

THE EFFECT OF FOREIGN DIRECT INVESTMENT ON AZERBAIJAN'S NON-OIL GDP

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ABSTRACT

This paper examines the effect of foreign direct investment (FDI) on Azerbaijan's non-oil GDP. Azerbaijan's economy has long been dependent on its oil sector and diversifying the economy has become a priority for the government. FDI is seen as a potential source of investment that can help diversify the economy and promote growth in non-oil sectors. This study aims to investigate the relationship between FDI and non-oil GDP in Azerbaijan and to provide insights into the factors that influence the success of FDI in promoting economic growth. The study uses a quantitative research method, and the data is collected from the World Bank and the Central Bank of Azerbaijan. The results of the study suggest that FDI has a positive effect on Azerbaijan's non-oil GDP, particularly in the manufacturing and services sectors. However, the study also highlights the challenges that FDI faces in Azerbaijan, including the lack of infrastructure, bureaucratic barriers, and political instability. The findings of this study have important implications for policymakers in Azerbaijan, as well as for investors who are considering investing in the country.

Keywords: foreign direct investment, diversifying the economy, non-oil sectors, gross domestic products, Azerbaijan economy.

JEL Classification: F21, F23, O16

THEORETICAL ASPECT OF FOREIGN DIRECT INVESTMENT

Foreign direct investment (FDI) refers to the investment made by an individual, company or entity in one country (the "investor") into a business or enterprise in another country (the "host country"). (Dunning & Lundan, 2008). FDI involves a direct ownership interest in the business or enterprise in the host country, with the investor having control or influence over the management and operations of the foreign enterprise. FDI can take several forms, including establishing new subsidiaries or branches, acquiring existing enterprises, or creating joint ventures with local firms.

The investor may also transfer technology, expertise, and other resources to the foreign enterprise, with the aim of increasing its competitiveness and generating profits. FDI is often seen as a way to expand business opportunities and access new markets and can be beneficial for both the investor and the host country, as it can promote economic growth, job creation, and technological development.

The Benefits And Potential Drawbacks of Foreign Direct Investment For Developing Countries

FDI can bring several benefits to developing countries, but it can also have some potential drawbacks. Here are some of the benefits and potential drawbacks of FDI for developing countries: (Loungani & Razin, 2001)

Benefits:

- **Job Creation:** FDI can lead to the creation of new jobs in the host country. This can help reduce unemployment and poverty, which are significant challenges in many developing countries.
- **Technology Transfer:** FDI can bring new technologies, production processes, and management practices to the host country. The technologies that are transferred to developing countries in connection with foreign direct investment tend to be more modern, and environmentally “cleaner”, than what is locally available. (The Organisation for Economic Co-operation and Development, 2002). This can help improve productivity and efficiency in local industries, which can contribute to economic growth.
- **Access to Capital:** FDI can provide developing countries with access to external sources of capital, which can be used to finance investment in infrastructure, education, and other areas that are important for economic development.
- **Market Access:** FDI can help developing countries access new markets, both domestic and international, which can help promote exports and economic growth. (Fugazza & Trentini, 2014)
- **Knowledge Transfer:** FDI can also bring new knowledge and skills to the host country, which can contribute to human capital development and enhance the local workforce.

Potential drawbacks:

- **Dependency:** FDI can create a dependency on foreign capital and technology, which can make developing countries vulnerable to external shocks and fluctuations in global capital markets.

- **Crowding out domestic investment:** FDI may also crowd out domestic investment, as local firms may find it difficult to compete with foreign firms that have access to more resources and better technology. (Jude, 2015).
- **Repatriation of Profits:** Foreign firms may repatriate profits earned in the host country, which can lead to capital outflows and reduce the availability of resources for domestic investment.
- **Environmental Degradation:** FDI can also have negative environmental impacts, such as pollution and resource depletion if it is not managed carefully.
- **Political Risk:** FDI can be sensitive to political risks, such as changes in government policy, which can create uncertainty for investors and reduce the attractiveness of the host country as an investment destination.

Overall, FDI can bring significant benefits to developing countries, but policymakers need to be mindful of the potential drawbacks and take steps to manage the risks associated with foreign investment.

The Challenges of Foreign Direct Investment in Developing Countries

FDI can bring various benefits to developing countries, such as increased employment opportunities, technology transfer, and access to new markets. The challenge for developing countries is to develop a well-calibrated and, preferably, unique combination of factors determining FDI location and to match those determinants with corporations' strategies. (Mallampally & Sauvart, 1999). However, attracting and benefiting from FDI can be challenging for developing countries due to a variety of reasons. Here are some of the main challenges:

Political instability and security risks: Developing countries that experience political instability and conflict can deter foreign investors. Investors may be hesitant to invest in a country where there is a risk of political turmoil or violence. Political instability can lead to a lack of policy consistency, changing regulations, and unpredictability, which can create a hostile business environment. (Erkekoglu & Kilicarslan, 2016).

Poor infrastructure: Infrastructure is a critical factor in attracting foreign investment. A lack of infrastructure, such as transportation, energy, and communication networks, can make it difficult for investors to operate efficiently. Poor infrastructure can lead to higher costs and delays, affecting productivity and profitability.

Limited access to finance: Limited access to finance is a significant challenge for many developing countries. Investors require access to financing to expand their operations, invest in new technologies, and manage risks. Developing countries with limited financial markets and weak regulatory frameworks may face difficulties in accessing the necessary funds. (OECD,2002).

Weak legal and regulatory frameworks: Investors need a stable legal and regulatory environment to operate efficiently. A weak legal and regulatory framework can create uncertainty and unpredictability, which can deter foreign investors. A stable and predictable legal and regulatory framework is crucial in attracting FDI and ensuring investor confidence. (Perry, 2000).

Lack of transparency and accountability: A lack of transparency and accountability in government institutions can lead to corruption, which can deter foreign investors. The higher in risk and uncertainty stemming from the presence of bribery and corruption, unstable economic policies, weak and poorly enforced property rights, and inefficient government institutions. (Drabek, 2002). Investors need to have confidence that their investments are safe and that they will receive a fair return. Transparency and accountability are crucial in creating a favorable investment environment.

In summary, developing countries face a range of challenges in attracting and benefiting from FDI. Addressing these challenges requires concerted efforts from governments, investors, and other stakeholders to create an enabling environment for FDI and maximize its benefits. For this purpose, it is important to implement the below strategies.

Strengthen institutional and regulatory frameworks: This strategy involves improving government institutions' and regulations' quality and effectiveness to create a stable and predictable business environment for foreign investors. This could include measures such as improving the rule of law, protecting property rights, and promoting transparency and accountability in government. (Mehtiyev, 2018).

Enhance political stability: This strategy reduces political risk and creates an investment-friendly environment. This could include measures such as reducing corruption, promoting good governance, and resolving conflicts. Countries can also work to improve the social and economic conditions of their citizens, which can help to reduce tensions and promote political stability.

Expand access to finance: This strategy involves expanding access to finance, which can help to attract foreign investors and increase investment in the country. Countries can work to improve their financial systems and reduce lending rates to make it easier for businesses to access credit.

Develop human capital and skills: This strategy involves investing in education and training programs to develop the skills and capabilities of the local workforce. This can help to attract and retain foreign investors who require a skilled workforce. Countries can work to improve their education systems, establish vocational training programs, and provide incentives for businesses to invest in training and development programs. (Michie, 2001).

In conclusion, the challenges of foreign direct investment in developing countries are significant and multifaceted. Political instability, poor infrastructure, lack of skilled labor, corruption, and cultural differences are just some of the obstacles that foreign investors may face when trying to establish a presence in these countries. However, despite these challenges, foreign direct investment remains an important source of economic growth and development for many developing countries.

CURRENT SITUATION OF FOREIGN DIRECT INVESTMENTS IN AZERBAIJAN

For Azerbaijan, attracting foreign direct investment is more crucial than ever. The growth of the non-oil sector and the diversification of the economy have taken on even more importance in light of the current state of global uncertainty. On the other hand, despite high oil prices, oil output has decreased recently, and despite this, the country's revenue from energy sales is lower than it was before to 2014. Taking into account the post-pandemic environment, 2021 was considered comparatively challenging in terms of FDI flow. Regional instability as a result of the post-war period also played a significant role in the assessment. (Center for Economic and Social Development, 2022). For a deep understanding of the current situation of FDI flows in Azerbaijan and its effect on the Azerbaijan GDP, it is important to make a SWOT analysis of the current FDI condition.

Strengths:

- Azerbaijan has a strategic location between Europe and Asia, making it an attractive destination for FDI.
- The country has abundant natural resources, including oil and gas, which has led to the development of a strong energy sector.
- The government has implemented several reforms to improve the business environment, including simplifying procedures for starting a business and reducing bureaucracy.
- Azerbaijan offers a favorable tax regime for foreign investors, including exemptions and reductions on corporate income, property, and land taxes for up to seven years.

Weaknesses:

- Despite its efforts to diversify its economy, Azerbaijan is still heavily reliant on the energy sector, which makes it vulnerable to fluctuations in global oil and gas prices.
- The country's infrastructure is still developing, particularly in the regions outside of the capital city of Baku, which can pose challenges for investors.
- Corruption and lack of transparency can still be a concern for foreign investors.
- The country has a relatively small market size compared to other countries in the region.

Opportunities:

- Azerbaijan is investing in non-oil sectors, such as tourism, agriculture, and technology, which can provide opportunities for foreign investors.
- The government is working to improve the education system and increase the number of skilled workers, which can benefit foreign investors looking to establish operations in the country.
- Azerbaijan has established trade agreements with several countries in the region, including Turkey and Russia, which can provide access to larger markets.

Threats:

- The global economic uncertainty and political instability in the region can impact the FDI inflows into the country.
- The government's reliance on the energy sector can pose challenges to diversification efforts and economic development.
- The ongoing conflict with Armenia over Nagorno-Karabakh can create geopolitical risks for foreign investors in the region.

Azerbaijan offers several strengths for foreign investors, such as its strategic location, abundant natural resources, and favorable tax regime. However, the country's heavy reliance on the energy sector and infrastructure development outside of Baku are weaknesses that need to be addressed. The government's efforts to invest in non-oil sectors, improve education and increase the number of skilled workers, and establish trade agreements with other countries provide opportunities for foreign investors. However, global economic uncertainty and political instability in the region, the ongoing conflict with Armenia over Nagorno-Karabakh, corruption and lack of transparency remain threats that need to be considered. Overall, Azerbaijan has potential for FDI, but continued efforts to diversify the economy, address weaknesses, and mitigate threats are necessary for sustained growth and development.

How Azerbaijan's Tax and Regulatory System Affects Attractiveness the of Foreign Direct Investment

Foreign Direct Investment plays a crucial role in the economic development of countries, providing access to capital, technology, and management expertise. However, the attractiveness of a country as an investment destination depends on various factors, including taxes and regulations. In recent years the government stimulated the flow of new investments into the country by making fundamental changes in a number of legislative acts and also in the tax legislation in the direction of increasing foreign direct investments in the non-oil sector.

The government accepted the law which is aimed to attract and efficient use of foreign material and financial resources in the economy, modern foreign equipment and technology, and managerial experience and guarantees the protection of rights of foreign investors. (Law of the Azerbaijan Republic About Protection of Foreign Investments, 1992).

Azerbaijan has implemented various tax and regulatory measures to attract foreign investors and promote economic growth. One of the key measures is the country's double taxation agreements (DTAs) with other countries, which aim to avoid double taxation of income earned in one country by residents of the other country. Double taxation occurs when the same income is taxed by two different countries. For example, if a foreign company earns income in a country, it may be subject to taxes in both its home country and the country where the income is earned. This can make investing in a foreign country less attractive, as the company must pay taxes twice on the same income. To avoid double taxation, many countries have entered into tax treaties with other countries. These agreements typically include provisions for reducing or eliminating double taxation, such as allowing companies to claim foreign tax credits on their home country taxes or providing for an exemption from taxes in one of the countries. Azerbaijan has DTAs with numerous countries including Turkey, Russia, Belarus, Kazakhstan, Kyrgyzstan, Moldova, Germany, Belgium, Italy, China, UAE, India, Iran, Czech Republic, Slovakia, and many others. The DTAs generally provide for reductions or exemptions on withholding taxes on dividends, interests, and royalties.

In addition to this, Azerbaijan has also implemented a transfer pricing regulation to prevent the abuse of DTAs by related parties for tax avoidance. The transfer pricing regulation requires companies to maintain documentation to demonstrate that their related-party transactions are conducted at arm's length. This helps to ensure that companies are not using the DTAs to artificially lower their tax liabilities.

Azerbaijan has also implemented the Common Reporting Standard (CRS) for the automatic exchange of financial account information to prevent tax evasion by foreign residents through the use of undeclared offshore accounts. This helps to create a level playing field for foreign investors and promotes transparency in the country's financial system.

Azerbaijan also offers several benefits to foreign investors. These include exemptions from customs duties, VAT, and profit tax for up to 7 years for certain industries and regions. (The Tax Code of the Republic of Azerbaijan, 2000). Additionally, the country has established special economic zones, such as the Sumgait Chemical Industrial Park and the Balakhani Industrial Park, which offer further tax and regulatory benefits to investors.

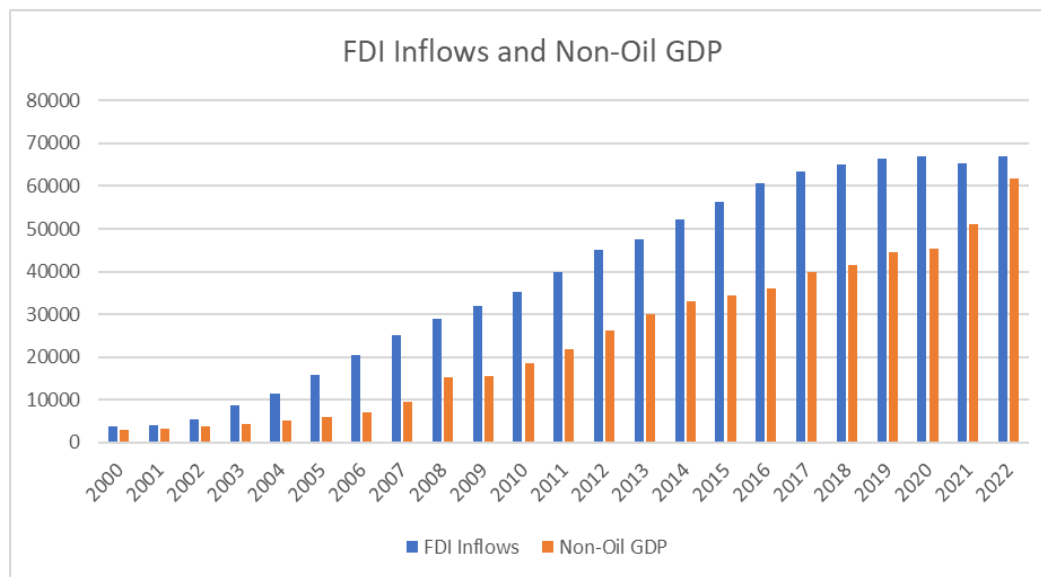
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In conclusion, taxes and regulations play a crucial role in determining the attractiveness of a country as an investment destination. Azerbaijan has implemented various tax and regulatory measures to attract foreign investment and promote economic growth, including DTAs, transfer pricing regulation, and CRS. These measures help to create a favorable investment environment by reducing the cost of doing business for foreign investors and promoting transparency.

Inferential Analysis:

In this part, we will pay attention to the statistical relationship between foreign direct investments and Azerbaijan's non-oil GDP based on data taken from the World Bank website.

Chart 1: Relationships between FDI inflows and Azerbaijan's Non-Oil GDP



Source: The chart was prepared by author based on the data taken from the World Bank website

Based on the secondary data and the impact of FDI inflows on Azerbaijan's Non-Oil GDP growth, some possible hypotheses are:

Alternative hypothesis (H_A): Foreign direct investment has a positive impact on Azerbaijan's non-oil GDP.

Null hypothesis(H₀): There is no significant relationship between the level of FDI inflows on Azerbaijan's non-oil GDP growth.

To analyze the statistical relationship between FDI inflows and Azerbaijan's non-oil GDP, correlation, and regression analysis should be used.

Correlation Analysis:

The Pearson correlation coefficient is the most common way of measuring a linear correlation. It ranges from -1 to +1, where -1 indicates a perfect negative correlation, 0 indicates no correlation, and +1 indicates a perfect positive correlation. Pearson's correlation coefficient assumes that the data is normally distributed and there is a linear relationship between the two variables.

On the other hand, Spearman's correlation coefficient is a non-parametric measure of the strength and direction of the relationship between two variables. It measures the monotonic relationship between two continuous or ordinal variables. The Spearman correlation coefficient ranges from -1 to +1, where -1 indicates a perfect negative monotonic correlation, 0 indicates no monotonic correlation, and +1 indicates a perfect positive monotonic correlation. Spearman's correlation coefficient does not assume that the data is normally distributed and can capture non-linear relationships between the two variables.

To know which method to choose, it is first necessary to clarify whether the data is parametric or non-parametric. For this, we will use the Shapiro-Wilk normality test. If the p-value is less than 0.05, then the data is non-parametric.

Shapiro-Wilk, Tests of Normality (SPSS):

Table 1: Tests of Normality

Tests of Normality						
	Kolmogorov-Smirnov ^a			Shapiro-Wilk		
	Statistic	df	Sig.	Statistic	df	Sig.
NON-OIL GDP	.143	23	.200*	.921	23	.072

*. This is a lower bound of the true significance.
a. Lilliefors Significance Correction

Source: The table was prepared by the author using SPSS

As shown in table above, we can see that Sig. level (P value) is greater than 0.05.

We identified that our data is Parametric. Now we can use Pearson correlation to measure the linear relationship between two continuous variables.

Pearson Correlation test (SPSS):

As shown in below table Pearson correlation coefficient of 0.963 indicates a very strong positive correlation between the two variables being measured.

The significance value (Sig) of less than 0.001 indicates that the probability of obtaining a correlation coefficient as strong as 0.963 by chance alone is very low.

In fact, it suggests that there is a less than 0.1% probability of obtaining such a strong correlation due to random chance. Therefore, we can conclude that the correlation is statistically significant.

Overall, this suggests that there is a strong positive relationship between the inflows of foreign direct investment and the non-oil GDP of Azerbaijan. In other words, as foreign direct investment increases, the non-oil GDP of Azerbaijan also tends to increase.

Table 2: Pearson correlation

		FDI flows	NON-OIL GDP
FDI flows	Pearson Correlation	1	.963**
	Sig. (2-tailed)		<.001
	N	23	23
NON-OIL GDP	Pearson Correlation	.963**	1
	Sig. (2-tailed)	<.001	
	N	23	23

** . Correlation is significant at the 0.01 level (2-tailed).

Source: The table was prepared by the author using SPSS

Regression Analysis:

For further investigation let's look at the Linear regression test between these variables. Regression analysis is a statistical technique used to examine the relationship between a dependent variable and one or more independent variables. Regression tests are necessary to evaluate the statistical significance of the relationship between the variables and to make predictions or estimates based on the model. Regression tests help to estimate the impact or effect of independent variables on the dependent variable. By analyzing the coefficients of the regression equation, we can determine how much the dependent variable changes for a given change in the independent variable(s). Regression tests also help us to make predictions or forecasts based on the relationship between the dependent variable and the independent variable.

Table 3: Liner Regression test (SPSS)

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.963 ^a	.927	.923	4941.8062

a. Predictors: (Constant), FDI flows

Source: The table was prepared by the author using SPSS

Our regression model has an R value of 0.963, it means that there is a strong positive correlation between the dependent variable and the independent variable(s). The R-value ranges between -1 and +1, with 1 indicating a perfect positive correlation and -1 indicating a perfect negative correlation. Therefore, an R-value of 0.963 indicates that there is a very strong positive correlation between the variables.

The R-squared value of 0.927 indicates that approximately 92.7% of the variability in the dependent variable is explained by the independent variable(s). The R-squared value ranges between 0 and 1, with 1 indicating that all the variability in the dependent variable is explained by the independent variable(s). Therefore, an R-squared value of 0.927 indicates that the regression model is a good fit for the data and that the independent variable(s) can explain a large proportion of the variability in the dependent variable. The Adjusted R-squared value of 0.923 is similar to the R-squared value but takes into account the number of independent variables in the model. The adjusted R-squared value adjusts for the effect of adding more variables to the model and is often a better measure of the goodness of fit for models with multiple independent variables. In summary, our regression model has a strong positive correlation between the dependent and independent variables, a good fit to the data, and a moderate amount of variability in the errors or residuals. Based on our statistical analysis we can conclude that there is a strong relationship between FDI inflows and Azerbaijan's Non-Oil GDP, that's why we can accept the Alternative hypothesis.

CONCLUSIONS AND RECOMMENDATIONS

In conclusion, this study provides evidence that there is a strong relationship between FDI inflows and Azerbaijan's Non-Oil GDP. The findings suggest that FDI can be an effective tool for promoting economic growth and diversifying the economy in Azerbaijan. FDI can contribute to economic diversification and growth in non-oil sectors of the economy, which is important for reducing Azerbaijan's dependence on oil exports. Therefore, policies that attract foreign investment and promote diversification are likely to be beneficial for Azerbaijan's long-term economic development. However, the study also highlights the challenges that FDI faces in the country, including a lack of infrastructure, bureaucratic barriers, and political instability. These challenges must be addressed in order to fully realize the potential benefits of FDI for Azerbaijan's economy.

Based on the findings of this study, several recommendations can be made for policymakers and investors in Azerbaijan. First, policymakers should prioritize the development of infrastructure, including transportation, telecommunications, and energy systems, in order to improve the business environment for investors. Second, efforts should be made to reduce bureaucratic barriers and streamline regulatory processes to make it easier for investors to do business in the country.

Third, political stability should be maintained and improved to instill confidence in investors and ensure the long-term sustainability of FDI inflows. Finally, efforts should be made to attract investment to a wider range of non-oil sectors, including agriculture and tourism, in order to further diversify the economy and reduce its dependence on the oil sector.

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