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Global Think-Tank

The Business environment: economic reforms in the context of institutional shortcomings

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Abstract

The existence of a well-functioning business environment is a key factor in the diversification of the economy, the efficient use of available resources and ensuring sustainable growth. The business environment, in its turn, should be regarded as a composite of conditions that incorporate quite complex components. If one or more of the composition components are not functioning appropriately, the result you will get is not adequate to the available capacity. The existence of contemporary institutions is the absolute requirement for a "good business environment", performing functions such as coordinating all other economic advantages, organizing appropriate arrangements, and risk management.

In the 21st century, policies aimed at the development of the economy are only possible through institutional reforms. The existence and effectiveness of relevant institutions and incentive mechanisms in the process of involving global resources (investment, tested experience, integration advantages, etc.) is considered to be one of the most important advantages. It is hard to imagine the development of modern economies without these global resources.

The sharp decline in oil prices since the second half of 2014 created serious difficulties for the Azerbaijani economy, which renowned for its hydrocarbon wealth. The government therefore has begun broad-based reforms in the economy. However, the growth trend in the real economy remains weak despite extensive reforms in the legal sphere and new incentive mechanisms. In other words, delays in implementation of reforms in the economy have been observed. We will try to briefly review the reasons for these delays in this article.

I. Evaluating economic reforms in the context of business environment

1.1. *Fire test of business*

A few days ago a fire broke out in one of the shopping malls located in Baku, Azerbaijan. According to local media which referenced official sources, the number of entrepreneurs who suffered financial damage due to the fire was 420.¹ According to some reports, the financial loss caused to the entrepreneurs as a result of the fire was about 200 million manats.² Although it's a heterodox approach, the fire in the shopping center can be considered as a test of the existing business environment in the country, including state and economic institutions. Because the fire accident presents a number of shortcomings in the listed areas, as well as provides practical explanations for the difficulties observed in the implementation of the reforms into the economy. It's worth taking a look at the final view of the real consequences of economic reforms before proceeding into a broader analysis of the topic. As noted above, the large-scale economic reforms carried out in the country over the past three years have been noted in a number of reports by prestigious rating agencies. For example, in the Doing Business report, prepared by the World Bank Group, Azerbaijan's position rose to 38 positions in 2016-2018. As a result, the country is ranked among the top 25 out of 190 countries. According to the "Doing Business-2019" report, Azerbaijan is competing with developed economies such as Canada, Germany and Ireland for the ease of doing business and is ahead of countries such as France, Italy and Austria.³ The organization has even included Azerbaijan in its list of top 10 countries where most reports have been carried out during the reporting period.⁴

In fact, the impact of the reforms on the real economy has not had the same effect as was illustrated in the ratings. As an example; Azerbaijan registered a 0.1% growth in 2017 and a 1.4% in 2018. The underlying cause here for the increase noted in 2018 was actually driven by a 29% increase (state budget expenditures: 2017-17.6 billion manats⁵, 2018-22.7 billion manats⁶) in state spending (state budget expenditures). On the other hand, the volume of foreign direct investment in the country's economy in 2018 dropped by 28% compared to the previous year (foreign direct investment: 2017 - \$ 5.7 billion US dollars⁷, 2018 - 4.1 billion US dollars⁸). The disturbing point is that in the corresponding period, direct

¹ RealTV, "Diqlas"ın yanması nəticəsində 420 sahibkara ziyan dəyib, 28.02.2019

<https://www.realtv.az/news/az/13570/diqlasin-yanmasi-neticesinde-420-sahibkara-ziyan-deyib>

² Milli.az, "Diqlas" yangından bir gün sonra: yeni kadrlar, 27.03.2019

<https://news.milli.az/country/741879.html>

³ World Bank Group, Doing Business-2019, baxış tarixi: 29.03.2019 səh: 5

http://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB2019-report_web-version.pdf

⁴ World Bank Group, Doing Business-2019, baxış tarixi: 29.03.2019 səh: 11

http://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB2019-report_web-version.pdf

⁵ Maliyyə Nazirliyi, 2017-ci ilin dövlət büdcəsinin icrasına (operativ) dair məlumat, 12.01.2018

<http://www.maliyye.gov.az/scripts/pdfjs/web/viewer.html?file=/uploads/static-pages/files/5aeada5decee9.pdf>

⁶ Maliyyə Nazirliyi, 2018-ci ilin dövlət büdcəsinin icrasına (operativ) dair məlumat, baxış tarixi: 29.03.2019

<http://www.maliyye.gov.az/scripts/pdfjs/web/viewer.html?file=/uploads/static-pages/files/5c46bca7b37f4.pdf>

⁷ Mərkəzi Bank, 2017-ci ilin yekunu üzrə Azərbaycan Respublikasının tədiyə balansı, baxış tarixi: 30.03.2019

<https://uploads.cbar.az/assets/7b5ceb4ec4c74e18de54a2bc7.pdf>

⁸ Mərkəzi Bank, 2018-ci ilin yekunu üzrə Azərbaycan Respublikasının tədiyə balansı, baxış tarixi: 30.03.2019

investment to the non-oil sector decreased by 15.5%. As is evident, the laws that have been adopted and the reforms implemented until now have so far not yielded the anticipated development for the economy. Naturally, the following questions arise: “What is the root of this problem?” and “Why have investors not reacted to the reforms implemented?”. In order to answer all of these questions, we will try to evaluate the current state of the business environment in practice through the following aspects within the context of the fire incident:

- *Quality of management*
- *The rule of law*
- *The availability and effectiveness of institutions*

In the following sections we will outline in more detail the above-mentioned aspects.

1.2. *Quality of management*

Factors such as the provision of only fiscal privileges (*tax burden reduction, tax deductions, transaction costs reduction*), the creation of various incentive mechanisms (*such as exports, subsidizing production, creating favorable loan mechanisms, applying a differential approach to investment zones*) and improving legislation are not sufficient for the development of a prosperous investment environment. This is because in the absence of other factors such as political stability, rule of law, government reputation, regulatory environment, synergy in the fight against corruption and monopoly, the effectiveness of various support mechanisms is unlikely to materialize. In other words, there is a direct correlation between the quality of governance and investment. While analyzing the fire incident and other similar events, it is clear that the following shortcomings observed in governance in Azerbaijan have had a negative impact on economic development:

1. *Low level of preparedness for force majeure events* – factors such as delays in the process of extinguishing fire, technical shortcomings, and non-professional behavior are all clear examples of the fact that emergency situations can not be managed by the responsible agencies. The fire that started in the area of 1 square meter covered all the commercial and catering facilities in the area of 17,000 square meters, or only 275 square meters, or 1.6 % of the commercial center could be protected.⁹
2. *Ineffective organization of the activity of state agencies* - the fire broke out in a catering institution constructed illegally near the shopping center. This institution has been operating there for 5 years but no specific steps have been taken against it. In addition, the fire protection system was not operational at the burning trade center. Although the building is considered a subject of compulsory real estate insurance in accordance with existing legislation, the relevant government agencies have ignored the activities of the center which hasn't been insured for 10 years. In other words, official agencies have not adequately reacted to the shortcomings listed above for various reasons (corruption, patronage, non-professionalism, irresponsibility).

<https://uploads.cbar.az/assets/3afb4e2dc9350ac345c37e1a4.pdf>

⁹ Report İA, “Diqlas”da 17 min kvadratmetr ərəzi yanıb, 27.03.2019

<https://report.az/multimedia/diqlas-da-17-min-kvadratmetr-erazi-yanib-fotoreportaj/>

3. *Poor organization of inter-state coordination* - The Minister of Emergency Situations said in its report to the president on this particular incident that, "although there have been appeals to the shopping center and district executive authorities since 2015, no fire safety and other security measures have been set up."¹⁰ Just this fact shows that cooperation not only between government agencies and businesses, and but also among state agencies, is at a low level, and agencies frequently attempt to avoid responsibility.

Additional note:

During most disasters in Azerbaijan (avalanche, fire, etc.), similar problems are observed in the behavior of government agencies, which can be grouped as follows:

- *Attempts by relevant agencies to avoid responsibility* - no agency assumes the responsibility for the incident.
- *Non-objective assessment of the incident* - the fair and transparent conduct of the investigation process is subjected to pressure at different levels and the presumption of innocence of the powerful is dominant.
- *Unsatisfactory performance of the judicial system and impunity* – cases of avoidance of responsibility by accountable people and non-consideration of public opinion are already institutionalized as public values

These shortcomings were seen in dozens of previous cases, such as the incident that occurred in multi-stored residential building in Baku in 2015 or at the Mingachevir hydroelectric power plant in 2018.

The main point that unites all the accidents is the inefficient response by the relevant state agencies, the level of irresponsibility, corruption and patronage. At the same time, instead of detecting and punishing accountable people, everyone involved (all accountable parties) find ways to get rid of their responsibilities.

This has led to insincerity and mistrust in state-business relations. We think that the views of Araz Rahimov, the director of the now burnt down trade center, are an adequate example for evaluating the responses of state agencies. A. Rahimov responded to the accusations of the relevant state agencies during his statement to the local press with: "If the management of Diglas Trade Center ignored the warnings (regarding the center's technical shortcomings), why would the Ministry of Emergency Situations not come and stop the operations of the center? Why would they allow us to operate?"¹¹.

The positive thing is that now the ineffectiveness of management is acknowledged at the official level. In early 2019, the President of the Republic of Azerbaijan sent a message to the public regarding structural reforms in the following manner: "Now structural reforms are expected. Because the style of governance is outdated. There should be a new governance structure - more flexible, more compact, more purposeful. But the governance system is inflated. This must be abandoned. Therefore, structural reforms, personnel reform should

¹⁰ Prezident.az, "Bakının Nizami rayonundakı ticarət mərkəzində baş vermiş yanğınla əlaqədar İlham Əliyevin sədrliyi ilə müşavirə keçirilib", 28.03.2019
<https://president.az/articles/32496>

¹¹ "Diqlas"ın direktor müavini: "FHN yanğını söndürmək əvəzinə şou göstərdi" – QALMAQAL, 03.04.2019
<https://paralel.az/article/az/98087>

be carried out"¹². We believe that the reforms carried out in this direction should be systematic and sustainable and should result in improved governance quality in Azerbaijan. One of the fundamental conditions for economic development in the country is the improvement and transparency of governance.

Conclusion:

The above-mentioned factors show that public administration has not been established in such a quality to meet the fundamental conditions (protection of rights, reduction of risks, provision of competitive environment, property protection, nepotism and fight against monopoly) of a business environment. This, in turn, has had a negative impact on the sustainable development of business in the country, weakening local and foreign investment flows to the economy, in particular, hindering the development of small and medium size enterprises (SMEs). However, the formal recognition of the problem provides more optimistic expectations in terms of improving the business environment.

1.3. The rule of law

Equality for all participants in the economy before the law is an important element of a developed business environment. The elasticity of laws and their adaptation depending on the status of different individuals have a devastating impact on the development of entrepreneurship, in particular the development of small and medium-sized businesses, by ultimately supporting the spread of negative trends such as unfair competition, monopoly, nepotism, and large-scale corruption. In an advisory report prepared by the OSCE in 2014 in order to support reforms carried out in member states it was noted that “the failure to ensure the rule of law isn’t a factor that only increases risks, it’s also a factor that increases costs associated with investments”¹³. The increase of expenses leads to the reduction of interest in economic projects and the orientation of funds to alternative markets. It was also noted that the judiciary, which is an independent, well-paid and qualitative human resource capacity, is the key to ensuring the rule of law¹⁴.

It is useful to pay attention to the already mentioned fire incident to evaluate the quality of application of the law. The facts that appear in this case include:

1. The formation of illegal business relationships:
 - *the rent contracts have not complied with the requirements of the legislation, and even some rentholders have operated without a renting agreement*¹⁵.

¹² Azertac, Prezident İlham Əliyevin sədrliyi ilə Nazirlər Kabinetinin 2018-ci ilin sosial-iqtisadi inkişafının yekunlarına və qarşıda duran vəzifələrə həsr olunan iclası keçirilib, 11.01.2019
https://azertag.az/xeber/Prezident_Ilham_Aliyevin_sedrliyi_ile_Nazirler_Kabinetinin_2018_ci_ilin_sosial_iqtisadi_inkişafinin_yekunlarına_ve_qarşıda_duran_vəzifələrə_həsr_olunan_iclası_kechirilib_YENILANIB_3_VIDEO-1232332

¹³ OSCE, Best-Practice Guide for a Positive Business and Investment Climate, səh: 25
<https://www.osce.org/eea/19768?download=true>

¹⁴ OSCE, Best-Practice Guide for a Positive Business and Investment Climate, səh: 32
<https://www.osce.org/eea/19768?download=true>

¹⁵ Həftəaz.TV, “Diqlas”da malı yanan sahibkarları günahkar çıxardı”, 27.03.2019
<http://hefteaz.info/2019/03/deputat-diqlasda-mali-yanan-sahibkarlari-gunahkar-cixardi/>

- *entrepreneurial activity has not been organized in accordance with the official accounting rules, so that entrepreneurs have avoided tax and other social obligations set out in the legislation*¹⁶,
 - *the obligation of compulsory insurance, as defined by legislation, have not been fulfilled,*
 - *the real estate involved in the entrepreneurial activity is not satisfied with the safety requirements.*
2. Inefficient organization of regulation and supervision - there are still serious shortcomings in the activities of the supervisory agencies:
- *Tax control,*
 - *control over compliance with compulsory insurance requirements,*
 - *control over the organization of entrepreneurial activities,*
 - *Supervision of the labor market,*
 - *Control of relevant requirements for the safety of real estate.*

In the case of discriminative approaches in the application of laws, doubts over upholding the rule of law emerge and, consequently, the importance of its execution loses its attractiveness. This is because the unequal enforcement of laws primarily creates a difference in costs, thus, consequently, affecting price competitiveness. Therefore, typically economic actors are interested in acting in accordance with “the rules of the game”. In other words, a domino effect in the application of laws is observed both in a scenario where the rule of law is upheld and in an opposite scenario when it isn't.

Additional note:

The weak application of existing laws in practice weakens the rule of law in the country. This, in turn, reduces the effectiveness of the government's economic instruments and the attractiveness of the business environment. The poor implementation of laws in the past years has led to the following problems:

1. *Scale of shadow economy, weak taxation and accounting system* - The majority of businessmen who suffered in the fire accident did not comply with local legislation. This has once again revealed the scale of the shadow economy in Azerbaijan along with the weak organization of tax administration. It should be noted that according to IMF estimates, the volume of the shadow economy in Azerbaijan was 43.66% in 2015 while the average figure between 1991-2015 was 52.19%¹⁷. According to the authors' calculations, the corresponding figures for Switzerland in 2015 are 6.94%, 7% in the United States, 8.32% in United Kingdom, 8.9% in Australia, 27.43% in Turkey, 24.26% in UAE, 11.18% in Slovakia, 16.67% 32.82% in Kazakhstan and 33.72% in Russia. As can be seen from the figures, there is a direct correlation between the size of the shadow economy and the development of the business environment in the country.
2. *Monopoly and weak development of SMEs* - weak implementation and flexibility of legislation has led to the strengthening of monopoly tendencies and the poor

¹⁶ BBC Azərbaycanca, İcra başçısı yanan ticarət mərkəzinin sahibkarları ilə görüşüb, 27.03.2019

<https://www.bbc.com/azeri/azerbaijan-47690204>

¹⁷ IMF working paper, Medina and Friedrich Schneider, “Shadow Economies Around the World: What Did We Learn Over the Last 20 Years?”, 2018, səh: 56

<file:///C:/Users/Pavilion%20g6/Downloads/wp1817.pdf>

development of SMEs in the country. In 2017, the value added by SMEs in the country's economy was only 5.9%¹⁸.

Table 1: Specific weight of SMEs in economy (%), Azerbaijan

Indicators	2017		
	Total	including	
		Small	Medium
Value added	5,9	4,7	1,2
- non-oil sector	9,5	7,6	1,9
Number of employed people	20,8	7,3	13,5
- non-oil sector	21,3	7,5	13,8
Investments to fixed capital	18,9	11,8	7,1
- non-oil sector	36,9	23,1	13,8
Share in product release	6,0	4,7	1,3
- non-oil sector	8,6	6,7	1,9

Source: The State Statistical Committee of the Republic of Azerbaijan, 2019

In 2016, SMEs in the economies of the OECD countries had an average share of 50-60% in GDP and 70% in employment¹⁹. As can be seen, the weight of SMEs in employment in the Azerbaijani economy is considerably lower. One of the reasons for the low share of SMEs in the economy is the size of the oil sector, however, the most important factors are the weak business environment and the shortcomings observed in the application of legislation.

An independent, non-corrupt and fair judicial system is considered to be a guarantee in the provision of the rule of law. Current conditions show that deep reform in the judicial system is needed to be carried out in Azerbaijan. It should be noted that the signing of the decree on "Deepening the reforms in the Judicial-Legal System"²⁰ and the recent approval of the "Law on Mediation"²¹ by the President of the Republic of Azerbaijan, may lead to a positive change in the rule of law and the judiciary system in the near future. In accordance with the requirements of the decree on "Deepening Reforms in the Judicial-Legal System," specialized courts will be set up with regards to economic disputes and issues related to entrepreneurial activity. The implementation of reforms in the judicial system can contribute to the development of the legal environment and, thus, can attract local and foreign investment.

¹⁸ Azstat, "Kiçik və orta sahibkarlıq subyektlərinin əsas makro-iqtisadi göstəriciləri", baxış tarixi: 04.04.2019 <https://www.stat.gov.az/source/entrepreneurship/az/002.xls>

¹⁹ OCED, Enhancing The Contributions Of SMEs In A Global And Digitalised Economy, 2017, səh: 6 <https://www.oecd.org/mcm/documents/C-MIN-2017-8-EN.pdf>

²⁰ Məhkəmə-hüquq sistemində islahatların dərinləşdirilməsi haqqında Azərbaycan Respublikası Prezidentinin Fərmanı, 03.04.2019 <https://president.az/articles/32587>

²¹ Mediasiya haqqında Azərbaycan Respublikasının Qanunu, 03.04.2019 <https://president.az/articles/32594>

Conclusion:

The analysis shows that the rule of law in Azerbaijan is not fully ensured and the shortcomings in this sector have a negative impact on the development of the business environment. It weakens the competitive environment, stimulates the shadow economy, hampers the development of small and medium-sized businesses by supporting monopolistic behaviour, and also creates serious risks for sustainable business development. However, the launch of reforms in the judiciary system gives hope that the existing shortcomings will be eliminated in the future.

1.4. Existence and effectiveness of institutions

Institutions, especially those promoting and sharing the risks, are considered to be one of the key conditions for economic development. By enhancing accessibility of services, playing the role of an appropriate infrastructure for organizing business relationships on legal platforms, creating appropriate incentives for entrepreneurial activities and entrepreneurship and providing competitive conditions, institutional development increases the favorability of the investment environment. Even though in recent years some positive steps have been taken in Azerbaijan to create new institutions and increase the effectiveness of existing institutions, there are still serious shortcomings in this area.

1. *Poor development of the insurance system* - over 400 entrepreneurs who suffered from the fire accident did not have any type of insurance. BBC Azerbaijan asked the following question "Why did not you insured?" to the entrepreneurs and their responses were that they were either "uninformed" or that "their appeals were rejected due to a lack of documents"²². It should be noted that insurance for "mobile property" in Azerbaijan is based on the principle of voluntarism. On the other hand, real estate insurance is compulsory²³ in Azerbaijan and the fact of the matter is that the burnt down trade center lacked any such insurance. Moreover, according to local media, the trade center has not had any kind of insurance for the past 10 years²⁴. This factor once again proves that even though real estate insurance is compulsory by law, in practice, this law is not enforced. One of the main stakeholders in the insurance process are in fact entrepreneurs. The incident shows that entrepreneurs did not insure their activities for various reasons. These reasons can be grouped as follows:

- Non-institutionalization of an insurance culture,
- Lack of confidence in the insurance system,
- Informal rent relationships,
- Insufficient capacity for insurance (lease agreement, tax registration, non-transparent accounting of turnover and movable property, etc.²⁵)
- Deliberate reduction of property value to avoid tax (property tax)

²² BBC Azərbaycanca, "Diqlas" yanğını: Sahibkarlar mallarını niyə sığorta etdirmir?, 26.03.2019
<https://www.bbc.com/azeri/azerbaijan-47705667>

²³ İcbari sığortalar haqqında Azərbaycan Respublikasının Qanunu, Maddə:42-49, 24.06.2011
<http://www.e-qanun.az/framework/22228>

²⁴ "Diqlas"dakı qanunsuzluqlara niyə göz yumulub? – ARAŞDIRMA, 01.04.2019
<https://oxu.az/economy/305649>

²⁵ BBC Azərbaycanca, İcra başçısı yanan ticarət mərkəzinin sahibkarları ilə görüşüb, 27.03.2019
<https://www.bbc.com/azeri/azerbaijan-47690204>

The weak development of insurance institutions caused serious financial loss for the affected entrepreneurs during the fire. Given the scale of the problem and considering the objections, the government has decided to compensate for the losses in various forms²⁶. The reimbursement of financial loss, offering alternative business opportunities for entrepreneurs, issuance of preferential loans, termination of rent expenses for a temporary period, etc. were some of the types of compensations offered by the government. Initially, 3 million manats were allocated from the state budget²⁷ and proposed potential new business ideas for the entrepreneurs²⁸.

2. *Weak insolvency system* - Another issue that has brought difficulties to the entrepreneurs who were victims of the fire incident is the fact that a well-functioning insolvency system does not exist in the country. One of the key issues that troubled entrepreneurs after the incident was the debt to suppliers and banks. Quotations from opinions voiced by entrepreneurs during the discussions with state officials were: *"I owe 40,000 manats to businesses in the Bina shopping center. How will I pay this money back?", "We have taken loans from banks. Tomorrow is the due day for the payment, how are we going to pay them back?"*²⁹

The lack of a developed insolvency system in the country narrows down the amount of solutions for the problems of entrepreneurs, which, in turn, undermines the business environment. Although the *"Law on Insolvency and Bankruptcy"* was adopted in Azerbaijan in 1994, and was then approved in a review of the law in 1997³⁰, serious problems remain with its practical implementation. Even though there are certain shortcomings in the legislation, the main obstacles that weaken its efficiency are the informal activities undertaken by entrepreneurial entities and inaccurate accounting. As a result, an entrepreneur can not present any official documents on debit/credit accounts during the appeal process for bankruptcy. This, in turn, creates difficulties for assessing the situation and for entrepreneurs when protecting their rights at courts. In particular, collaboration with wholesalers is often carried out in an informal basis, resulting in increased risks for both parties. If one looks at press releases and economic disputes in local courts, it can be seen that such disputes are widespread enough to affect the investment climate.

²⁶ Prezident.az, "Bakının Nizami rayonundakı ticarət mərkəzində baş vermiş yanğınla əlaqədar İlham Əliyevin sədrliyi ilə müşavirə keçirilib", 28.03.2019
<https://president.az/articles/32496>

²⁷ Prezident.az, Bakı şəhərinin Nizami rayonundakı ticarət mərkəzində baş vermiş yanğın nəticəsində zərər çəkmiş sahibkarlara maddi yardım göstərilməsi haqqında Azərbaycan Respublikası Prezidentinin Sərəncamı, 29.04.2019
<https://president.az/articles/32512>

²⁸ Report.az, "Diqlas" Ticarət Mərkəzindəki yanğından zərər çəkmiş sahibkarlara alternativ yer təklif olunub, 29.04.2019
<https://report.az/biznes/diqlas-ticaret-merkezindeki-yangindan-zerer-cekmis-sahibkarlara-alternativ-ter-teklif-olunub/>

²⁹ Azpolitika, "Desəm ki, dövlət sizə pul verəcək, yalan deyərəm" – İcra başçısının sahibkarlarla görüşü, 27.03.2019
<http://azpolitika.info/?p=501139>

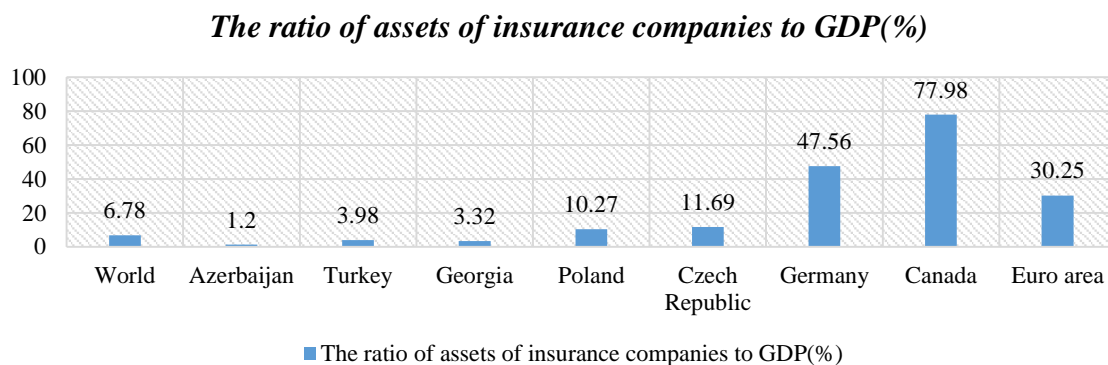
³⁰ Müflisləşmə və iflas haqqında Azərbaycan Respublikasının Qanunu, 13.06.1997
<http://www.e-qanun.az/framework/4014>

Additional note

The sustainability of the investment environment at present considerably depends on the institutional development of financial markets, including the effectiveness of insurance systems. Analysis of international experience shows that there is an opposite correlation between risk levels and investment in the economy. Regardless of origin (either domestic or foreign), investment is more attracted to economies that have developed insurance systems compared to economies who have not. The existence of an advanced insurance system is considered to be one of the most important elements of managing different types of (risks arising from financial, strategic, operational or natural events) risks, loss sharing and business sustainability.

Unfortunately, the insurance system in Azerbaijan has been poorly developed. In 2013, the ratio of assets of insurance companies to GDP in Azerbaijan was 1.2%, which is 5.5 times lower than the average world index³¹ (note: the latest data available on Azerbaijan is up to 2013) [See diagram 1].

Diagram 1: The ratio of assets of insurance companies to GDP, in percentage



Source: World Bank, 2019

In fact, it seems that the assets of insurance companies in Azerbaijan are lower even compared to Georgia – a neighbouring country in the region.

In 2018, insurance premiums in Azerbaijan amounted to 727.9 million manats³². This is 0.9% of GDP (GDP: 79797.3 million manats, 2018³³). In 2016, the Strategic Roadmap for the development of financial markets, including the insurance market, was approved. However, the implementation of the strategy has not yet made any serious progress in terms of developing the insurance market³⁴.

³¹ Data Market, Insurance company assets to GDP (%), baxış tarixi: 04.04.2019

<https://datamarket.com/data/set/28lf/insurance-company-assets-to-gdp#!ds=28lf!2rqg=h&display=line>

³² Maliyyə Bazarlarına Nəzarət Palatası, 2018-ci ilin yanvar-dekabr ayları üzrə hesablanmış sığorta haqları və sığorta ödənişləri, baxış tarixi: 03.04.2019

[https://www.fimsa.az/assets/upload/files/2018-ci%20il%20%C3%BCzr%C9%99%20%C5%9Firk%C9%99tl%C9%99r%20%C3%BCzr%C9%99%20%C3%B6d%C9%99ni%C5%9Fl%C9%99ri%20\(%C5%9Firk...xlsx](https://www.fimsa.az/assets/upload/files/2018-ci%20il%20%C3%BCzr%C9%99%20%C5%9Firk%C9%99tl%C9%99r%20%C3%BCzr%C9%99%20%C3%B6d%C9%99ni%C5%9Fl%C9%99ri%20(%C5%9Firk...xlsx)

³³ Azstat, 2018-ci ilin yanvar-dekabr aylarında ölkənin iqtisadi və sosial inkişafının makroiqtisadi göstəriciləri, 21.01.2019

<https://www.stat.gov.az/news/macroeconomy.php?page=3>

³⁴ “Azərbaycan Respublikası maliyyə xidmətlərinin inkişafına dair Strateji Yol Xəritəsi”, 06.12.2016, səh: 22 http://iqtisadiislahat.org/store/media/documents/SYX/strateji_yol_xeritesi_maliyye_xidmetlerinin_inkishafi_15122016.pdf

It should be noted that the economic significance of advanced insurance systems is perceived not only as the transfer of risks, but also as the promotion of financial intermediation. Moreover, insurance has a significant impact on ensuring financial stability and maintaining financial mobility³⁵. Such factors call for urgent change in the development of the insurance market in Azerbaijan.

Conclusion:

The weak development of an insurance system creates serious risks for business sustainability. In particular, the underperformance of the existing insurance system has had a negative impact on the sustainability of businesses through risk transfers, which increases the probability of failure and weakens entrepreneurship. Entrepreneurs who suffered during the fire could not resume their activities without state support. However, compensation for damages provided by state funds do not follow modern economic principles and cause additional problems:

- Creating a precedent for solving similar incidents in the future;
- Creating a reference point for compensation demands by victims of past similar incidents;
- A discriminative environment is established (the same approach will not apply to similar events)
- Fiscal load increases, there is a risk factor for fiscal sustainability,
- State funds are allocated to such incidents rather than being for important public domains,
- Negative impact on tax environment

The lack of an well-functioning insolvency system further hinders the development of an insurance system in the country. This is because, in such a case, the sole liability of the uninsured risks lies with the owner. Significant increases in investment or economic activity are not possible in a place where long-term forecasting does not exist and institutional sustainability is not maintained.

Final evaluation

Despite recent reforms in several areas in Azerbaijan, the business environment is lagging far behind modern standards. The evaluation of the current state of the investment environment on the backdrop of the recent fire incident revealed the following weaknesses:

1. ***The quality of public administration is low and does not meet new challenges.*** This, in turn, limits the possibilities of fair application of laws, creates a favorable environment for patronage and monopoly, and adversely affects the amount of investment by encouraging unfair competition. It also undermines the fundamentals of political governance by creating mutual mistrust in state-business relations.
2. ***The principle of rule of law is not fully respected.*** Despite the continued process of improving the legislation, the principle of the rule of law has not been properly

³⁵ Mirela Cristea, Nicu Marcu, Silviu Carstina "The relationship between insurance and economic growth in Romania compared to the main results in Europe – a theoretical and empirical analysis", baxış tarixi: 03.04.2019, səh: 227-228
<https://core.ac.uk/download/pdf/81955151.pdf>

respected. As a result, the shadow economy is widespread, and the impact of combating monopoly and corruption is weak, and there are continuing risks for ownership. Furthermore, the weaknesses of the mechanisms for implementing legislation and the lack of transparency in governance slow the transformation of the reforms into the economy.

3. *Challenges to improve existing economic institutions have been formulated.*

The weak institutional development and the ineffectiveness of the relevant structures increase the risk of a unfair makret competition. In particular, in the case of force majeure events for the economy or economic entities, the lack of institutions that reduce risks (a comprehensive insurance system, diversified funding sources, an integrated bankruptcy institution, etc.) undermines the attractiveness of making investments.

It should be noted that this article does not imply that shortcomings in the business environment in Azerbaijan are restricted to only those listed above. The macro-economic environment, security, transparency, human capital deficiency, weak development of public control mechanisms, the lack of independent media companies, an incomplete integration into the global economy, the fiscal burden, a high public sector share in the economy, etc. are all factors that can complicate the business environment.

Recommendations:

Economic reforms in Azerbaijan should be carried out in parallel with political reforms to accelerate the transformation of the ongoing reforms into the economy. There is a need for immediate action in the following areas:

1. With the aim of increasing the quality of management:

- *The fundamental principles of the division of power should be ensured;*
- *responsibility division should be deepened, concrete should be ensured and repetition should be eliminated;*
- *transparency and accountability in governance should be increased, and new, independent mechanisms for combating corruption and bribery should be created;*
- *favorable conditions for the formation of a real public oversight over the activities of state bodies should be created;*

2. With the aim of ensuring the rule of law:

- *Implementation of law enforcement mechanisms should be improved;*
- *independence of the judicial system should be increased;*
- *A legal framework to regulate conflict of interests should be improved;*
- *Specific criteria that distinguish entrepreneur and officer must be approved.*

3. With the aim of improving the risk transfer mechanisms:

- *Institutional reforms should be deepened, and particularly appropriate environment should be created for the development of institutional, regulatory and risk-sharing institutions;*
- *The appropriate conditions for the functioning and coverage of the insurance system and the insolvency mechanism should be established and the factors promoting the secret economy should be identified and eliminated.*

It should be borne in mind that each of the aforementioned directions is an essential component of the business environment, forming the overall composition. Therefore, the presence of factors that increase the risk level in any part of the value chain should be eliminated. Creating a business environment that responds to the challenges supports the sustainability of development in all aspects of the value chain by creating incentives for the economy and resource mobilization.

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