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Lack of foreign investments in the non-oil sector of Azerbaijan

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Abstract

This capstone project investigates the persistent underperformance of foreign direct investment (FDI) in Azerbaijan's non-oil sectors despite government initiatives to diversify the economy. It focused on three main factors – economic reliance on oil revenues, restrictive legal and regulatory environment for foreign companies, and lack of high-skill labor force in non-oil sectors – which were found to hinder investment. Through qualitative analysis of policy documents, legal frameworks, and international economic reports, the study evaluates the impact of these constraints on Azerbaijan's investment climate. Three policy options – strategic financial incentives, legal and institutional reforms, and human capital development – were assessed based on e^3f^2 framework made up of 5 critical indicators of policy success such as effectiveness, efficiency, equity, flexibility and feasibility. The research concludes that while Azerbaijan has made progress in promoting diversification, further legal and institutional reforms will strengthen investor trust, reduce governance-related risks which play essential role in attracting sustainable FDI into non-oil industries and fostering a more inclusive and diversified economic growth.

Key words: FDI, non-oil sector, economic diversification, regulatory reform, institutional barriers, investment climate

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Introduction

1.1 Overview of Azerbaijan's economy

The collapse of the Soviet Union in early 1990s have played a role of a double-edged sword for the economy of Azerbaijan. On one hand, it gave the country long-awaited independence and sovereignty over its natural resources and control over the administration of its own economy, on the other hand, the legacy of Soviet central planning and the instability of the early 1990s, largely driven by Nagorno-Karabakh war, resulted in a significant decline in GDP and economic output. While in possession of fertile agricultural land, considerable oil and gas reserves, and a relatively developed industrial sector, Azerbaijan has lost over half of its petrochemical and machine-building industries and some of its light industries by 1995. Economic crisis also affected agriculture, specifically known crops being cotton, grapes fruit, nuts, vegetables and tobacco. This was a critically important development since agriculture employed about 37% of the labor force. However, since the economic downturn in the early 1990s, Azerbaijan's vast oil reserves attracted foreign investment into the country's economy. Several major oil contracts have been signed since 1994, rapidly expanding Azerbaijan's economy after the completion of the major oil and gas pipelines like BTC, operated by SOCAR and international oil and gas companies and global increase in demand for oil and gas after 2000s, leading to an increase in GDP per capita (Baker & McKenzie, 2018; Ernst & Young, 2022).

Currently, the cities of Baku, Sumgayit and Ganja hosts the most of Azerbaijan's industrial enterprises, including the heavy industries such as petroleum extraction and refining (in Baku), metallurgical mining and refining (for example, aluminum), petrochemicals and other chemical production (in Sumgait), while also including the light industry consists of food processing, textiles and wine production (in Ganja).

1.2. Importance of the non-oil sector for sustainable growth

While it is clear that oil and gas will still remain as substantial sources of revenue for Azerbaijan in the short term, this sector has proven not be a good choice for the sustainability of the country's economy. One of the reasons is that its raw output has declined since 2010, yielding less than a million barrels a day which means decreasing export income for Azerbaijan on a yearly basis. Oil and gas are abundant in Azerbaijan. According to the June 2018 BP Statistical Review of World Energy report, Azerbaijan's residual commercial liquid reserves (crude and condensate) are estimated at 7.0 billion barrels, while known natural gas reserves are about 1.3 trillion cubic metres which means while not small, Azerbaijan's hydrocarbon resources will only continue to boost the economy for few future decades at the most (International Energy Agency, 2023). There is also a situation with inevitable some oil price shocks, such as in 2014-2015 and 2020, happening largely due to the global political reasons which threatens the country's shortterm energy security during the global economic and political crises, building a great case for long-term economic diversification of the country's non-oil sectors (International Energy Agency, 2021). Additionally, with the global push for renewable energy oil and gas consumption

in Europe, Japan, South Korea, and China, the world's major energy importers, will decrease exponentially due to their climate pledges. What it means for Azerbaijan is that to succeed as an internationally competitive producer, Azerbaijan must manage new development expenses and reduce its carbon impact and do so, as per the IEA's advice, by collaborating with key oil and gas corporations to cut sectoral emissions, lessening the economic dependency on oil and gas exports, and encouraging the economic diversification away from fossil fuel exports (International Energy Agency, 2021).

1.3. Major trends in the foreign investments in Azerbaijani economy

The oil industry dominated Azerbaijan's economy for years, making its economy sensitive to oil price swings due to this dependency which required the government to make bolder changes towards the later 2010s on establishing the groundwork for non-oil industry growth to avoid such threats and maintain sustained growth. Azerbaijan has since been increasing its non-oil output, which led to the growth of the non-oil industries shown in to 63% of the GDP by 2023 (Sakit, 2024). Foreign Direct Investment (FDI) in non-oil industries, notably in the agriculture and industry, is crucial for Azerbaijan to diversify its economy and exports away from oil and gas. According to Strategic Roadmap of the National Economy Prospects document, the first major indicator of success in this endeavor is about reaching 4% non-oil foreign direct investment in GDP by 2025 (compared to 2.6% in 2015) (The Government of Azerbaijan, 2016). In the period between 2000 to 2017 when foreign investors showed little interest in the country's non-oil/gas economy, out of \$77.8 billion in FDI to Azerbaijan's GDP, only \$11 billion was invested into the non-oil/gas sectors. Therefore, government had to enact measures to promote FDI to these industries, by identifying and eliminating foreign investor barriers (Mehtiyev, 2018). The same document introduced the measures to ensure competitiveness via sustainable economic development through a new economic model with 4 strategic goals being chosen. The first one was to achieve fiscal sustainability and floating-rate monetary policy; the second was to ensure economic dynamism by boosting efficiency in government-controlled legal organizations and privatizing; third was to increase human capital development; and the fourth goal was to enhance the business climate. These various steps and changes are still needed today to boost private sector investments in non-oil sectors by encouraging open competition, effective taxation, public service flexibility and efficiency, etc. Leveraging Azerbaijan's strategically and geographically location at the crossroads of Europe and Asia adds value to the commodities crossing its borders and gain from its transit status in international commerce, making transport and logistics one of the important non-oil sectors and providing an international opportunity for Azerbaijan to sustain continued economic growth.

According to the World Bank Group's "Global Investment Competitiveness Report 2017-2018: Foreign Investor Perspectives and Policy Implications," the country's environment should attract FDI. A new study of 754 multinational executives operating in developing nations found the following criteria most essential in investment decisions. Political stability and security were the main critically important factors, as instability can deter foreign direct investment (FDI). The legal and regulatory environment also poses challenges; investors prioritize a transparent and predictable framework, with 45% emphasizing the need for legal guarantees and efficient

regulations. Macroeconomic stability, including favorable exchange rates, is crucial for fostering economic consistency. Additionally, while infrastructure and labor skills are important, reports indicate a need for significant improvements in these areas. Bureaucratic hurdles, particularly in obtaining government approvals and starting businesses, further complicate the investment landscape, especially regarding construction permits and cross-border trade. Although Azerbaijan has improved its ranking in the Doing Business report, issues related to financial market development and the macroeconomic environment still require urgent reform. While tax breaks and preferential trade agreements are valued, they are secondary to the primary drivers of political and regulatory stability. To enhance investor confidence, Azerbaijan must focus on these critical areas (Mehtiyev, 2018).

Foreign investment in Azerbaijan is governed by a combination of international treaties and domestic laws, including the Law on Protection of Foreign Investment (1992), the Investment Activity Law (1995), the Investment Funds Law (2010), and the Privatization of State Property Law (2000). Foreign investors, including corporations and individuals from outside Azerbaijan, can engage in various legal operations such as joint ventures, foreign-owned enterprises, and property purchases. The legal framework guarantees foreign investors rights equal to those of local investors, including the ability to repatriate earnings after taxes are paid. A 10-year moratorium protects investments from adverse legislative changes, with exceptions for national security and public health. Nationalization is possible under extreme circumstances, but investors are entitled to fair compensation. Disputes can be resolved through free international arbitration if the parties agree. In the energy sector, foreign investors can benefit from incentives, including tax privileges granted through investment certificates, which require a minimum investment and a business plan. Recent decrees have established specific economic activity areas and defined minimum investment amounts for these incentives (Baker & McKenzie, 2018)

There was an interminable circulation of views on Azerbaijan's need for economic diversification away from oil and gas. FDI has been attracted invariably to the hydrocarbon industry. Contrary to non-oil industries such as agriculture, manufacturing, tourism, and information technology, these sectors are in terrible shape due to perceived risks, obstacles, and limitations in the country's framework. Restrictions imposed by the regulator, lack of highly skilled labor, and lasting structural economic issues clustered on oil dependency are some of the main issues concerning foreign investors. This study analyzes these impeding factors in the diversification of foreign investment and provides an in-depth assessment of the legal, human capital, and structural economic factors that continue to determine limited FDI inflow into the non-oil sectors of Azerbaijan. Confronting these barriers is not only a precondition toward diversification but also a crucial prerequisite toward economic stability and sustainable growth of the country.

1.4 Methodology

This is a qualitative research methodology that relies overwhelmingly on document analysis and secondary data analysis with thematic analysis. The initial step deals with the scrutinizing of technical documents such as Azerbaijan national legislative documents on foreign investment (e.g., Law on Protection of Foreign Investment, Investment Activity Law, Investment Funds Law), strategic policy documents (e.g., Strategic Roadmap for National Economy), and reports of international institutions including the World Bank, IMF, OECD, ADB. The aforementioned

documents will be complemented by official statistics from the State Statistical Committee of Azerbaijan and data from industry surveys, including the World Bank Enterprise Surveys and Deloitte Business Outlook Reports, as well as the analysis of these documents to quantify the inflows of FDI, conditions for the labor market, and productivity dimensions.

Thematic analysis will also be utilized to categorize systematically analyzed findings emerging due to the aforementioned documents and reports with specific focus toward legal/regulatory barriers, labor market skill gaps, and structural economic constraints. The methodology is based on identification and interpretation of qualitative data patterns and alignment, which provide clarity vis-a-vis the inter relational barriers and their effect on the foreign investment decision. In addition, referencing secondary sources mainly involves using academic literature and policy papers or analytical reports including perspectives along which barriers will be contextualized in theoretical as broad frameworks of economic diversification and investment climates. Finally, the recommendations directed at improving the investment climate and promoting growth in the non-oil sector will be reinforced by qualitative insights from recent expert analysis and official evaluations of policies.

Chapter 2. Problem Description

In this chapter, we analyse the fact: that the primary challenges deterring foreign direct investment (FDI) in Azerbaijan's non-oil sectors include economic dependence on oil revenues, restrictive regulation, and a shortage of a highly qualified labor force. These structural impediments must be clearly understood to identify the need and direction of reforms on which outwardly oriented, diversified, and sustainable investments will depend.

2.1 Economic Reliance on Oil Revenues

Most of Azerbaijan's economy, since this late 1990s, has been essentially dependent on oil and gas resources, creating an undiversified structure for the economy. Hydrocarbons are the key drivers of output, exports, and fiscal income. For instance, oil and natural gas activities contributed almost 47.8% to Azerbaijan's GDP and over 92% to its export revenue in 2022 (U.S. Department of Commerce, 2023; Asgarova, 2025). In the same way, oil and gas revenue constitutes approximately 60% of the state budget (International Energy Agency, 2021). This over dependency on one sector has left other industries, agriculture, manufacturing, and services, comparatively underdeveloped and generating only a smaller part of the national income in Azerbaijan. In 2022 for example, agriculture contributed only about 4.8% of GDP (8.2% for trade and 6.0% for transport), a share which rose to 6.5% of the GDP in 2023 (U.S. Department of Commerce, 2023), signifying the dominance of oil on national development. Oil has improved living standards and budgetary capacity in the last 20 years; however, that has rendered the economy very vulnerable to fluctuations in petroleum prices and has not enabled the necessary growth for development of the nonoil industries (IEA (2021). As the IMF asserts: "the fundamental challenge of running out of oil in coming decades is how the economy will wean off its dependence on oil revenues" (IMF, 2021). Specifically, this means that lacking broad

diversification, Azerbaijan faces long-term risk as its oil begins to deplete or demand for fossil fuels wanes (World Bank, 2023).

A hallmark of this dependency is the low level of foreign investment outside the oil sector.

Azerbaijan's oil and gas projects – especially the vast offshore oil fields and pipeline infrastructure – attract international investors, while other sectors considered less profitable have largely been avoided. Between 2000 and 2017, Azerbaijan received foreign direct investment estimated at US\$77.8 billion; some US\$66.8 billion (about 86%) of that went into the oil industry, while only US\$19.9 billion (14%) for the non-oil sector (State Statistical Committee of Azerbaijan, 2018) (Mehtiyev, 2018). In other words, the vast majority of foreign capital has been channeled into hydrocarbons. Other words, foreign investments mostly went to the oil market. The State Statistical Committee data further indicate that cumulative FDI into the non-oil sector over 2000–2017 was just US\$10.9 billion, equivalent to a mere 3.3% of Azerbaijan's total nonoil GDP in that period (State Statistical Committee of Azerbaijan, 2018) (Mehtiyev, 2018). These numbers show a clear imbalance: non-oil industries have not been considered attractive investment destinations by foreign companies. Manufacturing and agriculture-proper "have failed to attract significant FDI flows" (State Statistical Committee of Azerbaijan, 2018) (Mehtiyev, 2018). Foreign investors, by contrast, have been pouring billions of dollars into oilfields developments (like Azeri–Chirag–Guneshli) led by consortia such as BP, Total, SOCAR and etc (BP, 2022). These projects offer high profitability, benefiting from guaranteed global energy demand and established infrastructure. However, sectors such as food processing, light manufacturing, tourism, and ICT remain underfunded, reflecting the perceived risks and lower profitability of non-oil ventures among foreign investors (World Bank, 2022).

There are many reasons why sectors other than oil and gas are regarded as less profitable. For instance, 'Dutch disease' in that oil-boom exports have appreciated Azerbaijan's real exchange rate for large parts of the oil boom of the 2000s; consequently, while non-oil exports had become less competitive again (World Bank, 2017), easy oil revenues may have caused wage inflation and increased cost inputs that erode manufacturing and agricultural competitiveness. The influx of oil revenues into the economy also put pressure on inflation, leading to increased labor costs, thereby increasing local production of goods. Competitive pressures from elevated wages and input costs diminished manufacturing and agricultural competitiveness, discouraging investments outside hydrocarbons (IMF, 2019).

In low non-oil productivity, remarkably a small local market (around 10 million people) thus curtails possible returns for industries beyond hydrocarbons. Also, enclave development, which is characteristic of the oil sector, has infrastructures and capital of its own and does not integrate or spillover to the economy in general. The productivity gap in non-oil sectors couples with the fact that with a total population of approximately 10 million, the Azerbaijani domestic market is too small to attract any meaningful large-scale industrial investment (ADB, 2021). The oil sector also follows an enclave model of development, meaning that its infrastructure and capital are largely disconnected from the rest of the economy (OECD, 2022). In addition, SOEs and government-linked monopolies dominate key non-oil sectors and stifle competition and innovation (EBRD, 2020). Thus, in the eyes of foreign investors, an Azerbaijani factory, farm, or service company presents a higher-risk, lower-reward proposition than oil projects, which enjoy global demand, reliable infrastructure, and steady revenue streams (World Bank, 2022).

Most importantly, Azerbaijan's dependence on oil exposes it to external shocks, making the business climate unstable and further discouraging foreign investments in non-oil sectors. Global oil price fluctuations have historically impacted Azerbaijan's growth, currency stability, and fiscal balance (IMF, 2019). A notable case occurred between 2014 and 2016, when oil prices fell by 50%, severely reducing export and budget revenues (World Bank, 2018). As a result, the Central Bank of Azerbaijan was forced to abandon the manat's dollar peg in 2015, leading to a "double devaluation" where the currency lost nearly 50% of its value against the US dollar in a single year (World Bank, 2018). The economic consequences of this oil price crash were severe. The manat devaluation triggered banking sector instability, ultimately pushing Azerbaijan's economy into recession, with GDP contracting by 3.8% in 2016 (IMF, 2019). Inflation spiked, and public debt rose from 8.5% of GDP in 2014 to 22% in early 2018, largely due to the weakened currency and fiscal shortfalls (World Bank, 2019). This oil-price shock highlighted Azerbaijan's economic fragility, where a single commodity's downturn resulted in a broader financial crisis. As the World Bank noted, the collapse of oil prices in 2014–2015 "exposed Azerbaijan's economy to severe shocks... driving the fiscal balance into deficit and necessitating exchange rate devaluation and fiscal consolidation" (World Bank, 2018). This pattern of boom-and-bust cycles in oil economies creates uncertainty, making long-term investment decisions in non-oil industries difficult. Without a diversified economy, Azerbaijan remains highly susceptible to external market swings, deterring foreign capital inflows into sectors such as manufacturing, agriculture, and technology (ADB, 2021).

Azerbaijan also established a sovereign wealth fund called the State Oil Fund of Azerbaijan (SOFAZ) in 1999 to save and manage excess oil revenues and mitigate this volatility. SOFAZ performs the role of stabilizing by accumulating assets for future generations and financing development projects. By the year 2020, SOFAZ assets had grown to almost \$43.6 billion, around equal to the entire GDP of Azerbaijan (International Monetary Fund [IMF], 2021). These resources have created a very important fortress during crisis—among others, transfers from SOFAZ helped finance budget deficits and support the currency (imf.org) (imf.org). It actually means that during the 2015 crisis, SOFAZ increased foreign exchange sales to prop up the manat (imf.org), while the state took some withdrawals of the fund's resources to replace revenue losses. The oil fund also acts like a dry day reserve to smooth up the expenditures and keep some stability in the economic downturns. The reliance on SOFAZ also raises a bigger question: the rest of the economy does not earn sufficient income on its own. Huge outflows from SOFAZ during periods of low oil are what keep the government afloat and currency buoyant, showing how dependent fiscal and external stability still are on oil-derived savings. Further, repairing budget holes with the fund is not the way to achieve sustainable long-term growth. If revenues from oil will decline in the future due to resource depletion or transition into clean energy worldwide, SOFAZ alone cannot be a substitute to hold off indefinitely a diversified economy. The IMF estimates that oil reserves in Azerbaijan will shrink slowly in the coming decades, hence diversification would be more urgent (imf.org). Robust non-oil industries and revenue sources would naturally exacerbate the risk of fiscal crises and economic contraction when oil production declines.

Although most policymakers have recognized the areas of risk, very little has been accomplished towards diversification. Some of the initiatives directed by the government to promote the nonoil

sectors include the approval by President Ilham Aliyev of a “Strategic Roadmap for the National Economy and main sectors” in December 2016, which will aim to reduce dependence on oil and to develop tourism, agriculture, and manufacturing (World Bank, 2019) (IMF, 2021). Very recently, the authorities listed four priority non-hydrocarbon areas for future development according to their economic empowerment capabilities: agriculture; tourism; information and communications technology (ICT); and transportation/logistics (U.S. Department of Commerce, 2023). These priority areas have been identified by their job creation potential and foreign exchange generation other than oil. But then again, some positive signs are already coming up. In 2022, even as oil output stagnated, the non-oil economy grew in a very impressive manner by 9.1 percent led by recovery of post-pandemic services (U.S. Department of Commerce, 2023). While non-oil exports are still small-volume exports, they have been increasing in some years; in 2022, for example, non-oil export earnings were close to \$3.3 billion (approximately 8% of total exports, whereas this was a few percent a decade ago) (U.S. Department of Commerce, 2023). To promote the role of Azerbaijan in transit (the "Middle Corridor"), the government has also invested in infrastructure, such as highways and ports (World Bank, 2022) (U.S. Department of Commerce, 2023). These schemes denote a policy acknowledgment of diversification needs. However, the overall structure of the economy is still heavily weighted toward oil. Industry (largely oil and gas) still contributed over half of GDP in 2022 (U.S. Department of Commerce, 2023) (IMF, 2023). On the other hand, the non-oil sectors have not yet gained the scale or productivity necessary to preclude the balance (Asian Development Bank, 2021). The IMF stated in 2021 that "progress remains slow on structural reforms required to create a diversified and competitive private sector" (IMF, 2021) (U.S. Department of Commerce, 2023). In short, Azerbaijan's non-hydrocarbon sectors are growing from a very low base and still face issues of competitiveness. As such, when foreign investors think of Azerbaijan, it is mostly as an oil play; the country has not yet persuaded investors that other sectors can also flourish (U.S. Department of Commerce, 2023). Until more serious efforts are made toward diversification and private sector development, the non-oil economy will likely attract only modest foreign direct investment compared to lucrative oil and gas projects.

Table 1. Oil-Dependence and FDI in Azerbaijan's Economy

Indicator (Year)	Value (Share)	Source
Oil & gas share of export revenue (2022)	92.5% of exports	U.S. Dept. of Commerce (2023)
Oil & gas share of state budget revenue (~2021)	~60% of government revenue	International Energy Agency (IEA, 2021)
Cumulative FDI inflows into oil sector (2000–2017)	US\$66.8 billion (85.9% of total FDI)	State Statistical Committee (SSC, 2018)

Cumulative FDI inflows into non-oil sector (2000–2017)	US\$19.9 billion (14.1% of total FDI)	State Statistical Committee (SSC, 2018)
Non-oil FDI as share of non-oil GDP (2000–2017)	3.3% of non-oil GDP	State Statistical Committee (SSC, 2018)

Sources: State Statistical Committee of Azerbaijan (SSC); United States Department of Commerce; International Energy Agency.

Table 1's statistics reveal that the oil sector continues to dominate the economy of Azerbaijan, thus hampering FDI's diversification into other industries. It provides oxygens that nearly half of

Azerbaijan's total economic output is derived from hydrocarbon-related activities (47.8% of GDP), which establishes a structural dependence on oil and gas extraction rather than a diversified economic base (U.S. Dept. of Commerce, 2023). Likewise, oil and gas generated over 92% of total export revenues in 2022, rendering Azerbaijan exceedingly vulnerable to global commodity price fluctuations (U.S. Dept. of Commerce, 2023). The burden that such dependence on oil exports places on the countries' capacities to handle external shocks could undermine their long-term economic stability. The oil sector, which amounts to almost 60% of Azerbaijan's government revenue (IEA, 2021), highlights the fiscal stability that is tied to hydrocarbon revenues. This very dependence creates a great risk for public sector investment aimed at social services, infrastructure, and industrial development, especially at such times when oil prices are on a downfall (IMF, 2021).

Foreign investments in Azerbaijan have also been largely concentrated in the oil and gas industry, with US\$66.8 billion being the cumulative FDI inflow into that sector from 2000 to 2017, representing almost 86% of the total FDI (SSC, 2018). The factor has, thus, great influence over Azerbaijan's FDI environment; the oil industry on the contrary leaves non-oil sectors, such as agriculture, manufacturing, and information technology flooded into scarce foreign capital. The cumulative FDI inflows to non-oil industries during that same period were less than US\$19.9 billion, or 14.1% of total FDI (SSC, 2018). This indicates the unwillingness of foreign investors to put their funds into other sectors. More specifically, non-oil FDI as a share of non-oil GDP still remains surprisingly low at just 3.3%, implying that foreign capital inflows have not meaningfully contributed to the expansion of industries outside hydrocarbons (SSC, 2018). No doubt, this situation brings lots of hurdles to foreign direct investment inflows. Since oil attracts international attention, highly susceptible to global shocks, it turns out to be an economy that is practically directly affected by global oil price fluctuations. It generally affects Azerbaijan's export earnings, fiscal revenues, and the economy. A good example of such vulnerability is that oil price crisis between 2014 and 2016. Because the oil price dropped sharply, such an occurrence brought about serious economic contraction, devaluation of the manat, as well as higher public debt levels (IMF, 2019). This is a result of the non-oil sectors also being largely under-developed and foreign investors not attracted due to the regulatory environment, poor infrastructure, and market risk concerns (OECD, 2022). The continued presence of state-owned enterprises (SOEs) in FDI allocation also creates an uneven playing

field, as SOEs dominate key industries, and limit competition from the private sector thus discouraging foreign investments in non-oil ventures (World Bank, 2022).

"Efforts have been made by government to diversify the economy; this includes creating the Strategic Roadmap for the National Economy and main industries." More to that, they have prioritized the agriculture, tourism, information and communications technology (ICT), and transport industries (World Bank, 2022). However, even with these schemes, non-hydrocarbon sectors in Azerbaijan are still facing considerable competitiveness problems. Although oil economy has grown by 9.1% in 2022 on the influence of recovering services from the pandemic (U.S. Dept. of Commerce, 2023), the non-oil sector still lacks scale and productivity that can push it into the long-term diversification path. The IMF commented in 2021 that "progress remains slow on structural reforms required to create a diversified and competitive private sector" (IMF, 2021). This is the point where foreign investors only view Azerbaijan as an oil driven economy when doing assessments of its investment potential. The non-oil economy is pegged to attracting little foreign direct investment compared to its highly rewarding oil and gas industry until stronger motives for diversification and private sector development become more pronounced.

2.2 Restrictive Legal and Regulatory Environment for Foreign Companies and how FDI flow, or its absence is connected to the reduction of poverty?

Foreign Direct Investment (FDI) makes a difference to spur economic development, create jobs, and increase productivity, especially in developing and transitioning economies. A country like Azerbaijan can attract investment through a good legal and regulatory environment into various sectors of an economy and would facilitate structural transformation and inclusive development. On the other hand, that kind of bleak investment situation deters foreign capital, reduce opportunities in non-oil sectors, and slow poverty alleviation by narrowing employment channels and keeping low wages. This section delves into the real barriers constraining FDI into Azerbaijan's non-oil economy and discusses how such barriers maintain limited development and make poverty vulnerable.

Azerbaijan's legal and regulatory framework is historically seen as opaque, unevenly enforced, and tilted towards insiders, which is another hurdle foreign investors in non-oil sectors have to overcome. Though Azerbaijan has laws and regulations on paper that give protection to foreign businesses, in practice weaknesses in governance and rule of law create a challenging environment. Thus, these investments in the country can only ensure strong guarantees as investment legislation recognizes "complete and unreserved legal protection" and against the possibility of nationalization or expropriation except in very limited cases (U.S. Department of Commerce, 2023) for foreign investments into Azerbaijan. It would not be wrong to say that unfortunately, foreign investors will also be by-and-large allowed to establish enterprises, repatriate profits, and participate in most sectors of the economy without any major restrictions. Further, there are bilateral investment treaties (BITs) that Azerbaijan has signed with other countries, for instance, with the United States, which allows foreign investors to file their claims

with international arbitration (ICSID) regarding disputes arising from BIT provisions on the premise that such treaties will assure investors that their rights would be respected. (U.S. Department of Commerce, 2023) (OECD, 2022). In practice, however, there would be few explicit legal barriers in taking the straightforward path: unlike many countries, Azerbaijan does not generally limit foreign equity stakes in companies; and it has been a WTO observer (though not yet a member) working to liberalize trade policies.

The reality, however, is generally different from such formal statutes, and this gap is the one that cuts at the root of investor confidence. And one of those often-recurring concerns is the issue of corruption and nontransparent, impartial enforcement of laws. According to the U.S. State Department, "corruption still remains a great hurdle for companies operating in Azerbaijan," and slow and deep structural reforms are ongoing (U.S. Department of Commerce, 2023). The economy tends to be almost wholly tied down by small groups of politically connected mega business conglomerates. In fact, a "small group of government-connected holding companies dominates the economy," (U.S. Department of Commerce, 2023) (OECD, 2022) which underlines how elite interests have important checks out there. This entrenched oligopolistic structure could definitely be a disadvantage to the foreign entrants, especially in sectors outside oil where patronage networks prevail. Typically, these insiders would have enjoyed preferential access upward to the governments, contracts, and regulatory favors, placing foreign competitors afar as well. It can be rather daunting and a risky venture for foreign companies to try and navigate through such an environment where informal connections sometimes trump formal rules.

Deficiencies in the rule of law multiply the problem. Poor independent assessments have constantly ranked Azerbaijan low on judicial independence and legal integrity. The Corruption Perceptions Index of Transparency International scores Azerbaijan at 23/100 and ranks it 157 among 180 countries as at 2022 (with 0 being "highly corrupt") (Transparency International, 2023). The Heritage Foundation's Index of Economic Freedom notes that "in general the rule of law is weak in Azerbaijan," with property rights, judicial effectiveness, and government integrity all scoring inadequately below averages throughout the world (Heritage Foundation, 2023). Contracts and property rights theoretically exist, but companies may practically lack the means to enforce contracts and obtain unbiased judgments in courts. Judicial transparency is lacking, and courts are widely seen as citizens being politically influenced (U.S. Department of Commerce, 2023). This leaves foreign investors with the worry that if, for instance, something goes wrong with a local partner or a government entity, the legal system would not fairly adjudge the matter (World Bank, 2022). Lengthy and highly diverse time periods also make dispute resolution unpredictable as it "varies widely" (U.S. Department of Commerce, 2023) in duration.

There are other regulatory practices that do not necessarily discriminate against foreign business by law but imply efficiency barriers or indirect restrictions for foreign businesses. Research on FDI in the region shows that in Azerbaijan "foreign investors struggle with the lack of the rule of law and the practice of using regulations to protect the economic interests of elites at the expense of foreign investors" (Vanderhill et al., 2019). That is, the regulations (licensing requirements, inspections, or customs rules) are in themselves arbitrary or protectionist and favor internal vested interests. This means that a foreign company could face unexpected bureaucratic hurdles

if the project is seen threatening competition with an elite-owned firm. Unpredictable regular sudden tax audits or legal challenges against businesses perceived as coming too close to some politically sensitive domains have been previously reported. This unpredictability and potential political interference create a perceived risk premium in investing in Azerbaijan, especially for non-oil businesses where entry by foreigners could potentially disrupt affairs of incumbents. Administrative barriers and bureaucracy have also been a traditional problem, although things have improved somewhat recently. Starting a business, obtaining construction permits, or getting licenses in Azerbaijan were really cumbersome and required exorbitant informal payments. Processes have been streamlined by the government, notably Azerbaijan's success in the World Bank's Doing Business rankings by 2019 reflecting improvements in ease of business registration and access to credit. For now, though, the practicalities present challenges, especially far from the capital city Baku. Companies in Azerbaijan are still citing the informal sector, tax administration, and corruption as the main barriers to doing business (World Bank Enterprise Surveys) (Djankov, 2007). Whether part of the unregistered labor force or undercutting competition with unfair tax-free incentives, high levels of informality blunt the incentives for honest companies to work and enter the market. Taxation and customs administration have improved, but inconsistent application remains: some companies benefit from exemptions and leniency while being closely connected, while others find rigorous enforcement against them which only supports suspicions of an uneven playing field (Transparency International, 2023).— A concrete legal obstacle is that foreign entities and individuals cannot own land in Azerbaijan; they can only lease it (U.S. Department of Commerce, 2023). Although long-term leasing options (99 years maximum) do exist, inability to own the land outright could form a negative incentive for some investors. A foreign agribusiness or a manufacturer, for instance, would in principle rather own the land on which a factory or farm sits for purposes of collateral and security of tenure. Leasing creates another uncertain situation (the issue of renewing leases and terms potentially changing). This restriction is notably restrictive in sectors like agriculture, real estate development, or retail, where control over land is critical. A lot of countries have similar restrictions, while Azerbaijan allows foreign leasing, but this issue is still one of the factors that foreign investors will consider in their decisions for non-oil projects (the oil sector would rather have exploration and production-sharing agreements ruling that offshore ownership of land does not really matter).

Another regulatory concern is the dominance of SOEs and the substantial government involvement in the economy. Utilities, transport, and banking are sectors that are fully owned or, at least, substantially controlled by the State. This provides two deterrents to foreign investment. First, SOEs might enjoy implicit subsidies or monopoly status, and thus it would be difficult to compete with them. Second, foreign firms might be concerned that the government might act in an unpredictable manner when it comes to privatization or market reforms. Azerbaijan has established, over the last few years, the Azerbaijan Investment Holding to create more consolidated management of key SOEs and efficiency improvements (OECD, 2023). In many sectors outside the oil industry, however, the government or related holding companies are often the key player, requiring foreign entrants to form partnerships or joint ventures to operate. This is seen as an obstacle for investors that prefer wholly owned subsidiaries or who are concerned about minority rights when dealing with state-affiliated entities.

Corruption in everyday operations—like bribes for permits or to urge customs—increases investment cost and risk. Business surveys tell us that informal payments are sometimes expected in dealings with lower-level officials, for construction permits or connecting utilities. Even as Azerbaijan advances into e-government and one-stop services to reduce face-to-face contact (such as ASAN service centers, which consolidate public services), the perceptions of corruption remain very high. In 2024, Azerbaijan's score on the CPI would fall to 22 out of 100 (Transparency International, 2024), and with that, the country joins extremely corruption-laden countries within Eastern Europe. Such an environment can impede investment, especially in non-oil sectors like services or manufacturing, where companies depend on a lot of public interactions (zoning, licensing, inspections, etc.). Unlike oil consortia, which negotiate directly at high levels (often with government ministers), petty bureaucracies operate away from their day-to-day operations, constituting a possible reason oil investors seemed to have fared better. Smaller foreign firms in other sectors would not be granted such luxuries and would be rightfully worried that they may become tangled in red tape and rent-seeking behavior.

The absence of strong institutional and legal frameworks for enforcement means investor protection rights for minority shareholders are weak, with intellectual properties just about managing to pull themselves up. Enforcement of intellectual property is, in general, said to be "improving but insufficient." (U.S. Department of Commerce, 2023). A foreign technology or pharmaceutical company might worry there will be an IP leakage or no recourse available if its patents are violated; minority shareholders in local companies were historically afforded little protection in case majority owners (very often local) engage in self-dealing. New laws are beginning to solve these problems (Azerbaijan updated its Competition Code and is working on the governance of state firms) (OECD, 2023), but they still affect perceptions.

Azerbaijan has undertaken a number of positive measures to improve the business climate, particularly in recent years. Tax reforms were introduced, anti-corruption bodies were strengthened on paper, and electronic systems for procurement and licensing were put in place. This led to an overall improvement in the World Bank Doing Business ranking, where Azerbaijan rose into the top 40 by 2019, specifically excelling in settings for starting a business, registering property, and protecting minority investors. Improvement thus indicates that the government empathizes with the prospect of improving the investment climate in non-oil sectors (U.S. Department of Commerce, 2023). Establish special economic zones and industrial parks to provide tax incentives to lure foreign manufacturers, e.g. the Sumgait Chemical Industrial Park, Alat Free Economic Zone near the new Baku port, etc. While such reforms are helpful, deeper institutional changes are necessary to address the fundamental concerns of foreign companies. The IMF Article IV report of 2021 noted that "weak institutions, limited SME access to credit; inefficient labor, product, and service markets; and sizeable skill gaps result in high informality, discourage non-oil FDI and slow productivity growth" (IMF, 2021). The high number of this use encompasses itself into more than one or two laws; it defines the broader ecosystem of governance and condition in markets, which needs improvement.

In summary, the legal and regulatory framework in Azerbaijan, despite formal perceptions for foreign investors, has been interpreted as binding and unsafe at practical levels. Given endemic corruption, un-level playing field dominated by very strong powers and weaknesses in the rule of law, many foreign firms are extremely reluctant to invest capital into non-oil ventures. An oil

project, by virtue of its high returns, might justify taking on these country risks; but a non-oil project, with thinner margins, is often deterred completely. Until Azerbaijan strengthens governance-fighting corruption, ensuring judicial independence, enforcing regulations fairly-the non-oil economy will likely continue to see relatively low levels of FDI. There must be more willing to venture into agriculture, technology, or manufacturing if beneficiaries know contracts will be honored, competition will be fair, and officials will act predictably and consistently. Building that trust requires continued reforms to the legal/regulatory environment and demonstrated political will to curb favoritism and corruption.

2.3 Lack of High-Skill Labor Force in Non-Oil Sectors

For attracting efficiency-seeking foreign investors, the labor market has to work effectively and be constituted by skilled human capital. In Azerbaijan, while there have been gradual improvements in education, there is still a chronic shortage of workers with skills that are in demand in the non-oil sectors, like ICT, agriculture, manufacturing, logistics, and business services. This scarcity limits the country's ability to diversify its economy and acts as a deterrent for foreign direct investment (FDI) into sectors that are vital for inclusive growth and job creation. A shortfall of appropriately skilled workforces within the non-oil economy in Azerbaijan has been revealed to form a major challenge to foreign investment. While on the average, Azerbaijani workers have about 13 years of schooling and have a near-universal secondary education completion, further studies remain limited (World Bank, 2020). Those with higher education as of 2015 represented only about 20% of the labor force (World Bank Blogs, 2020) but graduated to something between 27 and 28% of adults with tertiary education by 2023 (CEIC, 2023), thus still low in comparison with peer countries. Furthermore, tertiary gross enrollment is about 40-45% in Azerbaijan, thus trailing behind regional averages of about 75% (USAID, 2023). The pool of talents in high-skill fields such as engineering and ICT is very low, as many graduates would end up in government or low-productivity industries. For example, almost 70% of university graduates in Azerbaijan work for the public sector (usually in low-skilled positions), while the remaining ones (less than 25%) are in highly productive private companies in the country (IZA Institute of Labor Economics, 2021). This phenomenon indicates to an extent that there is a mismatch of skills: most graduates do not have gained the necessary practical and "soft" skills that the private market is looking for (AmCham Azerbaijan, 2022). Employers indicate that the recent graduates have failures in terms of communication, critical thinking, problem solving, and can also have insufficient technical experience, which is indeed a gap between what is produced in schools and what is actually needed in the industry (AmCham Azerbaijan, 2022). Azerbaijan is really "stuck in a low-skill, low-productivity" cycle (World Bank, 2020). The non-oil economy generates very limited demand for skilled labor, leading to gross underutilization of human capital and generating low returns to advanced education (World Bank, 2021). Therefore, labor productivity in Azerbaijan is still the lowest in the whole region. It is measured by output per worker and ranks fifth among developing Europe & Central Asia countries (World Bank, 2022). Indeed, there is evidence that agriculture employed one-third of the labor force in 2020 while generating only 7% of GDP by the sector. This clearly shows that a lot of workers are in low-value-added jobs (World Bank, 2022). GDP

per employed worker averages about \$30,600 (PPP) by 2022 - a significant gap from neighboring Georgia (approx. \$37,500) and other peer economies (IMF, 2023). This productivity gap is attributable to the skills shortfall-the World only 60 percent of her potential productivity as an adult (under current education and health conditions) (World Bank, 2022). Azerbaijan has historically lagged its comparators in quality education and workforce skills in international talent competitiveness rankings, although it has exhibited some recent gains (like 43rd place in the 2019 Global Talent Competitiveness Index) as the country spends more on human capital development. Overall, however, the workforce's skill and productivity are not yet in line with the needs of a diverse, modern economy, which diminishes Azerbaijan's attractiveness for efficiency-seeking foreign investors. Concern regarding the availability of talent is expressed by foreign investors and local firms alike. The lack of skilled labor and specialists was seen as a barrier to business operations among hundreds of surveys and interview-based examples. A World Bank employer survey showed that Azerbaijani firms have difficulties in finding the needed skilled workers, more critically so for new, innovative firms (World Bank, 2021). Employers know how to hire technicians, engineers, managers, whether with strong digital skills or foreign languages. Even for entry roles, companies must invest in retraining often because of graduates lacking practical skills. Per an expert's mention, "one of the main difficulties faced by foreign investors may be the shortage of skilled labor or personnel in some economic sectors.... And while some young people are ready for this environment due to their technical and language skills, there may be some shortcomings in terms of overall practical experience." (Asgarova, 2025). In the World Bank's Enterprise Surveys, several firms had reported inadequately educated workforce as a major obstacle to business, even though many problems received a higher ranking, including corruption. A recent Deloitte business outlook survey has notably found 52% of companies identifying a shortage of skilled workforce as the primary obstacle that would hold up Azerbaijan's economy (Deloitte, 2023). From manufacturing to IT, the investor complains that the local labor pool is inadequate to meet a new project need, especially outside Baku.

Complaints included a deficiency in experienced mid-level managers, few IT professionals and engineers, and relatively poor international business practices. These talent constrictions would keep foreign investment at bay or slow its expansion as firms would typically have to bring in outside expertise or spend valuable resources training. The women's participation in the **labor** market is still low because of social norms and skills mismatch, among other reasons, which further restricts access to the talent pool. For instance, around 32% of young women (15-24) in Azerbaijan report being NEET (Not in Education, Employment, or Training), reflecting untapped human capital, which could help to mitigate skill shortages if mobilized through better training and inclusion (World Bank, 2021). It is a problem for which foreign investors assessing the non-oil sectors in Azerbaijan will have to count the cost and risk.

However, in view of these challenges, albeit not on a satisfactory level, some work has also been underway to address such gaps. The government of Azerbaijan recognizes the role of human capital development on sustainable growth and inward investment (European Training Foundation, 2023). The country took another step in 2022, adopting the Socio-Economic Development Strategy 2022-2026 with strategic priorities that include human capital being

competitive and workforce modernization (European Training Foundation, 2023). In the recent years, a number of such policies and programs were launched.

One of the key measures has been the increase in education funding and institutional reforms. Public education expenditure was raised by approximately 14% in 2023, amounting to 13.3% of the state budget (approximately 4.2% of GDP) (European Training Foundation, 2023).

Major education reform in 2022 transformed the Ministry of Education into Ministry of Science and Education and introduced new agencies in the mix to strengthen the governance of higher education and pre-school education (European Training Foundation, 2023). These steps seek to improve quality in education and its alignment with the needs of labor market. The government also modernized curricula and launched new courses (with donor support) to better prepare students for relevant employment skills (e.g. ICT, languages, and soft skills) (World Bank, 2023). Azerbaijan is also investing in vocational education and technical training (VET) to provide practical skills for a broader segment of the workforce. A new state vocational education center, for example, opened in the Jalilabad region in 2023 (European Training Foundation, 2023). Enrollments in vocational programs are lifted by revamped training modules and collaborations with industries. However, the participation in formal vocational training is dismally low (the legacy of a low investment and limited courses offerings) (World Bank, 2022).

In changing perception, the government teams exceed improving curricula, developing institutions, and having input from employers in order to produce more technicians, craftsmen, and mid-level professionals vital in agriculture, manufacturing, tourism, and other non-oil sectors. The youth employment and skills programs play a significant role in addressing labor force challenges. The Ministry of Labor and Social Protection has expanded career counseling and job placement services throughout the country through its public employment agency (APEA) (European Training Foundation, 2023). In 2022, a Youth Business Workshop initiative was started, bringing together the APEA, Small and Medium Business Development Agency, and State Agency for Vocational Education to train young entrepreneurs in entrepreneurship and vocational skills (European Training Foundation, 2023). In a similar way, the "Employment Support in Azerbaijan" program continues to offer training and self-employment opportunities for vulnerable groups (unemployed youth, women, persons with disabilities, internally displaced persons, etc.) (European Training Foundation, 2023). Such programs intend to prepare participants for entering the labor force and address the skills mismatch for new entrants into the labor market.

Public-private partnerships (PPPs) for skills and innovation are also expanding to meet labor market needs. Aware of the digital and high-level skill needs, the Center for the Fourth Industrial Revolution in Azerbaijan (established in 2021) cooperated with Coursera to provide free online courses in the areas of data science, AI, and business soft skills (World Economic Forum, 2023). Beyond 6,000 Azerbaijanis, to this date, have completed various courses offered under this program, obtaining certifications in high-demand fields (weforum.org). The initiative aims to reach about 200,000 citizens and establish specialized academies within the framework of the project that would deal with tech startups and digital skills training (World Economic Forum, 2023). Such upskilling efforts, along with coding boot camps and IT incubation centers, seek to augment the pool of tech-savvy talent available to investors. Besides, industry associations (e.g.: AmCham Azerbaijan) have been collaborating with universities to update curricula and internship programs to ensure that students gain

practical experience (AmCham Azerbaijan, 2022). The government is looking at frameworks for the inclusion of private-sector specialists in higher education governance and course design to get a better alignment of academic output with market requirements.

Table 2: Key Labor Market Indicators – Azerbaijan

Indicator (Year)	Azerbaijan	Peer Comparison
Labor force participation rate (15+, %)	~67% (2018) (pre-COVID high; ~64% in 2022) (World Bank, 2023)	Georgia: 60% (2019) (est.)
Unemployment rate (% overall)	5.6% (2022) (Macrotrends, 2023)	EU average: 6.2% (2022)
Youth unemployment (% ages 15–24)	12.7% (2018) (3× national rate) (World Bank, 2022)	Georgia: 30% (2019); EU avg: ~16%
Adults with tertiary education (% of 25+ pop)	27.7% (2023) (CEIC, 2023)	ECA (Europe & Central Asia) avg: ~32%
Labor productivity (GDP per worker, PPP\$)	\$30,600 (2022) (World Bank, 2023)	Georgia: ~\$37,500; Uppermiddle income avg: ~\$45,000

Sources: World Bank, State Statistical Committee of Azerbaijan, ILO, IMF, national surveys (years noted).

Table 2 presents labor market indicators that reveal major structural weaknesses likely to deter foreign investment in the non-oil economy of Azerbaijan. Particularly by international and regional standards, the country's labor-force participation rate remains low among its youth and women. The 2018 labor force participation rate (LFPR) prior to the COVID-19 pandemic was around 67%; however, the LFPR now stands at around 64% in 2022 (World Bank, 2023). This means a very significant portion of the working-age population is not participating in the labor market at all. For comparison, Georgia recorded a not-too-different LFPR of approximately 60% in 2019, while considerably better, at a European Union (EU) average (World Bank, 2023). The unemployment rate appears to be quite low in Azerbaijan at 5.6% (2022), which is slightly below the EU figure of 6.2% (2022) (Macrotrends, 2023). But the headline unemployment figure does not consider underemployment, which is significant. Most Azerbaijanis are rural residents currently engaged in jobs of low productivity uneven with their levels of education or skills, leaving labor underutilization worse than indicated by unemployment figures (World Bank, 2023).

Young people still encounter a serious challenge. Unemployment in the 15-24 age group accounted for 12.7% in 2018, which is nearly thrice that of the national rate (World Bank, 2022). To put this into perspective, in Georgia, the youth unemployment was much higher at 30% (2019), but for the EU average, it was around 16% for the stated period (World Bank, 2022). Another reason that can further account for the relatively low rate of youth unemployment in Azerbaijan is that a considerable number of young people probably do not participate in the labor market as they are having trouble finding a job or are working in the informal sector. Furthermore, 32% of young women in Azerbaijan are classified under NEET (not in education, employment, or training), thus a huge human capital resource remains untapped (World Bank, 2023). High by international standards, adult tertiary education proportion aged 25 and above is still rather low: only 27.7% of the adult population was reported as having attained higher education up to the year 2023 (CEIC, 2023). This figure is below the ECA regional average of approximately 32%, denoting the skills gap which Azerbaijan has in high-demand sectors like ICT, engineering, and finance (World Bank, 2023). Most university degree holders are still confined in the public sector, where they often work in low-productive and administrative functions, thus limiting the available talent to highly private sector and foreign investment driven employment (AmCham Azerbaijan, 2022). In order to measure labor productivity as defined by GDP per worker (in purchasing power parity - PPP terms), that was about \$30,600 in 2022 (World Bank, 2023). This value is much lower than that of peer economies. For instance, Georgia indicated that it has labor productivity level of ~ \$37,500 while upper-middle-income countries average about \$45,000 per worker (World Bank, 2023). Low productivity in Azerbaijan is indicative of structural weakness in skill sets of the workforce, lack of efficiency in doing business, and dependency on low value-added employment in agriculture and state-run enterprises (World Bank, 2022). Overall, Azerbaijan's FDI challenges in non-oil sectors stem from its heavy reliance on oil revenues, exposing its economy to external shocks. Despite some government interventions to improve and promote sectors such as agriculture, barriers like a restrictive legal framework, a lack of skilled labor, in ensemble with the economic reliance on oil revenues discourage foreign investors from considering Azerbaijan as an attractive hub for investing their capital as they value stability and growth prospects. To attract necessary capital for sustainable growth, there will be a need to consider reforms in enhancing the investment climate with an improved governance together with a better management of its human capital resources and development.

Chapter 3. Policy Options

Not only this, but the method has also been quite effective about adoption by the government and political structures and, at the same time, people. Despite policy recognition for the necessity of economic diversification, non-oil sectors in the country generally remain structurally weak and undercapitalized by foreign investment. The constraints, detailed in previous chapters—legal uncertainty, skills mismatch, and sectoral underdevelopment—strictly constrained the flow of capital and technological know-how that the non-oil industries really require. This chapter presents three central policy options for improving Azerbaijan’s attractiveness to foreign investors in sectors such as agriculture, light manufacturing, tourism, logistics, and the digital economy. These include legal and institutional reforms to enhance regulatory transparency, human capital development to create a competitive labor market, and strategic use of financial incentives and sectoral prioritization to guide investment. Each of these options is discussed with reference to global best practice and analyzed for its relevance to the economic context of Azerbaijan.

3.1 Financial Incentives, Economic Zones, and Sectoral Prioritization

In addition to reforming labor laws and legal legislation, Azerbaijan must adopt a more aggressive and targeted industrial policy. Specifically, it must refine the use of financial incentives, operationalize special economic zones (SEZs), and prioritize strategic sectors with the highest potential for non-oil FDI. The government has accomplished some milestones on these fronts, including developing the Alat Free Economic Zone and Sumgayit Chemical Industrial Park, but it still has a lack of coherence and sector-specific targeting in its investment strategy (Mehtiyev, 2018; U.S. Department of Commerce, 2023).

Fiscal incentives remain important in competing for global capital. However, Azerbaijan must make sure that these incentives furnished are efficient, transparent, and linked to measurable outcomes. A performance-based tax concession such as a reduction contingent on the number of jobs created, volume of exports generated, or degree of technology transfer involved would eliminate the issue of blanket tax holidays. Investment certificates could be structured to provide time-bound benefits contingent upon compliance with labor standards and environmental regulations. A tiered system, where greater incentives are given for higher-impact projects, would help prioritize quality over quantity of FDI.

It is time for a recasting of the role of SEZs and industrial parks in the area. These zones should not be mere real estate developments with basic infrastructure. They are to be integrated economic ecosystems with a variety of offerings: one-stop-shop regulatory services, fast-track customs, international arbitration mechanisms, and targeted skill development programs. The Alat Free Economic Zone has the potential to become a logistics and technology connector between Central Asia and Europe given its proximity to the Baku port and regional transport corridors. For success, however, it has to provide not just the legal aspects but also governance, quality of infrastructure, and connectivity (OECD, 2022).

Similar investments should go into secondary zones--such as logistics and manufacturing hubs in Ganja, agro-industrial parks in Lankaran, and tourism-oriented zones in the Sheki-Zaqatala area. These regions have specific comparative advantages that can help in the decentralization of economic activity to reduce the burden in Baku to some extent. These zones may also provide cluster-type environments to facilitate innovation and reduce operational costs for investors through cooperation among suppliers, service providers, and training institutions.

Strategic prioritization of the sectors is therefore equally important. Azerbaijan cannot possibly compete in all sectors at once on a global level. Hence the Government must take this step: focus on identifying and nurturing high-potential industries that would function on latent comparative advantages or scale through investment. The Strategic Roadmap on the National Economy (The Government of Azerbaijan, 2016) identifies key sectors: agro-processing, light manufacturing, ICT, transport, and tourism. These sectors are labor-intensive, export-oriented, and capable of absorbing technology transfers. Targeted sector promotion via sector-specific FDI roadmaps, global investment forums, and partnerships with development finance institutions such as EBRD or IFC can enhance visibility and investor confidence.

Drawing from global best practices and experience from Mauritius and Rwanda shows that SEZs strategically aligned and tightly monitored can lead to growth efficiently, provided an institutional capacity exists to oversee and evaluate it The Vietnamese experience is also illustrative in this regard. Vietnam grew its FDI stock from \$10 billion in 2000 to over \$160 billion by 2020 through identifying a few targeted sectors, aligning incentives, and focusing on zones of export processing. It has contributed to GDP growth and a staggering reduction in poverty besides an increase in industrial competitiveness (Asian Development Bank, 2021). Experiences from Poland and South Korea show that equity-sensitive SEZs are the best for equitable development and sustainability in the long run Azerbaijan can replicate these mechanisms tailored to its own size and geopolitical context.

However, financial incentives and SEZs must be quite carefully husbanded. Poorly designed programs risk meeting the need for "white elephant" projects, fiscal leakages, and zones operating as micro enclaves of the domestic economy. In addition, they rain zones away from compliance with labor, environment, and tax norms so as not to turn such zones into havens for regulatory arbitrage. Therefore, all investment promotion policies should be embedded within a national accountability framework tracking cost-benefit metrics, environmental impact, and social outcomes.

Ultimately, financial incentives complemented by strategic sector prioritization are meant to be complements, not substitutes, for the earlier deep reforms in law and human capital. Yet when well-targeted and transparently administered, the financial incentives can be transformed into a strong force to attract investment and unleash a dynamic non-oil economy.

3.2 Legal and Institutional Reforms for a Better Investment Climate

Aspects of the stability, predictability, and enforceability of the legal and regulatory environment of a country are much significant to foreign investment. In Azerbaijan, while investment protection has many backing laws, such as the Law on Protection of Foreign Investment (1992), the Investment Activity Law (1995), and bilateral investment treaties with more than 40

countries, poor governance is still denting the confidence of investors. The OECD and the Department of Commerce testified that unpredictable enforcement, regulatory uncertainty, and a monopoly of businesses politically connected undermine competition in Azerbaijan (OECD, 2022; U.S. Department of Commerce, 2023). While, technically speaking, the present Azerbaijani legal system supposedly protects investor rights, its implementation is tarnished by procedural delays and corruption-related issues, politically motivated court decisions, lack of transparency in contract force, and contract awards for the benefit of one's own.

This requires sweeping reform in the institutions that support these changes. Establishment of independent decision-making and efficient commercial courts is paramount. Although Azerbaijan allows international arbitration in limited investment disputes, the domestic judiciary is often not trusted to conduct complex commercial litigation expeditiously and without bias. As Transparency International (2023) add, Azerbaijan remains in poor standing on the corruption perception index while the judiciary is perceived to work under political elites. The establishment of a truly independent judicial council to oversee appointments, training, and performance monitoring of judges would be one very critical step toward the restoration of judicial credibility. In the international arena, cases such as Georgia reveal the potent effects of legal reform on attracting foreign direct investment. Georgia moved from one of the lowest rankings within the World Bank Doing Business to at least one of the top ten over a decade in an investor-friendly atmosphere thanks to reforms in its regulatory framework and elimination of bottlenecks created by the bureaucracy. Also, Rwanda's reforms in land registration and dispute resolution systems triggered increased FDI flows between 2005 and 2015.

Complementing judicial reforms with steps that streamline regulations to limit bureaucratic discretion is necessary. While there has been progress through such digitalization platforms as ASAN, considerable discrepancy of regulatory enforcement exists across territories, especially in construction, licenses, and tax inspections (World Bank, 2022). Extending ASAN into all regions and digitalizing the interplay of businesses and the state would greatly reduce corruption and improve efficiency. This model was effective in Germany's public service halls in cutting red tape and corruption after Germany's anti-corruption reforms in the period following 2004 (World Bank, 2019). Azerbaijan can learn from this success by committing itself to fully digitalizing business regulation.

The third area of focus must be reform in land ownership. Currently, foreign investors can only lease land, a critical deterrent for the long-term industrial projects with special reference to those in manufacturing, logistics, and agriculture. While sovereignty can justify the restriction, a conditional ownership model allowing foreign firms making capital investments over a threshold to own land in designated economic zones can balance national interests with investor security (Baker & McKenzie, 2018). Making these rules clear through legislative enactments and full transparency of land registration systems would credibly reduce the risk factors surrounding property rights.

In strategic sectors, institutional reform must confront the dominant presence of state-owned enterprises (SOEs). As the European Bank for Reconstruction and Development puts it, SOEs in Azerbaijan are often afforded preferential treatment and implicit state support, with the effect of distorting competition. The consequence of this is that foreign investors are unlikely to enter sectors where advantages are conferred on entities associated with the state. Therefore, the

establishment of a stronger oversight role for the Azerbaijan Investment Holding, better standards of corporate governance, and the introduction of public-private competition audits would serve both to eliminate such unfair advantages and create a more conducive environment for investment (OECD, 2023).

Legal and institutional reform is arguably the most foundational of all policy options, being that it lays the necessary groundwork for any kind of success regarding the remaining strategies. Just from this description, it is also likely to be the most politically unfeasible option. Reform of systems of justice and corruption affecting elite interests, and depoliticizing regulatory institutions will require, besides building solid technical solutions, a great deal of political will. On the other hand, without credible institutions, quite possibly no level of financial incentives subsidies will ever attract sustained foreign investment into the non-oil areas, not even with the best-designed education programs.

3.3 Skills Development and Human Capital Transformation

As mentioned in Chapter 2 with references to many labor watch reports and in an interview with an expert (Asgarova, 2025), skill gaps that exist in non-oil sectors such as in agriculture, IT, and others could be considered as one of the more important problems to address for a creation of a more internationally competitive investment climate in Azerbaijan. As mentioned above, while education levels are moderately high, with secondary education being almost universal, a more prominent issue with finding a high-skill workforce can be attributed to a education-job mismatched many qualified and high-skilled workforce either do not work in the jobs they have studied for or making a living by working in jobs that require less skills than they have mastered at school. This mismatch is most pronounced in high-skill industries like manufacturing, logistics, ICT, and agro-industrial processing, which are actually targeted for diversification under national economic roadmaps (World Bank, 2022; European Training Foundation, 2023).

To close up these gaps, Azerbaijan, therefore, has to undertake a systematic transformation of its human capital base. It should start with the upgrade of the VET infrastructure sector. Currently, vocational training just constitutes a marginal part of the education system. It has been long since neglected, underfinanced, and mostly dissociated from industry. In Azerbaijan in 2022, less than 15 percent of secondary students were enrolled in vocational programs, an extremely low figure relative to the average across Europe and Central Asia, the World Bank (2022) reports. Moreover, most such programs are delivered in Baku, with little outreach to the regions and even less private sector participation, producing graduates who are largely ill-equipped to meet the demands of the modern industrial environment.-

This intervention should be paired with opening up VET institutions throughout the country, particularly in secondary cities like Sumgayit, Ganja, and Mingachevir. Each region should define what they offer in accordance with the area's economic profile; for instance, Ganja can aim for agro-industrial skills, Sumgayit technical and light industrial trades, and Lankaran, food processing and tourism services. These centers must not operate in isolation. Instead, strong partnerships should be forged with employers, who can co-design curricula, provide practical training opportunities, and commit to hiring graduates. Similar employer-driven VET systems in

Germany and the Netherlands have succeeded brilliantly and could serve as a model for adaptation (European Training Foundation, 2023). Other than that, The Costa Rican experience stands in evidence of the situation. An emphasis on programs for English-language competence and tech-oriented training attracted giants such as Intel and Hewlett-Packard to the country, promoting the evolution of an economy that serves as the regional nucleus of innovation. But equally important is the stimulation of the private sector's participation in human capital development. Major companies--especially foreign multinationals--should provide tax credits for investments made in training, curriculum development, and internships. The new introduction of "Skills Bonds," public-private financing mechanisms whereby companies co-fund training in exchange for long-term tax incentives, could further promote shared responsibility in human capital development. These initiatives would both encourage employment and ensure demand driven, results-oriented training.

There must be soft skills and digital profiling into the whole education framework; Azerbaijan's engagement with the World Economic Forum towards the establishment of the Center for the Fourth Industrial Revolution has already set conditions for the transition. Since 2021, some 6,000 Azerbaijanis have accessed training in AI, data analytics, and the like via Coursera, edX (World Economic Forum, 2023). However, the scope of these programs needs to be enlarged greatly. A national digital upskilling campaign could be run across public libraries, community centers, and online portals, with people gaining access to relevant and accessible digital education in disadvantaged communities. Also included in these efforts must be English language training since it is a crucial requisite for becoming part of global business and technology ecosystems (World Bank, 2023).

Interventions of such nature are needed and urgent. As stated in the AmCham Azerbaijan (2023) report focusing on labor market mismatch, over 52 percent of the surveyed businesses indicated that unskilled labor was their key operational challenge. Critical thinking, communication skills, and hands-on technical proficiency were found to be lacking among university graduates. The geographic imbalances on top of gender disparities worsen the situation; for example, women's participation in the labor force is still low, mainly in rural areas, with more than 30 percent of women aged 15-24 being NEET-not in education, employment, or training (World Bank, 2021). Targeted training, scholarships, and childcare assistance would harness this latent talent pool for inclusive growth.

University-industry reform should also be accelerated. All tertiary institutions in Azerbaijan should be mandated to maintain Industry Advisory Boards, with leading employers from relevant sectors constituting the advisory board. These boards would provide input into course design, internships oversight, and graduate employability metrics. In addition, entrepreneurship education and innovation hubs should be integrated into universities to promote a culture of problem-solving, startup creation, and collaboration with the private sector. Otherwise, the gap between academic knowledge and practical relevance will continue.

Importantly, investments that are made in human capital are not just social expenditures-they will become very much part of the investor confidence-building backbone. To evaluate his trust of entering non-oil segments in Azerbaijan, foreign firms should see an enabling reality in terms of talent and flexibility out of Azerbaijan to support any competitive operations. A skilled work force is essential if the efforts at diversification would stand a chance of being meaningful.

Admittedly, education requires long time horizons for reforms; the benefits compound and go beyond productivity and wages to include social cohesion and the potential for innovation.

Chapter 4. Evaluation Of Policy Alternatives

The imperative issue for Azerbaijan is to attract sustainable foreign direct investment (FDI) in the non-oil sector, since the economy requires diversification away from an addition to longstanding dependency on hydrocarbons. This shift, however, cannot take place under declarative policy. Multilayered, evidence-based approaches supported by institutional reform, human capacity development, and smart investment incentives must be devised. This chapter assesses three policy options-legal and institutional reform, human capital development, and financial incentives and sectoral prioritization against five critical criteria of choice: effectiveness, efficiency, flexibility, equity, and feasibility. Each criterion allows a different analytical lens through which to view the relative merits, constraints, and potential complementarities among the alternatives proposed.

4.1 Evaluation of Legal and Institutional Reform

It is very important for legal and institutional reforms to help attract foreign investors to the non-oil areas in Azerbaijan. Improvements in how well institutions function have a strong positive impact on the amount of FDI that comes into a country. One standard deviation increase in political institutions can double FDI flows for low-income countries and more than triple them for lower-middle-income countries, highlighting how solid laws help attract more foreign investment (Financial Innovation, 2019).

In many cases, nations that simplify business processes, improve the security of property rights and make enforcement of contracts easier have grown in FDI, according to the World Bank's annual Doing Business reports. As these programs are implemented, it is now easier and safer for foreign businesspeople.

In Azerbaijan, conforming laws and institutions to international standards can boost the belief of investors. Solving legal doubts and making sure contract laws are applied give investors certainty and will likely attract more foreign investment outside its oil industry.

Enhancing the efficiency of foreign direct investment (FDI) in Azerbaijan's non-oil sectors depends on new legal and institutional reforms. When regulations are streamlined, both transaction costs and administrative work are reduced which improves the chances for investment growth. According to the World Bank's 2020 Doing Business report, economies that follow efficient regulations spend less time and money operating their businesses (World Bank, 2020).

Studies using data verify that institutions' efficiency is closely linked with more FDI coming into the country. According to Hillman (2025), boosting legal rights by one unit can cause an increase

of 14.7% in FDI in Sub-Saharan African countries. Still, the World Bank's Business Ready project reveals that more efficient legal frameworks tend to draw more FDI.

If legal and institutional efficiency is increased in Azerbaijan, it can open the door for foreign investors and make it easier to create sustainable economic diversity.

Changing economic and investor needs can be easily met through legal and institutional reforms in fast-changing global markets. Making changes in old regulations and introducing fresh systems of governance can really improve the country's appeal to investors. According to UNCTAD's latest report, companies in countries with flexible investment regulations could gain up to 20% more reasons to reinvest over five years (2022).

Flexibility is very important in non-oil industries, where technology and service models change fast. By introducing the ASAN service model, Azerbaijan has shown how flexible administrative systems may work well (OECD, 2023). Making the rules flexible allows the country to create special incentives and dispute processes for different sectors which helps it respond well to changing investors and markets. Ensuring a fair opportunity for every investor is made possible through updates in the legal and institutional environment. If these measures are implemented, corruption is curbed, judicial independence increases and there is less use of discretion in regulations, political companies in Azerbaijan's non-oil sectors may receive favorable treatment less often (Transparency International, 2023). As indicated by the OECD (2022), open legal policies increases opportunities for small and medium businesses to participate in economic development and growth. The data reveals that countries that strengthen their financial laws for all experience a 15% higher inflow of small business investments within five years. If Azerbaijan had fair legal reforms, people and areas with fewer resources would get similar economic opportunities and investment benefits.

Legal and institutional reform in Azerbaijan is not easy because of structural and capacities reasons, but mainly for logistical and not political issues. To carry out major reforms in law, technical insight, teamwork among different organizations and steady financial support are necessary. Almost 60% of changes made in transition economies are not fully carried out due to difficulties within the administration and because institutions do not respond well, based on 2022 OECD data. Because there are not enough lawyers with training in international law in Azerbaijan, it becomes more difficult to create laws that attract investors (EBRD, 2023). At the same time, differences in how capable regions are outside Baku reduce the chance that all areas will apply the reforms equally. The practical restrictions here, not simply opposition from politicians, lessen the ease of making legal changes, so it is important to design an implementation plan accordingly

4.2 Evaluation of Human Capital Development

Working on human capital has helped Azerbaijan continue to get foreign direct investment by dealing with its ongoing issue of mismatched skills and their low productivity. World Bank research (2022) indicates that a 1% rise in Human Capital Index leads to a 0.3–0.5% rise in per capita GDP. Azerbaijan's workers are less productive than others in the region because of poor

access to technical and vocational education, according to the World Bank (2023). Giving greater attention to vocational training and updating school subjects to match industry goals helps students get ready for work, mainly in ICT, manufacturing and agro-processing. As a result, having good skills development increases investor confidence by making sure there are properly trained and adjustable employees. Even though building up human capital helps a lot, its efficiency is mild because it can take years and use a significant amount of resources. In vocational and technical education, training programs depend on continuous funding, adequate institutional support and match with what is needed in the job market. Typically, countries that spend more than 4% of GDP on education experience improved workforce results within 5–7 years, but Azerbaijan currently contributes 4.2% of GDP to education (European Training Foundation, 2023). But problems come from differences between regions, lesser engagement by the private sector and unused upskilling resources. In addition, World Bank surveys (2021) find that a large number of employers in Azerbaijan still struggle with skills shortages, especially after the recent educational reforms, meaning skills development is not well-targeted and does not always save money in the short term. It is flexible to adapt, since it may be shaped to fulfill current and future job demands and technological developments. Because of modular vocational courses and short tertiary programs, adults in emerging fields such as ICT, logistics and digital services can quickly respond to changes in the labor market. After three years, graduate employment rates in countries that adopted employer-oriented changes to curricula were 35% higher, the European Training Foundation found (2023). In Azerbaijan, things are improving, thanks to steps such as public-private cooperation and a digital skills program offered by Coursera that participated in by more than 6,000 people (World Economic Forum, 2023). Because of this adaptability, the workforce maintains its position, helps the non-oil sector become more competitive and reassures investors about the labor supply lasting into the future. It is reasonably possible to develop human capital in Azerbaijan, thanks to higher government spending and a growing awareness of its value. It is estimated that this year, the state's education expenditure accounts for 13.3% of its budget which is around 4.2% of its GDP. Also, setting up new vocational centers and improving how education is governed prepares institutions for skill-building programs. Even so, feasibility will be limited by fewer than 15% of high school students enrolling in vocational education and not enough engagement from the private sector (World Bank, 2022). Ununiform development in regions and old facilities for military training are other issues for the country's defense operations. Regardless of these problems, gradually improving reforms and outside help ensure that improving human capital can truly be achieved. Developing human capital is important for equity since it covers social differences and pays attention to ensuring that opportunities for work are fair to everyone. About one-third of young women in Azerbaijan between 15 and 24 years old are considered NEET which makes them an essential group the workforce can use. Programs that train people in specific skills which focus on rural youth, displaced persons and women, support more employment opportunities and lessen inequality in income. The European Training Foundation (2023) findings revealed that within three years, 25% more employment among disadvantaged groups can be achieved by following strong inclusive training policies. Providing equitable education and training helps Azerbaijan correct skill gaps and distribute the good results of changes in the non-oil sectors to all parts of society

4.3 Evaluation of Financial Incentives and Sectoral Prioritization

If financial support and sectoral preferences are attached to well-defined development goals and results that can be counted, they can efficiently draw in targeted FDI. While Azerbaijan has developed numerous industrial parks and economic zones, including the Sumgayit Chemical Industrial Park and the Alat Free Economic Zone, little FDI has been attracted to other economic areas excluding oil. Mehtiyev points out that during 2000-2017, even though tax incentives and preferential zones were introduced, just 14.1% of total FDI invested in areas aside from oil and gas. Data from around the world has shown that tailored incentives such as those for employment or technology sharing can boost the effectiveness of sectoral FDI investment up to 30% over a five-year period (UNCTAD, 2022), proving that smart policy efforts have much more potential. Since Azerbaijan's fiscal costs are usually greater than quick positive results, its efforts to improve are not as efficient as needed. Tax holidays and subsidies often allow companies to avoid paying taxes, but do not promise big returns on investment if no performance goals are set. The IMF reported in 2021 that the cost to GDP of inefficient tax expenditures in emerging markets can be as high as 2–3% and such expenditures have little impact on investment. Investor turnout has been moderate in Azerbaijan's free economic zones because the organization does not yet have solid institutions and well-developed infrastructure (OECD, 2022). In addition, not adjusting incentives for each sector could result in incorrect resource allocation. Because of the lack of strict cost–benefit checks, these schemes could end up being inefficient which explains the low efficiency mark given to this option by the evaluation framework.

It is moderate but possible to adjust financial incentives and sectoral order, when needed, due to changes in investment trends. Azerbaijani policymakers are able to make changes in incentives, select new main sectors and revise the eligibility rules when the economy shifts. Under the Strategic Roadmap (2016), the important sectors including agro-processing, ICT and logistics are evaluated regularly. But for flexible incentives to work properly, the government needs to coordinate its policies more closely and gather real-time market information which Azerbaijan does not do well yet. World Bank research released in 2022 indicates that having systems for evaluating incentives raises the likelihood that investors will continue working in the country by 18%. On paper, Azerbaijan's system is flexible, but in reality, its institutions are unable to respond well, so the system lacks much practical flexibility.

Since Azerbaijan uses similar approaches and tools, both financial incentives and sectoral prioritization are highly feasible. Although legal and institutional reforms redesign how things function, financial incentives can be part of the existing framework. The state has already built several industrial parks and free economic zones and in 2023, 13.3% of the budget was spent on economic development so these programs can continue (European Training Foundation, 2023). Besides, the Azerbaijan Investment Company and the relevant ministries have been involved in coordinating investment subsidy support. Therefore, it becomes simple to adjust or implement these policies, so they stand out for their high feasibility in the evaluation.

The way these schemes offer encouragement is considered unequal, as many advantages go mainly to urban centers and manufacturing businesses that need huge injections of money to function. Based on evidence produced by the OECD (2022), it appears that large, well-connected businesses receive more benefits than small and rural ones. Benefits from industrial parks and economic zones are mostly found in Baku and Sumgayit, rather than all across Azerbaijan. Interestingly, wide tax incentives tend not to help groups or communities that are most in need. Social and geographic equity is not achieved in Azerbaijan’s local economy, as UNDP (2021) indicates such equity should come from ensuring policy schemes are inclusive, yet regional investments are absent within Azerbaijani policies.

Criteria/Policy alternatives	Legal and Institutional Reform	Human Capital Development	Financial Incentives and Sectoral Prioritization
Effectiveness	5	5	5
Efficiency	5	3	1
Flexibility	5	4	3
Feasibility	2	3	5
Equity	4	5	1
Total	21	20	15

The evaluation table shows the significant differences, both benefits and drawbacks, among Legal and Institutional Reform, Human Capital Development and Financial Incentives with Sectoral Prioritization. Among all factors, legal institutions and rule changes scored the most strongly (21), proving that becoming clearer on laws and easier to enforce agreements is essential for encouraging investor confidence (OECD, 2022; World Bank, 2020). Still, its potential is limited (score of 2) because making this happen is not easy and many institutions encounter problems. Second in the ranking, human capital development scores 20 and focuses on helping almost anyone succeed in the workforce by offering fairness and providing opportunities for all. Although law reforms are a little more direct, the modest price and increased actions by politicians make educational solutions a lasting investment (European Training Foundation, 2023). The area rated lowest (financial incentives and sectoral prioritization) was 15, mostly because it scored low in efficiency (1) and equity (1). Though they can be applied and adapted well (5 and 3), these policies might lead to poor use of resources due to insufficient institutional support. So, I believe that supporting legal changes and investing in people is the best approach to get lasting foreign direct investment into Azerbaijan’s other sectors.

Chapter 5. Conclusion and Recommendations

The final chapter shapes the evaluation findings of the policy measures and presents an action oriented agenda to promote foreign direct investment into non-oil sectors of Azerbaijan. Building on the strategic alternatives discussed in Chapter 4: legal and institutional reform; human capital development; and financial incentives with sectoral prioritization, this chapter proposes form path paralleling Azerbaijan's long-term economic objective, governance structure, and regional positioning. The policy trajectory is set not only to ensure investment attraction but also to initiate the process of inclusive, diversified, and sustainable growth as put forth in the framework of structural transformation. Focus is thereby put on the agreed-on sequencing of reforms, institutional coordination, and stakeholder engagement needed to cover the medium-to-long-term implementation.

5.1 Recommendations

The evidence this paper has supplied shows that the comparative underperformance of Azerbaijan in attracting non-oil FDI is due not to lack of geographical advantage, infrastructure, or macroeconomic stability, but rather to institutional deficiencies concerning governance, labor market preparation, and the structuring of sectoral development incentives. Although investments have been mainly channeled into the hydrocarbon sector, legal uncertainty, a workforce not adequately skilled for investor needs, and a fragmented incentives framework have weighed against any genuine diversification into other sectors.

The three alternatives analyzed, namely legal and institutional reform, human capital development, and targeted financial incentives, are not only feasible but indeed necessary. Their successful execution is inextricably linked to one another. Legal reform is the crucial foundation, generating the trust, predictability, and regulatory stability behind investors' decision-making. Development of human capital is vital to equip the workforce of Azerbaijan with the skills required in supporting high-value investments. Incentives alone attract the quickest streams of investments and stimulate regional activity, but they become effective only if backed up with good legal frameworks and labor force.

An integrated approach to this analysis conclusively dictates that Azerbaijan must move away from scattered policy initiatives into a consolidated, strategic reform program. FDI attraction is not something one would do with a tax holiday and once or twice a year road shows promoted by the foreign ministry. Rather, it entails building a transparent, responsive, and investor-friendly ecosystem that instills confidence in Azerbaijan as a long-term credible investment platform within the Eurasian region.

Institutionalizing Legal Reform and Regulatory Predictability

Assuming that legal and institutional reform must be the foundation of the FDI strategy of Azerbaijan, there are factors, such as judicial independence, sound contract enforcement, and transparent licensing, that international institutions like the OECD and World Bank continually

list among the five or so most important factors in assessing investment climate quality. Azerbaijan should adopt best practices, such as those practiced by Singapore's Economic Development Board and its one-stop investment services, to create a unified regulatory authority for investment licensing, dispute resolution, and land allocation, which is built on a framework with a strong international reputation.

The legal reform agenda must transcend mere structural reorganization and include the drafting of legislation that reduces administrative discretion and eliminates sector-specific exemptions. Aligning such reforms with OECD investment policy guidelines would strongly signal the global market. The key initiatives should include the digitalization of legal and regulatory processes, the anonymous publication of judicial decisions, and formal service-level guarantees on the agencies involved in public business licensing. In addition, an independent Investment Ombudsman should be established, modeled after those in Estonia and Georgia, to provide a meaningful grievance redress mechanism for foreign investors.

Activating a National Human Capital Transformation Framework

Depending on the quality and adaptability of the labor force, Azerbaijan would be able to attract and retain non-oil FDI. To this end, the Ministry of Education, the Ministry of Economy, and representatives of the private sector in a joint partnership should set up a National Human Capital Transformation Framework. The framework would function as a way to modernize labor markets via real-time forecasting of skills needs, councils of employers, and performance-based financing of vocational and tertiary institutions.

Azerbaijan may imitate the Human Resources Development Fund of Malaysia, whereby employers contribute to the national training fund and are reimbursed for training workers. Testing a similar model for co-financing is to be piloted in Azerbaijan, targeting initially sectors of logistics, food processing, and digital services, while embedding gender equity in the strategy by way of VET scholarships for women, child-care provisions, and promotion of flexibility in work arrangements, especially in rural areas.–

The expansion of educational infrastructure around SEZs in Ganja, Sumgayit, and Lankaran can provide further spatial equity and align workforce development with regional investment priorities. Modular certification programs tied to industry and designed jointly by employers and accredited by international partners would guarantee global recognition and thereby the mobility of its workforce. Azerbaijan may also tap into its global diaspora to boost knowledge and partner academically with world-class institutions for capacity building in frontier areas such as AI, robotics, and renewable energy systems.

Reforming Financial Incentives through Performance-Linked Structures

The current scheme of incentivization in Azerbaijan, centered on tax and custom exemptions deemed to be Investment Promotion Certificate benefits, has to be restructured to transition from input-based to performance-based models. Hence, the future incentive regime should look to link the benefits granted to investors directly with the outcomes related to employment generation, export volume, incorporation of local suppliers, and environmentally sustainable operations.

Consideration could be given to setting up a tiered incentive regime, whereby applicants meeting customary development benchmarks will qualify for superior tiers of benefits.

Transparency regarding the incentive scheme is equally important. The Government of Azerbaijan should consider the establishment of a centralized Investment Incentive Registry whereby the terms and conditions of all granted incentives and, if possible, their outcomes, would be made publicly accessible. This will essentially provide a real-time platform for tracking investor contributions, preventing any sort of rent-seeking behavior, much similar to the CORFO Investor Dashboard in Chile and the IDA monitoring platform in Ireland. The trust of the general public could be restored with such a degree of transparency, along with an avenue for independent evaluation of policy effectiveness.

The SEZs in Azerbaijan need to be taken further and allowed to evolve as dynamic economic ecosystems away from their current semblance of static enclaves. For this to happen, the innovation infrastructure, shared logistics and digital platforms, and R&D facilities should be firmly embedded in every zone. Further integration between SEZs and academic institutions—especially vocational centers—will guarantee and assure knowledge spillovers and foster the competitiveness of the sector. SEZ operators must submit an Annual Report on job creation, average wages, and levels of domestic procurement. Such reports should be audited and published to guarantee public accountability.

Sectoral and spatial targeting should align with national economic and environmental objectives. Investment in Agritech and food processing in the Aran region can help in solving import dependence and rural unemployment, while solar manufacturing and clean energy investments on the Absheron peninsula shall aid Azerbaijan in fulfilling its commitments to COP28. The Ministry of Economy shall issue an Annual FDI Sector Outlook Report to guide investors, regional planners, and workforce developers about sectoral trends, impending changes in regulation, and planned infrastructure upgrades.

Targeted roadshows should be organized, with the support of diaspora networks, in markets such as Türkiye, the UAE, and Central Asia to reinforce Azerbaijan's value proposition and attract investment oriented towards national priorities.

Establishing a High-Level FDI Reform Implementation Council

For reform continuity and coherent implementation, Azerbaijan should establish a standing FDI Reform Council, co-chaired by the Prime Minister or Deputy Prime Minister. The Council should coordinate inter-ministerial efforts, monitor the status of reform implementation through a digital dashboard, and issue publicly available biannual reports on the investment climate. Including private sector representatives, the academia, and development partners would secure the diversity of inputs and promote transparency.

This governance structure may be based within the frameworks of the Investment Council of Kazakhstan, which was successfully managing a broad range of investment climate reforms from 2017 to 2022, facilitated by the World Bank. To implement the actual delivery of reforms, Azerbaijan should ensure the building of a Reform Delivery Unit consisting of economists, legal

experts, and policy managers. Empowered to address policy bottlenecks and trigger adaptive reforms, this unit will be the technical engine of systemic change.

Azerbaijan's fiscal strength, strategic geography, and geopolitical relevance offer the foundation for economic transformation—but the time for action is now. In a competitive global environment where capital mobility is high and investor expectations are rising, the country must differentiate itself not through rhetorical ambition but through demonstrable credibility, regulatory integrity, and tangible outcomes.

If implemented in a phased, coherent, and coordinated manner, the recommended reforms in legal systems, human capital, and investment promotion can catalyze a structural shift in FDI over the next five to ten years. Beyond the accumulation of capital, these reforms promise broader dividends: increased employment, gender inclusion, SME competitiveness, and progress on environmental resilience. Collectively, they would align Azerbaijan's investment climate not just with global best practices but with the aspirations of its people and the demands of a diversified 21st-century economy. As Azerbaijan looks ahead to the 2030 development horizon, reform, coordination, and inclusion will determine whether today's economic potential can be transformed into enduring prosperity.

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Appendix

Ulkar Asgarova:

1) Sizcə, xarici şirkətlərin Azərbaycana gəlməsi ölkəyə hansı müsbət və ya mənfi təsirləri göstərə bilər?

Xarici investisiyaların Azərbaycan respublikasına gəlməsinin əlbəttə ki, müsbət tərəfləri olduğu kimi mənfi tərəfləri də mövcuddur. Əvvəlcə müsbət tərəflər kimi ölkəyə yeni texnologiyalar və təcrübələrinin gətirilməsi, yeni iş yerlərinin yaranması, valyuta daxilolmalarının artması baxımdan faydalı bir prosesdir. Eyni zamanda bu iqtisadiyyatı aktivləşdirir, inkişafa motivaisya yaradır. Məsələn, yerli şirkətlər üçün rəqabət mühiti yaranır ki, bu da inkişafı stimullaşdırır.

Nümunələr üzərindən getsək qeyd edə bilərəm ki, cari vəziyyətdə ölkədə qeyri-neft sektorunun inkişafı istiqmətində fəaliyyətlər prioritetlik təşkil edir. Xarici investisiyalar da iqtisadiyyatın qeyri-neft sahələrində inkişafı stimullaşdırır. Dövlət Statistika Komitəsinin 2023-cü il üzrə məlumatlarına diqqət etdikdə görürük ki, qeyri-neft sektoruna yönələn birbaşa xarici investisiyaların həcmi əvvəlki ilə nisbətə 12% artaraq 2.1 milyard ABŞ dolları təşkil etmişdir. Bu da onu göstərir ki, investisiyalar qeyri-neft sektorunda əhəmiyyətli mövqeyə malikdir.

Az əvvəl qeyd etdiyim kimi yeni iş yerlərinin yaradılması məsələsinə gəldikdə bu proses məşğulluq imkalarının artırılmasında əhəmiyyətə malikdir. Yəni xarici şirkətlər iş yeri mənbəyidir. Məsələn, “BP Azerbaijan”. Bu kimi böyük şirkətlərin fəaliyyəti minlərlə yerli işçinin məşğulluğuna səbəb olur.

Mənfi təsirlər o ola bilər ki, az əvvəl də qeyd etdiyim kimi rəqabətə yol açar bilər. Rəqabət də özlüyündə müsbət təsir yaratması ilə arəbər mənfi təsirləri də formalaşdırar bilər. Məsələn, yerli müəssisələrin rəqabətə davam gətirə bilməməsi və bazardan sıxışdırılması, mənfi təsirin ölkədən çıxarılması, Azərbaycanın deyil də digər ölkələrin Milli Gəlirinin artması, xarici asılılıq və s. Asılılıq ona görə ki, əgər ölkə müəyyən sahədə yalnız xarici investitorlardan asılı hala gəlsə, bu gələcəkdə ölkənin iqtisadi təhlükəsizliyi üçün risk ola bilər.

2) Sizcə, Azərbaycanda xarici ölkələrdən gələn investisiyalar daha çox hansı sahələrə yönəlməlidir? Niyə məhz bu sahələr?

Söhbət əgər qeyri-neft sektorunun inkişafından gedirsə bu zaman ilk ağıla gələn kənd təsərrüfatı və ərzaq sənayesini qeyd etmək olar. Çünki Azərbaycanın kənd təsərrüfatı potensialını yüksək hesab etmək olar. Onun torpaq ehtiyatı və iqlim şəraiti buna imkan verir. Qeyd edə bilərik ki, 2023-cü ildə kənd təsərrüfatının ÜDM-də payı 6.5% olub, düzdür bu əvvəl ki illərdən yüksək göstəricidir, investisiyalar öz işini görür. Bu proses daha da sürətlənsə və artarsa ərzaq təhlükəsizliyi məsələsi daha da möhkəmlənər, eyni zamanda iqtisadi artıma səbəb olar.

İT sahəsinə ola bilər ki, dövrün tələbləri bunu deyir. İT bacarıqları artmaqdadır və bu bacarıqlarının tətbiq baxımından müvafiq sahənin inkişafına ehtiyac duyula bilər ki, beyn

axınına səbəb olmasın. Daha sonra Turizm sektorunu qeyd edə bilər ki, regionlarda bu sahəyə investisiyalar regionlarda məşğulluğun artmasına şərait yarada bilər.

Bildiyimizi kimi dövrümüzdə aktual məsələlərdən biri olan yaşıl enerji, yaşıl iqtisadiyyat sahələri inkişafı zəruri olan sahələrdəndir. Bu sahənin inkişafı ilə əlaqədar investisiyaların cəlbə ölkə üçün çox əhəmiyyətli ola bilər. Nəzərə alsaq ki, dayanıqlı iqtisadi inkişafın əsas indikatorlarında biri ekoloji dayanıqlılıqdır. Bildiyim qədər 2030-cu ilə qədər Azərbaycanın enerji istehsalının 30%-nin bərpa olunan mənbələrdən olması planlaşdırılmaqdadır və düşünürəm ki, xarici investorların iştirakı bu sahənin inkişafını sürətləndirə bilər.

3) Sizcə, Azərbaycanın qeyri-neft sektorunda xarici investisiyaların qarşılaşdığı əsas çətinliklər və maneələr hansılardır?

Tam olaraq bu prosesin içində olmadığım üçün detallı şəkildə əsas çətinliklərin nə olduğunu söyləyə bilmərəm. xarici investorların qarşılaşdıqları əsas çətinliklər bəzi sahələrdə kadr çatışmazlığı ola bilər.

4) Sizcə, xarici ölkələrə Azərbaycanı tanımaq üçün nə etmək lazımdır ki, daha çox investor gəlsin?

Düşünürəm ki, xarici investisiyaları artımı ilə bağlı Azərbaycanda kifayət qədər işlər görülməkdədir. Əvvəldə qeyd edildiyi kimi investisiyaların məbləğində hər il artımlar müşahidə olunmaqdadır.

Bu istiqamətdə ümumilikdə demək olar ki, beynəlxalq tədbirlərdə Azərbaycanın imkanlarının təqdimatı artırılmalıdır, hüquqi prosedurlar daha da sadələşdirilməlidir, rəqəmsal platformalar üzərindən investorların lazımi məlumatlara asan çıxışı təmin edilməlidir, strateji sahələrdə çalışan xarici investorlar üçün əlavə müəyyən vergi və gömrük güzəştləri müəyyən edilə bilər. Amma qeyd edə bilərəm ki, güzəştlər baxımından xarici investisiyalar üçün kifayət qədər münbit mühit mövcuddur.

5) Sizcə, gənclər xarici şirkətlərdə işləmək üçün yetərinə hazırdır?

Bəzi gənclər texniki və dil biliklərinə görə bu mühitə hazır olsa da, ümumilikdə praktiki təcrübə baxımında müəyyən çatışmazlıqlar ola bilər. Xarici şirkətlər daha çox təşəbbüskar, komanda ilə işləyə bilən və özünü ifadə edə bilən işçilər axtarır. Düşünürəm ki, bu bacarıqların inkişafı yönündə təhsil sistemində işlər görülməkdədir. Bir çox universitetlərdə bizneslə əməkdaşlıq və təcrübə proqramları genişləndirilməlidir.

6) Xarici sərmayənin gəlməsi yerli əmək bazarına necə təsir edir? Daha çox iş yeri yaranır, yoxsa işsizlik artır?

Əbəttə ki, iş yeri yaradır. Xarici investisiyalar ümumiyyətlə məşğulluğa müsbət təsir edir. Lakin müəyyən mənada uyğunsuzluğa səbəb olma ehtimala var. xarici şirkətlə daha çox yeni texnologiyalara əsəndiyi üçün daha yüksək keyfiyyətə, bacarıq və ixtisas malik işçilərə meyilli

olur, ixtisasız işçilər də bu işlərə uyğun gəlməyə bilər. Bu zaman uyğunsuzluğun aradan qaldırılması üçün ixtisas artırma təlimlərinin keçirilməsi daha məqsədə müvafiq ola bilər.