

The Next Wave of Privatization in Azerbaijan: What Kind of Environment Is Favorable for Privatization?

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In a period of economic stagnation in Azerbaijan, a discussion has been growing around the issue of privatization. Amidst the recent decline in oil prices and the weakening of the economy in most sectors due to the coronavirus pandemic, the issue of privatization of state property is on the table once again. At a meeting between the presidents of the Republic of Azerbaijan and the European Bank for Reconstruction and Development in April this year, a few issues related to privatization and commercialization were [announced](#) to the public and it became clear that Azerbaijan is preparing to transition to the commercialization and privatization of state-owned enterprises.

The share of the public sector in Azerbaijan's economy

One of the indicators of the high share of the public sector in the Azerbaijani economy is the distribution of employees by sectors. According to the [latest figures](#), there are 1.6 million employees in the country, of which 930,000 work in the public sector and 751,700 in the private sector. In other words, 55% of salaried employees in the country—almost 1 million people—receive their salaries from the state budget. Although it has been [noted](#) that three-quarters of the total employed population are in the private sector, given the fact that citizens with land share are considered employed regardless of whether they use the land or not, and taking into account other controversial [issues](#) regarding employment numbers, we can conclude that the real indicator for employees

in the public sector is higher. *Government at a Glance*, report released by the Organization for Economic Co-operation and Development (OECD), which includes 37 leading economies, shows that the average share of the public sector in total employment is about 18%. In this regard, Azerbaijan is one of the leading countries in Europe in terms of the number of public sector salaries it pays.

This fact raises certain challenges regarding the state budget. There has been a significant increase in social spending in the state budget especially in recent years. If in 2015 a total of 7 billion AZN, or 36% of total expenditures from the relevant budgets, was allocated from the state budget and the Social Protection Fund for social protections, as well as for the salaries of employees of state-funded organizations, in the 2020 state budget those expenditures are [projected](#) at 13.4 billion AZN or 44.1% of total expenditures. An interesting consequence of the rise of these types of expenditures is that, in previous years, the government could influence the stability of the financial situation by reducing these investments, because in previous years the main expenditures were for public investment, but now the main expenditures are direct payments to the population, and in a time of crisis it does not seem plausible that the government could risk reducing them.

In 2014, the share of the private sector in Azerbaijan's exports was only 6%. Although private companies' share in exports increased to 40% in 2019, this cannot be attributed simply to the growth of the private sector. If in [2014](#) the value of public sector exports was 20.4 billion USD and the value of private sector exports was 1.12 billion USD, [last year](#) these figures were 11.9 billion USD and 7.5 billion USD, respectively. The increase in the private sector's share of exports is also due to the 40% decrease in the value of public sector exports. According to the latest official [figures](#), private enterprises account for 84% of Azerbaijan's GDP, but the weight of the public sector is felt more in certain

sectors of the economy. In addition to natural monopolies, we can point to the banking and telecommunications sectors. Currently, two of the 26 banks operating in Azerbaijan are state-owned and [account](#) for 17.4% of the country's loan portfolio. According to the figures for the first quarter of this year, about 28% of bank assets in Azerbaijan belong to the International Bank of Azerbaijan (IBA) alone. The fact that Azerbaijan's major internet providers and [51.3%](#) of the largest mobile operators are owned by the state is an indicator of the state's share in the communications sector. Interestingly, in the post-devaluation period in 2016, the Minister of Finance [announced](#) the privatization of the IBA, and at the same time the *Strategic Roadmap for the Development of Telecommunications and Information Technologies in the Republic of Azerbaijan* adopted at that time provided for the privatization of agencies within the Ministry of Communications and High Technologies, but in the following years no steps were taken in this direction.

Azerbaijan on the way to privatization

Privatization is not a new concept for Azerbaijani society. Although the first steps in this direction were taken in Azerbaijan after independence in 1992, the first privatization program was launched in 1995. The program, scheduled for completion in 1998, was completed two years late, in 2000. Two-thirds of state property was privatized under the first privatization program. Under this program, the privatization of small-scale firms such as restaurants, cafes, barbershops, grocery shops, and tailors was considered mandatory, and 22,193, or 74%, of the 30,000 small state-owned enterprises and facilities envisaged in the program were privatized. About 99 percent of the privatized enterprises were [acquired](#) by labor collectives.

The second phase of the privatization of state property in Azerbaijan began in 2000. Although it had been planned to privatize medium-sized and large companies in the second

privatization program, the privatization of small companies remained a priority since it had not been completed in the first phase. The organizations and enterprises to be privatized in the privatization program were divided into three groups: small, medium, and large. The program provided for transferring 15% of small businesses to employees for free, while 85% were to be sold at check auctions. Medium-sized and large companies were first transformed into joint-stock companies and then privatized. At least 50% of the companies' shares were privatized through check auctions, 15% were offered to company employees for checks, 10% were privatized by auction for a certain amount, and the remaining 25% were transferred by the state to a closed-end investment fund. The small number and slow pace of privatization of medium-sized and large enterprises was the main criticism of this privatization program. Most experts do not consider the results of the privatization process in Azerbaijan successful. This is because the privatization failed to lead to the expected economic and social development, many enterprises that had been operating for many years were forced to close, jobs were lost, and attempts to establish sound and effective management systems in the vast majority of enterprises failed. In this regard, serious reforms are needed in Azerbaijan to ensure the success of the next privatization process.

Natural monopolies

Since it was primarily small enterprises that were privatized in previous phases of the privatization process, it is expected that the new wave of privatization will cover large state-owned enterprises. In this regard, one of the issues that has caused controversy is enterprises that are considered natural monopolies and are engaged in the provision of public utilities. According to the [Law on Natural Monopolies](#), a *natural monopoly* is a state of the commodity market that is more efficient in meeting demand in the absence of competition due to the technological characteristics of production and cannot be replaced by other commodities in the consumption of

commodities produced (sold) by monopolies. They are only those sectors where specially licensed state-owned enterprises operate and there is no competitive environment. According to the law, services such as the transmission and distribution of electricity and heat, heat supply, the water supply network, and the distribution of natural gas are included in the activities of natural monopolies.

But are the activities of natural monopolies operating in this sector economically efficient? According to the latest financial [reports](#) of these enterprises, the accumulated losses of Azerenergy OJSC amounted to 2.3 billion AZN, the losses of Azersu OJSC were 6.4 billion AZN, the losses of Azerishig OJSC were 330 million AZN, and the losses of Azeristiliktechizat OJSC were 68 million AZN. Along with the support these agencies receive from the state budget, the economic efficiency of their activities cannot be ensured through the regular increase of service fees. The activity of these enterprises is also one of the main factors influencing the growth of public debt. Although the government announced last year that public debt was 17.2% of GDP, this figure is not unequivocally [accepted](#) by economists, as this figure does not include state-guaranteed funds obtained by state-owned companies. The ratio of public debt to GDP, including state-guaranteed loans taken by state-owned companies, is about 40%. Although it is not a critical situation when public debt payments account for about 10% of the state budget, it is a significant figure. From this point of view, the privatization of public utilities could lead to positive changes both in terms of freeing the state budget from this burden and benefiting the population from the competitive environment. The entry of several private players into the market in these areas will affect not only economic issues, but also the quality of services provided. Considering the inefficient distribution of consumer groups, the need to improve the fee system and existing standards, the lack of incentives, gaps in the accounting system, the lack of modern technology, low

productivity, and future debt obligations, it is important to privatize such enterprises.

What kind of environment is favorable for privatization?

To ensure the effectiveness of the privatization process, we must first emphasize the need to ensure transparency and participation. From this point of view, one of the main obstacles in Azerbaijan is the entrepreneurship of state officials and the resulting monopolization. The first privatization process created the conditions for rising property inequality in Azerbaijan because that privatization did not uphold these principles. It is very important to ensure transparency and participation so that we do not face the same situation again. One important step that must be taken is that officials' income declarations should be made public. Azerbaijan is one of the [few countries](#) in the world where income is not declared. Although the Law on Income Declaration was proposed in 2005, the adoption of the law has been postponed for 15 years. However, the adoption of the law could serve to increase Azerbaijan's economic transparency.

Beneficiary ownership is another area of activity that needs to be implemented in the country in order to increase economic transparency. Beneficiary ownership is when one or more persons are the actual or indirect owners of a company or have the ability to control the formal owners of the company, and directly or indirectly benefit from the financial and non-financial assets of that company. The disclosure of beneficial ownership data provides additional opportunities for governments to effectively combat tax evasion, corruption, and money laundering. Amendments passed in the 2016 referendum restricting access to information about property owners and beneficiaries of state-owned companies made it even more difficult to access such information. Therefore, for a favorable privatization environment in the country, there is a need for amendments that will allow the disclosure of beneficial ownership data.

Another bill that has the potential to have a positive impact on the issue and whose adoption has been delayed for a long time is the Competition Code. The adoption of the Competition Code is very important for the development of entrepreneurship in Azerbaijan, the elimination of monopolies, and the attraction of foreign and domestic investment in the economy. Although the Competition Code was submitted to the Milli Majlis 14 years ago, and during that time there were different convocations of parliament, the code has still not been adopted. The adoption of the Competition Code will primarily help reduce monopolies. Of course, the adoption of the Competition Code would not be enough to resolve these issues entirely, but the adoption of the code would encourage companies with a larger market share to act in accordance with the rules of competition, pricing, and market policies.

As part of the privatization process, it is very important to encourage foreign investors to invest in the country in order to ensure economic recovery. At present, in the context of the globalization of the world economy, competition between developing countries to attract foreign investors is growing. In this regard, it is necessary to take certain steps to stimulate the process of attracting foreign capital and investors to Azerbaijan and to create a favorable investment climate. Analyses conducted in Azerbaijan and the country's position in international rankings [show](#) that, in order to attract foreign investors to the privatization process in Azerbaijan, serious reforms are in order, such as increasing the transparency and accountability of public administration and eliminating corruption, ensuring the protection of property rights, building an independent and fair judiciary, improving the legal and regulatory environment (ensuring the rule of law, ensuring equality before the law, making the behavior of government agencies predictable, abandoning the practice of making government decisions that affect business costs and revenues without public discussion, ensuring that such changes take effect at least 6 months after adoption,

etc.), and without ensuring these things, it will be impossible to attract foreign investors to Azerbaijan.

The abovementioned problems and the existence of a closed market also hinder the development of the securities market in Azerbaijan. Although Azerbaijan formally has a stock exchange, this important tool of liberal market relations does not play a significant role in the country's economy. From this point of view, the development of the securities market in Azerbaijan is a step that must be taken in a favorable privatization environment. At the same time, in addition to all these institutional steps, certain tax and customs exemptions for investors may be considered to ensure interest in the privatization process.

Considering that it is one of the main factors influencing the growth of public debt of state-owned companies in Azerbaijan, considering the allocation of serious state funds to such enterprises in the context of declining state budget revenues, and considering the opportunities to attract investment to Azerbaijan through privatization, as well as the competitive environment that will result from privatization, we can say that there is a need for a new privatization program in Azerbaijan. However, in order for this process to contribute to the solution of the above-mentioned issues, a favorable investment climate must be created and the necessary reforms must be implemented. Otherwise, the privatization program, which will begin without creating a favorable privatization environment—without ensuring transparency and participation—will be remembered as another missed opportunity.