2. SMEs in Azerbaijan

The aim of this chapter is to present information on the size and the economic dimension of the micro, small and medium sized sector in Azerbaijan. This is required in order to understand its development dynamics, impact on the economy and the reflection of the current problems burdening the sector on their operations.

As the country’s economy has grown in recent years, mainly as a result of its burgeoning oil industry, the number of small and medium enterprises (SMEs) has also grown. However, the growth in SMEs does not reflect the contribution of this entrepreneurial sector to the GDP. The growth of the oil sector results in the growth of the non-oil sector almost as ‘free-riders’ in the general economic boom. The recent trends yet indicate a slower growth of the non-oil sector, i.e. its shrinking compared to the oil industry in proportional terms.

Micro and small and medium sized entrepreneurship in Azerbaijan is divided into two groups: individual entrepreneurs (i.e. sole owners of the enterprise without forming a legal entity); and small and medium enterprises (i.e. legal entities). All individual entrepreneurs are legally considered small enterprises by default, whereas those registered as legal entities are classified according to two indicators: number of employees and annual turnover.
The increase in the SME sector reflects its growing importance to the country’s economy. This is clearly demonstrated in the expanding number of registered entities, but even more so the increasing number of employees, either hired or formally registered. Nevertheless, approximately 90 percent of all the labor force within the entrepreneurship community is employed by IEs.

Table 2.1 Number of employees of IEs and SMEs

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No of subjects</td>
<td>Total No of employees</td>
<td>No of subjects</td>
</tr>
<tr>
<td>Small Enterprises (legal entities)</td>
<td>17,028</td>
<td>68,565</td>
<td>11,982</td>
</tr>
<tr>
<td>Individual Entrepreneurs</td>
<td>144,406</td>
<td>292,654*</td>
<td>166,558</td>
</tr>
<tr>
<td>Total</td>
<td>161,434</td>
<td>361,218</td>
<td>178,540</td>
</tr>
</tbody>
</table>

* Official sources do not contain information on the average number of employees working for individual entrepreneurs (IE). This calculation was done based upon the empirical evidence, using the formula: 
(Average number of employees per small enterprise – 2) x number IE = Total number of employees working for individual entrepreneurs.

According to the State Committee for Statistics’ data and some calculations based upon these indicators, the role of SMEs in the country’s economy is growing, particularly in its contribution to the private sector.
Meanwhile, the number of small and medium enterprises (SME) per 1,000 residents shows that there is potential for the sector to grow even more, providing a significant contribution to the GDP and enterprise growth.

### 2.1 Individual entrepreneurs

The individual entrepreneur is an individual person (sole owner), who is involved in entrepreneurial activity without forming a legal entity and has unlimited liability.

Individual entrepreneurs represent the majority of the SME sector, as far as the number of enterprises and the number of employed are concerned. According to the State Committee for Statistics’ data, 93 percent of the local entrepreneurs are registered as individual entrepreneurs.

As indicated in the survey, it is simpler for entrepreneurs to operate in the formal economy as individual entrepreneurs for a number of reasons:

1) The registration process is simpler for the individual entrepreneurs than for legal entities;

2) The expenses for the registration process, license and permits are much lower for individual entrepreneurs;

3) In businessmen’s opinion, individual entrepreneurs are more often checked by the local or regional branches of the inspection services compared to SMEs, since the headquarters of ministries and agencies do not have a list of registered IEs. Legal entities must register with ministries and agencies’ headquarters; therefore, they are checked by these government structures, with whom it is not always easy to come to reach an informal settlement.

In 2007, one in four entrepreneurs on average invested in fixed assets of his enterprise using mainly internal sources of financing (personal savings/family capital). The low investment level can be partially explained by the limited access to external financing sources (see chapter Access to finance), as well as by insufficient confidence in the business environment.

As the country’s overall economy grows, this corresponds to an increase in income for entrepreneurs. If the growing income on the one side increases consumer income, then on the other side it creates the financial foundation for the development of individual and small-scale entrepreneurship, which, in turn, should cover the growing consumer’s needs. Thus, during the 2004-2006 period (according to official data from the State Statistics Committee), the number of individual entrepreneurs grew significantly (the aggregate average annual growth was, on average, 6 percent), and at the beginning of 2006, there were about 171,000 IEs.

Individual entrepreneurs represent the largest category of SMEs in the country, as far as the quantity and share of income are concerned.
The economic opportunities in Baku, employment shortages in some regions, and low profitability in agriculture create seasonal employment and migration. According to official data, the population of Baku is slightly more than two million people, but this figure does not include people formally registered in other places in the country, yet living in the capital. Some experts believe that a more realistic figure of Baku’s population is twice the official indicator, or four million. Hence Baku, followed by Sumgayit and Ganja, remain the most populated cities in the country. The proportions of individual entrepreneurs and SMEs favor the three most populated cities of the country; the total number of individual entrepreneurs in Baku, Sumgayit, and Ganja equals 42 percent of the whole country. These entrepreneurs work mainly in the consumer market, i.e. the dominating share is employed either in the trade area, or in the services area.

Individual entrepreneurs are predominantly involved in activities requiring minimal investments and giving quick income, especially trade. Only a small number of individual entrepreneurs are involved in manufacturing, requiring high initial investments, which bring income after a relatively long period of time. Individual entrepreneurs hire on average three employees on either full or part-time basis, paying them an average monthly salary of $185.

Table 2.2 Statistical information on IE activity

<table>
<thead>
<tr>
<th>Average annual turnover</th>
<th>AZN 42,000</th>
<th>$51,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average profit</td>
<td>AZN 10,450</td>
<td>$13,000</td>
</tr>
<tr>
<td>Employees number</td>
<td>3 people (full and part-time)</td>
<td></td>
</tr>
<tr>
<td>Average monthly salary</td>
<td>AZN 150</td>
<td>$185</td>
</tr>
</tbody>
</table>

The economic opportunities in Baku, employment shortages in some regions, and low profitability in agriculture create seasonal employment and migration. According to official data, the population of Baku is slightly more than two million people, but this figure does not include people formally registered in other places in the country, yet living in the capital. Some experts believe that a more realistic figure of Baku’s population is twice the official indicator, or four million. Hence Baku, followed by Sumgayit and Ganja, remain the most populated cities in the country. The proportions of individual entrepreneurs and SMEs favor the three most populated cities of the country; the total number of individual entrepreneurs in Baku, Sumgayit, and Ganja equals 42 percent of the whole country. These entrepreneurs work mainly in the consumer market, i.e. the dominating share is employed either in the trade area, or in the services area.

Table 2.2 Statistical information on IE activity

<table>
<thead>
<tr>
<th>Average annual turnover</th>
<th>AZN 42,000</th>
<th>$51,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average profit</td>
<td>AZN 10,450</td>
<td>$13,000</td>
</tr>
<tr>
<td>Employees number</td>
<td>3 people (full and part-time)</td>
<td></td>
</tr>
<tr>
<td>Average monthly salary</td>
<td>AZN 150</td>
<td>$185</td>
</tr>
</tbody>
</table>

The economic opportunities in Baku, employment shortages in some regions, and low profitability in agriculture create seasonal employment and migration. According to official data, the population of Baku is slightly more than two million people, but this figure does not include people formally registered in other places in the country, yet living in the capital. Some experts believe that a more realistic figure of Baku’s population is twice the official indicator, or four million. Hence Baku, followed by Sumgayit and Ganja, remain the most populated cities in the country. The proportions of individual entrepreneurs and SMEs favor the three most populated cities of the country; the total number of individual entrepreneurs in Baku, Sumgayit, and Ganja equals 42 percent of the whole country. These entrepreneurs work mainly in the consumer market, i.e. the dominating share is employed either in the trade area, or in the services area.

Table 2.2 Statistical information on IE activity

<table>
<thead>
<tr>
<th>Average annual turnover</th>
<th>AZN 42,000</th>
<th>$51,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average profit</td>
<td>AZN 10,450</td>
<td>$13,000</td>
</tr>
<tr>
<td>Employees number</td>
<td>3 people (full and part-time)</td>
<td></td>
</tr>
<tr>
<td>Average monthly salary</td>
<td>AZN 150</td>
<td>$185</td>
</tr>
</tbody>
</table>
2.2 Small enterprises

A small enterprise is a private legal entity meeting the requirements of the Cabinet Council Decree on Criteria for defining SMEs.

By the beginning of 2006, there were about 12,000 small enterprises registered in the country, which corresponds to 6.6 percent of the whole SME sector. The annual growth indicator from 2005 to 2006 was 2 percent. This indicator is lower than the corresponding growth of the sector, reflecting the small number of entrepreneurs that opt to become more structured by registering their business as a legal entity.

As in the case with individual entrepreneurs, smaller firms are mainly located in large cities. Thus, the total number of small enterprises in Baku, Sumgayit, and Ganja equals 56 percent of the total number in the country. (Sumgat is included in the Aran region, Ganja is included in the Ganja-Gazakh region).
The “typical” small enterprise has the following characteristics:

<table>
<thead>
<tr>
<th>Table 2.3 Statistical information on SME activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average annual turnover</td>
</tr>
<tr>
<td>Average profit</td>
</tr>
<tr>
<td>Employees number</td>
</tr>
<tr>
<td>Average monthly salary</td>
</tr>
</tbody>
</table>

Unlike individual entrepreneurs, legal entities are involved in a much greater variety of economic sectors. Thus, if 69 percent of individual entrepreneurs are involved in trade, then, among legal entities only 28 percent are in trade.

2.3 Main source of investments: own funds

One important indicator for measuring the growth of the SME sector is the level and the source of the investments made by entrepreneurs into their businesses. Research shows that local entrepreneurs seldom make capital investments in expanding their business. Thus, in 2007, only 28 percent of entrepreneurs invested in their enterprises.

A large portion of these investments are financed from the entrepreneurs’ personal money. Only a small number of entrepreneurs apply for external financing with the purpose of receiving financial support for investments. The chapter on Access to finance elaborates on the reasons for the low level of commercial funding and provides recommendations on overcoming the current limitations.

In the entrepreneurs’ opinion, the stable growth in income, the potential for market development, as well as their business experience allows them to achieve satisfactory turnover. However, as seen in the course of focus group discussions, a significant part of their profit is spent on rent.

The number of entrepreneurs in Baku that lease some premises for their business activity equals more than half, while in the regions only 26 percent of entrepreneurs rent their commercial premises.
According to the entrepreneurs’ own views expressed through in-depth interviews, in the capital, where about 60 percent of the enterprises are located on the leased premises, prices for the lease accounts for 30 to 40 percent of the enterprises’ profits. Closer to the capital’s center and on the active streets of the city, locations with direct exit to the street are leased for different types of activity, and change tenants sometimes several times a year. This is explained by the fact that the enterprises’ profit and their income are frequently insufficient to cover the high rental rates. Accordingly, the entrepreneurs who manage to cover the high expenses of the rental rates, as a rule are forced to shift their investment needs to a lower priority.

2.4 State subsidies for SME development

The Government of Azerbaijan provides three different plans for SME support. The largest of them is the Azerbaijani Investment Company (AIC) that invests in companies by taking equity stakes of at least $1 million, providing venture capital. The National Entrepreneurship Fund (NEF) provides highly subsidized loans (up to $3.2 million in value) to SMEs. Finally, the Mortgage Fund also provides highly subsidized loans for a special purpose. All three funds rely heavily on the state oil revenues and issue debt at below market rates.

According to the Ministry of Economic Development data, in 2007 NEF allocated more than $112 million in the form of such subsidized loans aimed supporting local entrepreneurship. These credit lines were allocated to 882 small businesses in 56 cities and regions of the country. The interest of the entrepreneurs in receiving subsidized loans increases the demand for the fund’s activity, which in turn called for a greater allocation of public funds for the purpose. Thus, during the first half of the year, the fund allocated an additional $66.5 million to entrepreneurs for subsidized loans. The system of resource allocation and the details of the beneficiaries, including how the subsidies were spent, remain largely non-transparent.

---

According to the IFC survey, more than half of the entrepreneurs face the problem of access to finance, i.e. insufficiency of financial resources to grow their businesses. The number of enterprises that received loans from the designated fund amounts to only 1 percent of those who faced difficulties in access to finance. Moreover, the average loan size, according to the fund’s 2007 report, is $127,000. The figure suggests that the loans were not distributed to the smaller enterprises and individual entrepreneurs, but in fact to larger companies, whose turnover and profit margins allow for larger scale borrowing. Given the IFC survey data, the average loan size from NEF more than triples IE’s annual turnover (which stands at $42,000) and is about the half of the annual turnover of SMEs ($250,000).

2.5 Legal environment and SME confidence

2.5.1 Legal unpredictability – higher cost of compliance

Over the last decade, Azerbaijani legislation has undergone substantial improvement and systematization through the enactment of new laws in line with best international practices, the introduction of numerous amendments to the existing laws, and the abrogation of dysfunctional and obsolete laws. As a result of these reforms, Azerbaijan was named the top reformer for 2007-2008 in Doing Business 2009.

Among many others, the Tax Code has been amended 19 times since it came into effect on January 1, 2001 and 30 amendments have been made to the Civil Code since it became effective on September 1, 2000. Considerable amendments were made to the law on State Registration and State Register of Legal Entities in connection with the introduction of a one-stop-shop system in the registration of commercial legal entities. Relevant changes were made to the Tax Code as well. Among the more notable improvements in the legislation was the adoption of Presidential Decree No. 782 on Improvement of Rules of Issuance of Special Permits (Licenses) for Certain Types of Activities dated September 2, 2002. These rules unified the licensing issuance rules for all types of licenses, approved the list of activities subject to licensing, determined the amounts of state duties for the issuance of licenses, and designated the license issuing authorities and the authority supervising the license issuance process. Also the law on Mortgage adopted April 15, 2005, broadened the mortgage market by providing the necessary legislation that was lacking before.

Such legislative volatility, while intended to improve the business environment in practice, also has negative effects on businesses, especially individual entrepreneurs and SMEs, who are less able to stay abreast of frequent legislative changes.

The complexity of the laws and legislative instability, coupled with the insufficient means for dissemination of laws, contributes to a poor legal awareness of entrepreneurs. In Azerbaijan, new legislative acts are published in two official newspapers and three official publications depending on the type of legislative act. However, no authority is officially responsible for the effective dissemination of information about new legislative acts. Nor are they published online, or if published, are usually not up-to-date, and again, no authority is officially in charge of the publication of laws online. To keep track of legislative developments, an entrepreneur needs to subscribe to official newspapers and
publications and constantly follow-up with the publishers in order not to miss publications, since delays in publishing are not unusual. In fact, at times even having the texts of laws available may not be sufficient, as understanding the impact of new legislation may, more often than not, require legal expertise. Although entrepreneurs may file inquiries with the state authorities to obtain official explanations with regard to legislative matters, the procedures for processing such inquiries are too complicated and time consuming⁶ to be efficiently used in the fast-moving business world.

Box 2.2 The role played by MED in the support of entrepreneurship

The Department of Entrepreneurial Development Policy has played a positive role in the improvement of the business environment in Azerbaijan.


It has drafted the Presidential Decree on Measures for the Development of Entrepreneurship signed by the President on April 30, 2007, which envisaged improvement of the business environment, especially business establishment and registration procedures, and collaborated with the WB and IFC in the implementation of a one-stop-shop principle in corporate registrations.

View from an entrepreneur:

“I am running a small business and I don’t have sufficient legal expertise and time to follow the changes made to the laws, nor can I afford a lawyer to advise me on these. Therefore, most of the time I find out that I am cheated by officials. My opinion is that if these changes are necessary, then the government must provide free and comprehensive consultation to businesses on these changes.”

2.5.2 Institutional development of entrepreneurship

The existence of a central state agency that advocates for entrepreneurship and supports policy changes is important for developing and strengthening the business environment. In Azerbaijan, the authority in charge of this function is the Ministry of Economic Development, namely its Department of Entrepreneurial Development Policy. The department is responsible for the preparation and implementation of state programs for the development of entrepreneurship, the provision of financial and non-financial support to entrepreneurs, and the development of regulation policies concerning entrepreneurial activities.

⁶ Under the law on Obtaining Information, dated September 30, 2005, state officials are accorded seven days to process an inquiry, with the right to extend the deadline in cases where an authority is deluged with a large number of applications, there is need for further research, or additional documents need to be obtained. This, in terms of timely processing, works against the inquirer.
2.5.3 Legal disputes

Most entrepreneurs tend to avoid courts in the settlement of economic disputes. Such a tendency is related to the mistrust towards courts in general formed over the years. Also the following observations may explain the low level of court applications: influential businessmen/officials are said to receive decisions in their favor; the procedures are non-transparent, allowing for unofficial payments during the process; the process can become very lengthy, and therefore unacceptable for dynamic entrepreneurship; the process can become very costly, so entrepreneurs risk going through the entire process and losing more money in the long run.

2.5.4 Expectations of entrepreneurs

More than half of entrepreneurs viewed 2007 as more favorable for conducting business compared to the previous year.

However, one-third of entrepreneurs still see potential for improvement.
Despite the fact that entrepreneurs evaluate the situation around the business environment as changing in a positive sense, at the same time half of them do not agree with such statements, as:

1) The local authorities clearly and steadily obey all laws and standards of the central government body;

2) The local authorities assist in business development by providing equal conditions for conducting business;

3) Government representatives interpret the laws and standard acts and regulate business activity, in an adequate and predictable manner;

4) The business environment in my city contributes to the development of investment and business;

5) The business environment in my city is better than in other regions of the country.

There is little differentiation between how entrepreneurs in the regions and in the capital evaluate the business environment.

The SME sector analysis, as well as the focus groups with entrepreneurs, showed that the business environment in Azerbaijan has been developing rapidly, but there are some common problems in administrative procedure. The scope and frequency of inspections, and the high requirements for permits, licenses, and mandatory certification are the most complex administrative procedures hindering the development of local entrepreneurship. These administrative barriers, coupled with the difficulties in obtaining external financing, high rental payments and the inadequacy of infrastructure all negatively impact the growth of the SME sector.

The procedures, to which many entrepreneurs are subject, will be covered in further separate chapters. The analysis of the related processes reveals the problems entrepreneurs face and also helps to make recommendations for eliminating superfluous barriers and obstacles to develop entrepreneurship.