imports. Infrastructure is another sector with good potential for development. The country's steady economic growth has generated increased demand for a modern, well-functioning infrastructure.

Investment opportunities are available through the privatization or acquisition of liquidated assets, such as land, buildings and machinery belonging to state-owned companies. In addition, there is significant potential for new ventures and greenfield investments in several sectors of economy. The facts show that committed and capable foreign investors can do profitable business in Azerbaijan. But these facts in no way mean the perfection of business climate established in the country. Much remains to be done.

After twelfth years of gaining independence Azerbaijan has successfully achieved macroeconomic stability. This fact together with a skilled, inexpensive labor force and abundant natural resources are strengths which Azerbaijan could leverage when developing into an attractive destination for non-oil sector foreign investments, just as it has successfully done for the oil and gas sector.

### **Legal Initiatives**

The business and investment climate in the non-oil sectors of the Azerbaijani economy remains challenging, with prospective investors facing similar issues as in other newly independent countries in the early stages of transition. While investors may not expect a perfectly functioning legal system in a transition economy, they nevertheless require basic framework conditions before making substantial long-term investments. Aware of this situation and committed to improving the business and investment climate, the government of Azerbaijan has worked on improving the framework conditions in the recent years.

This has led to a burst of legislative activity, with a number of new laws adopted in crucial areas. These include the Tax Code, the Customs Code and Customs Law, the Foreign Exchange Law, the Civil Code and Civil Procedure Code, the Labor Code, the Land Code, the Law on Public Service, the Law on International Arbitration and the Anti-Monopoly Law.

As a consequence of these new legislative instruments, Azerbaijan's overall framework conditions have shown a gradual improvement over the past years, reducing the unpredictability of doing business in the country. Although Azerbaijan's commercial laws have not yet reached international standards, the country compares reasonably well with other transition countries. Based on a 1999 European Bank for Reconstruction and Development (EBRD) survey, the commercial laws of Azerbaijan were considered "adequate" for supporting investment and other commercial activity.

The commercial law of Azerbaijan ranks among the best in the CIS, although it still lags behind that of some of the developed countries. Foreign investors and business people also consider that the legal measures taken by the government since 1995 have led to significant improvements in the overall investment climate.

### **Reforms announced in 2002**

Despite significant progress in the legal framework, much work remains to be done to establish a business climate conducive to rapid and sustainable growth, to create lasting confidence in the foreign investors community, and to unlock the full potential of Azerbaijan's economy. In this regard, the series of presidential decrees announced in early September 2002 are a clear message to the private sector and foreign investors.

Indeed, in order to facilitate business in the country, boost the development of entrepreneurship and attract further foreign investment, the President has defined a number of reforms to be carried out by the relevant ministries and state bodies.

**Privatization:** Accelerating privatization of state-owned enterprises while ensuring full transparency of auctions; improving procedures for leasing state-owned property.

**Taxation:** Reduction of tax rates as of January 1, 2003; enhancing the scope of the simplified tax system; reduction of payroll taxes.

*Trade Regime and Customs Administration:* Introduction of custom duties to protect the domestic market; encouraging export; establishing a free customs zone and bonded warehouses.

- *Expatriate Employment:* Further simplification of visa regime and procedures for business people visiting the country, eliminating remaining bottlenecks in this area.

- *Legal Forms of Doing Business and Business Registration:* Elimination of red tape in the business registration process and simplification of registration procedures; reduction of the number of activities to be licensed from 240 to 30, extension of license validity from 2 to 5 years; reduction of the number of activities requiring special permission.

- *Policy on Competition:* Restriction of economic monopolies and support for free market competition.

- *Protection of Property Rights:* Prevention of unlawful restrictions in the exercise of property rights by property owners.

- *Banking Sector and Project Financing:* Establishing a unified national real estate register to facilitate registration of mortgage agreements so that entrepreneurs can receive funding from credit institutions; ensuring a sustainable reduction of discount rates for centralized credits in order to decrease annual interest rates; preparation of measures encouraging commercial banks to supply credit to businesses and to increase the number of long-term loans granted; accelerating the creation of a micro-credit bank to support SME development; provision of financial assistance for implementing investment projects in key areas of economic development.

- *Investment Promotion and Facilitation:* Establishing a business incubator and industrial site with adequate communications facilities and infrastructure in Baku to support SME development; setting up business centers in different regions. A number of laws and policies that influence the investment climate in the non-oil sectors are valid for all private businesses, both locally- and foreign-owned. Together, they define the general standards of treatment for foreign investors. In addition, a number of laws and policies are only applicable to foreign investors. At a minimum, foreign investors would like to be assured of equal treatment with national investors, non-discriminatory treatment compared with foreign investors from other countries, protection from arbitrary expropriation and proper compensation if expropriation is required in the public interest, the right to repatriate funds, and access to international arbitration to resolve certain disputes with the State. These issues and others are discussed below in greater depth.

### **Openness to Foreign Investment**

The government welcomes foreign direct investment as it plays a vital role in the development of the country's economy. The major laws governing foreign investment include the Law on Protection of Foreign Investments (1992), one of the first legislative acts adopted in Azerbaijan after it became independent, and the Law on Investment Activity (1995). The former is the main FDI law while the latter is a general investment law that supplements the rules stipulated in the FDI law. Of relevance are also the legislation pertaining to the privatization issue and the network of bilateral investment treaties.

Azerbaijan's Law on Protection of Foreign Investments, the enabling law for FDI, provides a permissive regime for FDI. Foreign investments are permitted in any activity open to a national investor, unless prohibited by another law. National security and defense are the only prohibited areas. Specific sector restrictions on the entry of FDI apply only in the case of very important industries that are state monopolies (oil sector including oil service industries, energy and etc.). In these sectors, FDI should be in the form of a joint venture with a state partner. Such monopolies also exclude national strategic investors; in this respect there is no additional impediment to foreign investors. Another limitation on FDI is the National Bank of

Azerbaijan's (NBA) current regulation limiting the aggregate amount of foreign participation in the banking sector to 50%. Azerbaijan's FDI regime, nevertheless, remains liberal by international standards, since many countries restrict FDI from certain sectors and require specific approval of foreign investment in many if not all sectors.

The presidential decree of September 2002 confirmed the government's openness to foreign investment and announced the implementation of effective measures aimed at simplifying the registration procedure.

Foreigners and foreign entities can invest in the country either through greenfield investments (by setting up a wholly owned company, branch or representative office), purchase of enterprises or assets (by direct negotiations with the owner or by purchasing shares on the stock market), and acquisition of rights to use land. A joint venture with a local company remains the most popular form of investment. In addition, foreign investors are explicitly allowed to participate in the privatization program.

### **Foreign Exchange Control**

Azerbaijan has a liberal exchange regime based on the Foreign Exchange Law. In general, there are no restrictions on converting or transferring funds into freely usable currency at a legal market-clearing rate. This is a major improvement compared to the previous foreign exchange control regime. In addition, reporting requirements have been diminished.

The official currency of Azerbaijan, the Manat, is not yet a freely convertible currency in international markets. But thanks to the government's macroeconomic achievements it has been stable and convertible at a value set by the inter-bank market for the last few years. As a consequence, none of the severe convertibility problems that affect investors in neighboring countries exist in Azerbaijan and foreign currency is easy to acquire. Cash exchange is carried out at numerous currency exchange points. Foreign exchange market operators also have access to real time exchange markets.

### **Taxation**

There are currently three separate and distinct tax regimes that are applicable in Azerbaijan. Physical persons and legal entities operating outside the framework of production sharing agreements (PSAs) [each PSA contains its own tax regime] and the Main Export Pipeline are subject to the statutory tax regime. Only the statutory tax regime is discussed here.

In the past, tax rules were scattered among numerous laws and regulations. In 2000 a new Tax Code was passed. It entered into force on January 2001, replacing the confusing number of separate pieces of law. Further amendments were made in January 2002. For the first time, a comprehensive legal source for all tax rules and procedures was created. This increased significantly the transparency of the tax regime for the taxpayer.

Furthermore, rate cuts and modernized tax procedures were adopted. Business representatives and foreign investors consider the new Tax Code to be a major improvement over previous tax legislation. The Tax Code contains the rates and procedures for direct and indirect taxes. Tax rates might be lower according to Double Tax Treaties concluded with a number of countries, in particular for withholding taxes. The following briefly describes the cornerstones of the tax regime:

- *Corporate profit tax.* The corporate profit tax is paid by resident and nonresident enterprises at the same rate. General tax rate on profits is 25%, down from 32%. A simplified tax with a tax rate of 2 to 4% of turnover is applicable to business entities with a turnover under 125 million Manat (USD 25,700) quarterly. Taxpayers of the simplified tax do not pay profit tax and value added tax (VAT). The tax base is reduced for certain business expenses.

Certain types of bad and doubtful debts are also deductible, as is the depreciation of capital stock, with an accelerated schedule for some items. Losses may be carried forward over the following five years.

- *Personal income tax.* Residents and non-residents pay the personal income tax. The income tax rates are assessed progressively based on gross income and range between 12% and 35%, down from 40%. Some forms of income of persons are exempt from the income tax, such as income from agricultural activities.

- *Value added tax (VAT).* The VAT applies to goods, works and services within the country as well as to imports. VAT registration is required if the value of transactions exceeds a certain amount. The standard VAT rate is 18%. There is no reduced VAT rate but VAT exemptions exist among others for property purchase in the process of privatization, imports of capital goods, financial services including leasing, transactions connected with currency or securities circulation, etc. VAT on exports of goods is also zero-rated, which is essentially an exemption with credit giving rise to the recovery of the input VAT. In principle, Azerbaijan exporters can obtain refunds in 45 days, but prompt refund is always an issue for exporters. International transportation of cargo and passengers is also zero-rated.

- *Withholding taxes.* Withholding taxes on payments made to foreign entities apply at rates between 4% (insurance premiums and leasing fees), 10% (dividends, interest, rents and royalties) and 15% (management fees). Profits derived from a permanently established foreign company (representative office, branch) are subject to a branch remittance tax of 10%.

- *Other taxes and fees.* All enterprises and physical persons producing or importing excisable goods are taxpayers. Excisable goods include oil products, tobacco products and alcoholic beverages. Resident and non-resident physical persons and enterprises are taxpayers of a property tax of up to 1% of the current value of fixed assets including buildings, machinery and equipment and vehicles. A road tax is levied on vehicles from foreign states entering the country at a rate determined by the type of vehicle. There is also a land tax payable for the use of land. Enterprises engaged in the extraction of mineral resources are subject to a royalty tax (3 to 26% for minerals other than crude oil). There is a land tax levied on land plots owned by residents and nonresidents at a rate differing by region, type of site and value of land.

- *Payroll taxes.* Finally, there are social contributions, which consist of a 27% employer contribution rate charged on all employees' gross salaries. A presidential decree (September 2002) stipulated a further reduction of tax rates as of January 1, 2003. It aims to extend the application of the simplified tax, as well as to reduce payroll taxes.

### **Trade Regime and Customs Administration**

#### *Trade Policy*

Trade policy and regime are important elements in the definition of the business and investment climate. This is particularly true for countries like Azerbaijan that have a relatively small domestic market and good export potential, as enterprises active in the non-oil sectors

need to have access to cost-effective inputs and to export markets. With the collapse of the Soviet Union and the severing of trade links with Soviet markets, Azerbaijan needed to integrate into the multilateral trading system and expand access to international markets. As discussed, Azerbaijan has significantly strengthened its trading relationships with non-CIS countries, in particular with Western countries, thanks to the creation of a moderate trade regime and the conclusion of a number of bilateral trade agreements granting favorable conditions.

### *Tariffs, Fees and Duties*

Effective from 1997 and updated in 1999 and 2001, Azerbaijan has introduced a simplified tariff regime that consolidates the previously complex and confusing legislation. The new Customs Law and Customs Code govern customs rates and procedures. Key reforms include uniform duty bands. With a weighted average tariff level of 7.8%, Azerbaijan is approximately in the middle of the range with respect to average tariff levels of other countries. Investors see the new legislation as a major improvement and as an appropriate legal base for import and export business.

In addition to the standard customs' processing fee (0.15% of the declared customs value, and a minimum charge of AZM 16,500)) all imports are subject to duties at uniform rates of 0.5, 3, 5 or 15% of the declared customs value, unless they are duty free. Most goods are subject to the 15% maximum rate. There are no export duties on any products. Imports of industrial raw materials and semi-finished inputs are generally taxed at 0 to 5%. Imports of containers and packaging are taxed at 0 to 5%. Many finished consumer and industrial goods attract the highest import duty of 15%, which implies a certain level of protection for domestic producers of these products. The valuation of imported goods is based on the declared value that appears on the invoice.

Customs duties do not apply to goods imported under bilateral free trade agreement treaties. Nevertheless, importers have to pay the standard customs processing fee. A number of items are fully exempt from import duties, regardless of whether they have been imported under a bilateral free trade agreement or not. These include capital goods for foreign investment projects, personal property imported by expatriate employees, and goods in transit. Goods imported into Azerbaijan for processing before re-export are subject to the normal import duties at the time of import. As soon as processing has been completed and the goods are re-exported, a reimbursement procedure can be initiated to recover the duties paid.

### *Imports and Exports Restrictions*

When importing goods to Azerbaijan, importers also face non-tariff barriers. Some products are subject to quantitative restrictions and/or import licenses that amount to quantitative restrictions since they are limited to the import of a predetermined quantity. This is the case for alcoholic beverages and tobacco products, food products of animal origin, defense equipment, technological equipment, large-scale satellite dishes and other communications equipment, drugs, and pyrotechnical devices. Labeling and marking regulations require that the following be stated: product origin, ingredients (if applicable), production and expiration dates (if applicable), and warnings on improper product use (if applicable). No language requirements currently exist under present regulations.

All goods are exempt from custom duties when exported from Azerbaijan. Nevertheless, exporters have to comply with the export control regulations of the government, which provide for a number of restrictions and licensing requirements. These prohibit the export of

weapons, explosives, radioactive materials and waste, narcotics and psychotropic drugs. In addition, it regulates the export of strategic commodities produced in Azerbaijan, including petroleum products, cotton, electric power and non-ferrous metals.

### *Customs Administration*

The Customs Committee has committed itself to introducing administrative reforms following the recommendation of an independent private evaluator in January 2002. The government's Letter of Intent of February 2002 outlines the main objectives of the customs administration reform program, including better data collection and control, the adoption of international standards for valuations of import goods and the introduction of an automated customs documentation process. Furthermore, the government has signed a long-term contract for technical assistance with an international consulting firm to improve governance and modernize operations within the customs administration. These measures should bring greater accountability and efficiency to the customs process.

Azerbaijan is still not a member of the World Trade Organization (WTO). However, it has applied for accession to the Organization and is in the full accession negotiation phase. The benefits of joining the WTO for Azerbaijan extend beyond market access under favorable terms. Membership will also grant credibility to the reform measures that the government has undertaken, which is crucial to mobilizing further investment in the country.

A presidential decree (September 2002) supports the introduction of custom duties to protect the domestic market and encourage export, as well as the establishment of a free customs zone and bonded warehouses.

### **Corporate Governance, Accounting Standards and Auditing**

#### *Corporate Governance*

There have been no high profile cases of minority shareholder rights abuse in Azerbaijan, as has been the case in some other CIS countries. Nevertheless, the legislation in the area of corporate governance and related issues such as fiduciary duty of directors and officers to the company and shareholders' rights, including minority shareholders rights, is not very developed to date. Foreign and local shareholders have equal rights under the law.

#### *Accounting Standards*

Regarding accounting standards, although banks began using International Accounting Standards (IAS) in 1999, full implementation of this process across all sectors is not yet complete. The Law on Accounting (1995) defined the Azerbaijani Accounting Standards (AAS), according to which every legal entity engaged in business in Azerbaijan has to keep its books and records. Using the AAS, companies have to maintain and submit general ledgers, financial statements, tax filings and related reports so that authorities are able to assess the tax liability of each company.

While some similarities exist between the AAS and the IAS, there remain a number of differences. In contrast to IAS, AAS establishes a rigid series of accounts on a cash flow basis. AAS has a lower degree of transparency, uses historic Manat valuations and has property recorded at acquisition price or cost of construction. Several value adjustments were made in the past, which distort information because the indexes used did not necessarily

reflect the real value changes. Revaluations of property are not allowed under AAS, as is the case under IAS. In addition, under AAS there are no provisions for deferred tax accounting.

For foreign companies, the legal obligation to use AAS represents a hindrance to conducting business in Azerbaijan. There are considerable costs involved in maintaining two sets of accounting books, one based on AAS and the other on IAS. Accounting according to AAS standards provides little benefit to companies, as management to effectively run a competitive company cannot rely on this system. The introduction of IAS would bring greater clarity to tax calculations and improve the reliability of accounting information for prospective investors.

### *Auditing*

Legislation defining the requirement of legal entities to be audited is contained in the Special Law on Auditing Services (1994) and an Instruction (1997). An audit in Azerbaijan is necessary for tax purposes. The main reporting requirements for legal entities with foreign investment in Azerbaijan consist of: a report about their activities in Azerbaijan, budget or cost estimations certified by the home office and an income declaration together with the opinion of the auditor.

### *Employment*

#### *Skilled Workforce*

Azerbaijan has a notably well-educated work force. More than half of the population has a higher technical or academic education. The country has a 97% literacy rate.

When the Soviet industrial sector collapsed during the 1990s, a large part of the work force became unemployed or under-utilized. As a result there is an abundant supply of qualified, trained technicians and skilled and unskilled laborers at low costs. This certainly represents one of the main factors influencing investments in the country, and the overall competitiveness of its investment climate positively. Employers are generally satisfied with the quality of the workforce considering that new skills are needed in private business. Foreign investors have found that employees are both easy to train and eager to learn.

#### *Labor Code*

A Labor Code that took effect in July 1999 regulates labor relations. The Labor Code defines a set of rules regulating the relationship between employer and employee. It is applicable to any entity registered to do business in Azerbaijan. The Labor Code provides a reasonable degree of flexibility in hiring and laying-off employees, as well as in setting terms of employment. It imposes minimum terms and conditions regarding working hours (40 per week), compensation, holidays (21 calendar days per year plus 15 official holidays), maternity leave (up to 140 paid days) and sickness leave. Rights to strike and to hold union membership also exist.

Azerbaijan is a member of the International Labor Organization (ILO) and has ratified more than 50 ILO Conventions.



### **Expatriate Employment**

Companies require a general license to employ foreign employees who need a work permit and residence permit to work in Azerbaijan. The procedures to obtain employment and residence rights for foreigners are exceptionally favorable compared to many other countries where the systems for regulating expatriate employment cause delays and are vulnerable to corrupt practices. The Ministry of Labor licenses companies to employ foreign employees. Foreigners must then register with local authorities at their place of residence and obtain a work permit from the Ministry of Labor. Work permits are valid for one year and can be extended. The management of foreign companies and foreign entrepreneurs do not require work permits.

A presidential decree (September 2002) endorses a further simplification of the visa regime and procedures for business people visiting the country, eliminating remaining bottlenecks in this area.

### **Legal Forms of Doing Business and Business Registration**

#### *Legal Forms for Enterprises*

Permissible forms of business organizations are defined in the Civil Code (1999) and the Law on Enterprises (1994). Besides state enterprises, this law identifies certain organizational and legal forms of doing business in Azerbaijan. These include:

- *Individual Enterprises.* An enterprise that is owned by an individual or jointly owned by members of a family. The owners of the individual enterprise have unlimited liability with respect to the obligations of the enterprise.
- *General Partnership.* An enterprise that is established by not less than two physical or legal persons with all partners having unlimited liability.
- *Limited Partnership.* A limited partnership is established by not less than two physical and/or legal persons with at least one of the partners having unlimited liability.
- *Limited Liability Enterprises.* An enterprise that is established by one or more physical or legal persons with founding members actually owning shares in the enterprise. The shareholders of a limited liability enterprise have limited liability to the extent they subscribe in or own shares of the limited liability enterprise.
- *Joint-stock Company.* A joint-stock company structure is similar to a limited liability enterprise, except that a minimum of three physical or legal persons are required to form a joint-stock company, and minimum capital requirements should be met. Joint-stock companies may be established either as open or as closed companies. An open joint-stock company is able to offer its shares to investors, while a closed joint-stock company can only redistribute its shares among its founder shareholders.

Azerbaijan does not have any single law defining foreign legal entities and specifying all the legal forms available to them. Accordingly, it is necessary to refer to a number of different laws in order to determine the legal forms of doing business. These include the Civil Code, the Law on Enterprises and the Law on Protection of Foreign Investment.

Determining the form of doing business that applies to foreign legal entities is nevertheless important since it has legal consequences, particularly with regard to tax, reporting and currency issues. Subsidiaries wholly owned by foreign investors are considered as Azerbaijani legal entities. Branch and representative offices are considered non-resident.

### *Registration of Legal Entities*

The procedure to register a business in Azerbaijan is not complex. Every legal entity or permanent establishment (representative office or branch) must register with the Ministry of Justice. The Law on State Registration of Legal Entities (1994) stipulates the necessary documents to be submitted. All documents must be submitted in the Azerbaijani language. The list of required documents and the language requirements are based on international standards.

The law sets a limit of 10 days for registration. After registering with the Ministry of Justice, the applicant must register with the tax authorities, social insurance and statistical agencies. If a general business license does not exist, licenses and special permissions are required for some activities. A presidential decree (September 2002) aims to eliminate business registration bureaucracy and simplify state registration procedures. These measures result in a significantly lower number of activities requiring licenses and special permissions (from 240 to 30), in addition to an extension of license validity from 2 to 5 years.

### **Land Ownership**

After a bit late start following independence, the legal framework changes enable Azerbaijani citizens and legal entities to own, buy and sell freeholder titles to land. The relevant legislation consists of the Land Code (1999), the Law on Land Reform (1996), the Law on Land Leasing (1999), and the Law on Land Market (1999). As discussed, agricultural land belonging to smallholders has been rapidly privatized since 1995. However, land titles have to be registered at the land registry and the land cadastre. As the administrative capacity to register land titles has only just been put in place, the registration of all land titles may still take time. Accordingly, dealing in land titles or bank lending secured with land will remain limited in the short term.

Despite Land Code specifically prohibiting direct ownership of land by foreign individuals and legal entities, they have the right to lease land. Foreign legal entities may also own land indirectly through foreign-owned Azerbaijani entities. However, this is not permissible where land is acquired within the framework of privatization projects.

In addition to ownership, the Land Code recognizes perpetual and temporary land usage rights, lease rights and easements. Leases are concluded for the period agreed by the parties and rental payments for the lease of privately held plots of land are freely negotiable. Provided lease rights are long enough, there is no fundamental commercial distinction between leaseholder and freeholder titles, and the prohibition of direct ownership of land by foreign individuals and legal entities is of little importance to foreign investors. Foreign investors, whether participating through an Azerbaijani legal entity or not, may be restricted to acquiring leaseholder rights for agricultural land only.

Landowners have the right to transfer their land by sale, contribution to charter capital, mortgage, exchange, grant or by other means, subject to certain restrictions established by law. The value of land set forth in land transactions must correspond to its market value and, in any case, cannot be less than the minimum statutory value fixed by law.

### **Policy on Competition**

In the privatized sectors, commerce is generally free and the market alone sets prices. There is constitutional and legal support for the principles of competition. As early as 1993 the Anti-Monopoly Law (amended in 1997) dealt with monopolies and unfair competition in the marketplace. Decision-making procedures and enforcement measures of the anti-monopoly department were defined at this time. The Department for Anti-Monopoly Policy within the Ministry of Economic Development (MED) is in charge of implementing the Anti-Monopoly Law. This department was a separate body until July 2001 when several ministries and authorities were merged under the newly created MED. The Ministry has the power to implement a full range of measures against monopolistic behavior including termination of a company's activity. These measures also cover regulatory functions, such as setting price and service parameters for state monopolies.

The presidential decree (September 2002) confirmed the commitment of the government to further restrict economic monopolies and support free market competition.

### **Protection of Property Rights and Respect for Contracts**

Investors throughout the transitional economies are uneasy about security of property and contract rights. Azerbaijan ranks well among the transitional economies according to a recent EBRD survey. The Azerbaijani Constitution provides specific protection for private property. A modern Civil Code came into effect in 2001. The Code includes fundamental provisions on contracts, commercial relations, ownership rules and securities. The adopted Civil Procedure Code simplifies court procedures. The presidential decree of September 2002 reflects the commitment of the government to preventing unlawful restrictions on the exercise of property rights by property owners. Despite improved legal provisions, there is a need to ensure more effective means of guaranteeing full property rights.

### **Protection of Intellectual Property Rights**

Copyright, trademark and patent legislation is in place. In the mid-1990s Azerbaijan began to implement a national system for registering and protecting intellectual property rights. Modern copyright legislation (Law on Copyright and Related Rights, 1996), patent legislation (Law on Patents, 1997) and trademark protection legislation (Law on Trademarks and Geographic Names, 1998) were enacted. Azerbaijan is also a signatory of the main international conventions on protection of intellectual property, such as the Paris Convention for Protection of Industrial Property, the Berne Convention for the Protection of Literary and Artistic Works, and the Geneva Phonograms Convention.

### **Banking Sector and Project Financing**

#### ***Structure of the Banking Sector***

Access to financing is critical for investment and growth of domestic and foreign enterprises. In this regard, the early stage of development of the Azerbaijani financial sector constitutes a significant bottleneck to private sector development. Currently, total banking sector assets only amount to a bit more than USD 1 billion. The sector consists of 46 banks, but is dominated by the 51% state-owned International Bank of Azerbaijan (IBA), slated for privatization soon. Overall, the banking system acts as not sufficiently strong financial intermediary, and thus needs further reforming to respond international standards.

### *Reforms of the Banking Sector*

With the aim of remedying this weakness, in 1999 the government embarked on a program of reform in coordination with the World Bank and the IMF. Key elements of the strategy included restructuring and privatizing the remaining state-owned banks; consolidating and rationalizing privately-owned banks; enhancing the regulatory, supervisory and banking capacity of the National Bank of Azerbaijan (NBA); improving the legal framework; and developing the institutional and technical infrastructure to support a healthy, efficient, and competitive banking system, including accounting, payment systems, and auditing.

In the past three years, the banking system has undergone a number of reforms. Three of the four state-owned banks were unified into a single entity called United Universal Bank, with a number of additional private banks also planning to merge. Improvements in prudential regulation and supervision under the guidance of the NBA were implemented.

In an attempt to consolidate the sector minimum capital requirements for existing and new banks were raised. In 2001 a Real Time Gross Settlement System, AZIPS, the immediate settlement of payments between banks (within 30 to 60 seconds) went live. The Securities Committee and the Baku Stock Exchange were also established.

The said presidential decree confirmed the commitment of the government towards reforms in the banking sector. Anticipated reforms include establishing a unified national real estate register to facilitate registration of mortgage agreements so that entrepreneurs may more easily receive funding from credit institutions; ensuring a sustainable reduction of discount rates for centralized credits in order to decrease annual interest rates; preparation of measures encouraging commercial banks to supply credit to businesses and to increase the number of long-term loans granted; accelerating the creation of a micro-credit bank to support SMEs development; provision of financial assistance for implementing investment projects in key areas of economic development. Moreover, the NBA is emphasizing the importance of corporate governance in the banking sector and is starting projects in this sector.

One the most important strategic goals of the National Bank of Azerbaijan in terms of improving the payment system further is to establish an electronic small payment system.

### *State Financial Support to the Private Sector*

The government recently established a National Fund for assistance to entrepreneurship. This fund will provide financial assistance to SMEs in the amount of 250 billions manats (USD 50 million) in the period 2003 to 2005.

### *Activities of International Financial Institutions*

Besides the local banking sector and donor-backed credit lines, a number of international financing institutions and bilateral instruments providing project financing are active in Azerbaijan. Currently the International Finance Corporation (IFC), the European Bank for Reconstruction and Development (EBRD), the Asian Development Bank (ADB), the Islamic Development Bank (IsDB) and the Black Sea Trade and Development Bank (BSTDB) have operations in Azerbaijan. In terms of guarantees, the Multilateral Investment Guarantee Agency (MIGA), which provides guarantees against non-commercial risk, operates in Azerbaijan. Three equity funds targeting the region are also active in the country.

IFC's strategy focuses on strengthening the financial sector, promoting micro enterprise and SME development, supporting investment in agricultural and industrial sectors, channeling FDI in non-oil sectors and supporting investment in the oil and gas sectors. Funding has been approved for projects representing an investment of more than USD 130 million.

The EBRD is extensively involved in the development of Azerbaijan's oil, transportation, banking and power distribution sectors. Although the bank continues to provide assistance to Azerbaijan's oil and gas sector, it also supports greater diversification of Azerbaijan's economy. In an effort to improve the investment climate in Azerbaijan, the EBRD is expanding its private sector activities, particularly in the areas of small- and medium-size enterprises, oil and gas, the financial sector and infrastructure. As of September 2002, EBRD's portfolio in Azerbaijan consisted of 17 signed projects with outstanding financing commitments of EUR 329 million. Since the beginning of its operations in Azerbaijan in 2001, ADB's strategy has been to help the government improve the delivery of essential public goods and services, and to strengthen the environment for private investment and job creation,

Azerbaijan has been a member of the IsDB since 1992. In addition to financing infrastructure projects, IsDB also provides grants for refugees and finances the preparation of feasibility studies for investment projects in the public and private sectors. So far IsDB has provided financing for feasibility studies in the amount of USD 1.2 million.

Azerbaijan became a member of BSTDB in 1997. Two projects, an equity investment in the Azerbaijan Micro Finance Bank and a Multiple Buyer Credit Facility to IBA, have been concluded to date. BSTDB will concentrate its activities in Azerbaijan on providing financial support in particular for projects in the non-oil sectors. It plans to establish a post privatization facility to help privatized enterprises restructure and develop. As a long-term priority BSTDB will support investors from member countries who wish to participate in privatization in Azerbaijan. The bank also considers financing projects in telecommunications, transportation, manufacturing, agribusiness, and oil and gas industries.

As part of the World Bank Group, MIGA's guarantee program is designed to encourage the flow of private investment to developing countries by mitigating political risks associated with a project. MIGA has issued six guarantees in the amount of USD 77.1 million to companies operating in Azerbaijan.

Project financing is also provided by bilateral instruments, such as the German KfW, the US Overseas Private Investment Corporation (OPIC), the Japanese JBIC, the Turkish Eximbank and the Swiss Government (SECO) Start-up Fund.

In addition to foreign sources of project financing, the relevant presidential decree endorses the provision of financial assistance from the Azerbaijani government for implementing investment projects in key areas of economic development.

#### **Transparency of the Regulatory System, Administration of General Standards and the Corruption Issue**

As mentioned above, the government has significantly improved the regulatory system in the past years by adopting new laws and decrees. Investors and business facilitators evaluate the government's legislative efforts positively and consider the laws and regulations that comprise the general standards affecting business today as reasonably effective.

Even though legislation includes some overlaps, inconsistencies and contradictions it can be seen as a remarkable achievement considering that the country only recently embarked on its transition to a market economy.

Recognizing the impact of poor governance and corruption, the government of Azerbaijan has recently taken a number of steps to improve the situation. In June 2000 a decree on fighting corruption was issued. In 2001 the Law on Public Service was passed. The Law defines codes of conduct for civil servants and sets standards and rules for their appointment, promotion and remuneration. In 2003 the Law on Combating Corruption was adopted and currently the relevant program is being elaborated. Last year Azerbaijan also became a part to the Civil Law Convention on Corruption and Criminal Law Convention on Corruption of the Council of Europe.

The government raised the salaries of some 25,000 government employees in an effort to strengthen public administration and reduce incentives for corruption. Other recent steps in the fight against corruption include the establishment of two new ministries: the Ministry of Fuel and Energy and the Ministry of Economic Development, with the intention of separating commercial and regulatory interests in the energy and other sectors. The government also launched a reform of the judiciary in order to improve the quality and independence of the courts. New laws on civil and criminal procedures were passed and merit-and test-based nomination of judges introduced. As mentioned the presidential decree of September 2002 has decreased the number of activities requiring licenses and special permission (from 240 to 30). This measure reduces bureaucratic obstacles to entrepreneurial activity and eliminates situations where entrepreneurs are required to make additional payments in order to expedite the licensing process.

Under the new IMF program, the government has shown its readiness to reform the public sector and improve governance. The government is also working with the World Bank to implement further reforms. It plans to establish a public procurement system and pass legislation to endorse the creation of a supreme audit institution. Azerbaijan's accession to the Council of Europe in January 2001 should also contribute to such improved governance.

### **National Treatment and Non-Discrimination**

The Law on Protection of Foreign Investments stipulates that the government will treat foreign investors in a manner no less favorable than the treatment accorded to local investors. It also specifies that foreign investors may not be treated any better than national investors, if not otherwise stated in any piece of law. The only exception made in the FDI law is that foreign investors may get "privileges" for investing in priority activities or regions, whereas this does not apply to domestic investors. If a change in Azerbaijani legislation should have a negative impact on an investment project, the implementation of that change is subject to a ten-year moratorium.

In the FDI law there is no mention of non-discrimination towards foreign investors of different countries. The assumption is that the FDI law guarantees equal treatment to local and foreign investors, regardless of nationality.

### **Nationalization, Expropriation and Compensation**

The Law on Protection of Foreign Investments protects foreign investors against nationalization and expropriation of property, except under certain specified circumstances, when national interests or population are endangered, and then only with prompt, effective and adequate compensation. No acts of nationalization or expropriation have occurred in recent years.

### **Repatriation of Funds**

The Law on Protection of Foreign Investments provides for repatriation of profits, revenues and other undefined investment-related funds in foreign currency provided that the appropriate taxes and fees have been paid. Thanks to the liberal foreign exchange regime and sound monetary policy there have been no inconvertibility problems to date.

### **Dispute Settlement**

Effective means of protecting and enforcing property and contractual rights through the traditional dispute settlement mechanisms suffered from the weakness of enforcement mechanisms. But recent changes in Azerbaijan's legal framework have made arbitration a potentially more effective mechanism than the traditional recourse to the Economic Court.

The Law on International Arbitration came into force in 2000. It confirms the right of contracting parties to elect international arbitration to resolve their disputes and introduces international standards applicable to international arbitration. The Law provides for enforcement of foreign arbitration decisions rendered abroad provided they do not contravene legislation or public policy.

To supplement domestic laws on international arbitration and to reduce potential uncertainty among investors, the parliament ratified Azerbaijan's accession to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. This provides for binding international arbitration of investment disputes between foreign investors and the state without a re-hearing of the basic issues by Azerbaijani courts. Some bilateral investment treaties between Azerbaijan and third countries provide foreign investors with recourse to the International Center for the Settlement of Investment Disputes (ICSID, member of the World Bank Group of institutions), Azerbaijan is indeed a party to the World Bank Convention on the Settlement of Investment Disputes between States and Nationals of Other States under which ICSID was established. It is also a member of the Multilateral Investment Guarantee Agency (MIGA, an institution of the World Bank Group), which issues guarantees against political risk to private investors. The US Overseas Private Investment Corporation (OPIC) is also active in Azerbaijan and provides insurance for new investments.

These are important structural components in building investor confidence. So far there has been no dispute between a foreign investor and the state that has required referral to international arbitration.

### **Performance Requirements**

Performance requirements are not imposed on new investment in non-oil sectors. This is different from the performance requirements within the framework of oil sector PSAs.

Investors who participate in the privatization process or win tenders for management contracts, nevertheless, often assume specific obligations regarding future investment and

employment. Foreign investors are neither required to purchase from local sources nor to export a certain percentage of output. There are also no legal requirements for employment of Azerbaijani nationals.

### **Stability**

The foreign investment law contains a grandfathering clause, which states that any ruling that has a negative impact on the legal framework for business will not apply to a foreign investor for up to ten years after the change was made. This does not apply to changes in legislation related to matters of national safety, environmental protection, taxes or public health. All Azerbaijani state agencies are legally bound to recognize and act according to the grandfathering clause.

### **Specific Investment Incentives for Foreign Investors**

The government of Azerbaijan is currently developing a comprehensive set of specific incentives to attract foreign investment in the non-oil sectors, as it has done successfully with Production Sharing Agreements in the oil and gas sector. The possibility of establishing free trade zones for some specific sectors is currently being discussed by the government. The Law on Protection of Foreign Investments contains the provision on customs duty exemptions for capital goods. Personal goods belonging to employees of a foreign company are also exempt from customs duty.