



How Accession to WTO would benefit Azerbaijan

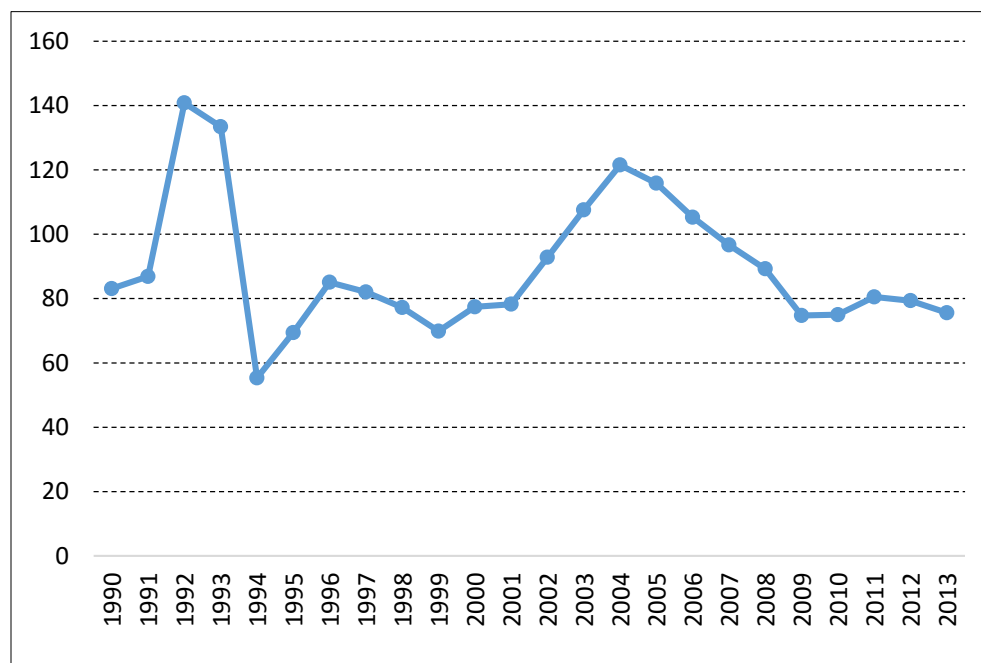
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Introduction

Foreign trade plays crucial role in the Azerbaijan's economic growth tracks during last 10 years (2005-2015)¹. Extraction of oil and gas and infrastructure-building made foreign trade sector in the country one of the leading sectors of economy. Surplus of the country's current account runs more than \$11 billion in 2014. Despite volatility with the international market, volume of foreign trade in goods and services increased by 7 times to \$54 billion over the past 10 years. Trade surplus remains a dominant trend and export on average exceed import value by 2.6 times.

Chart 1: Ratio the trade to GDP (%)



Source: World Bank's Metadata

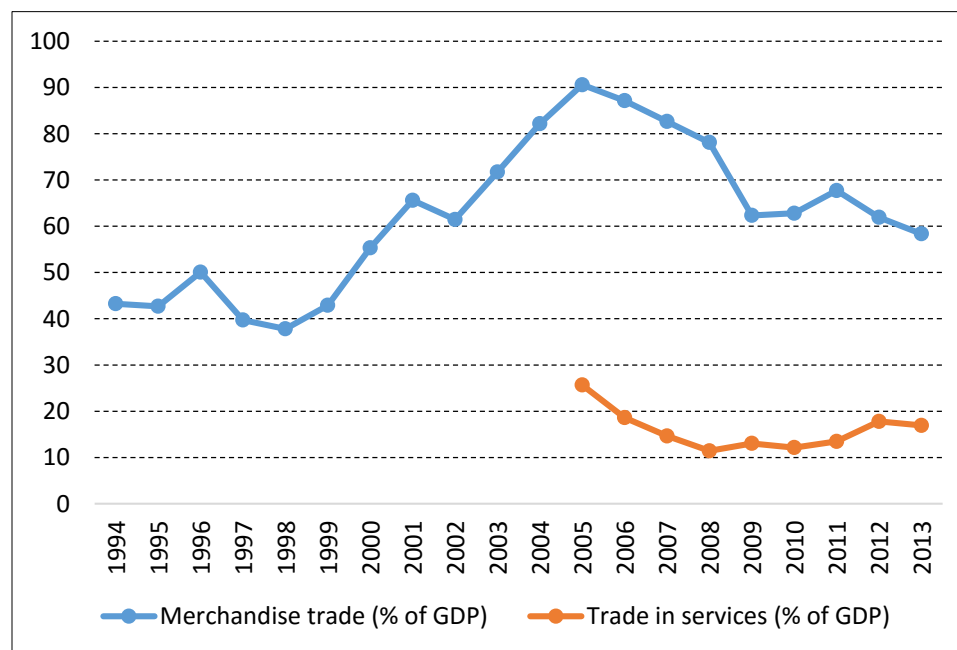
Natural resources have been the major pillar of Azerbaijan's economy over the past 25 years since its independence, In 2014, 92% of export, 70% budget revenues and a minimum of 45% of the GDP come from oil and gas sector². However, major challenges of the country remain at the institutional level. Prosperity is out of the question when there is a lack of freedom to trade

¹ http://www.azerbajjans.com/content_1679_en.html

² 1) Assessment of economic and export diversification of Azerbaijan. Revenue Watch Institute Report. Baku, New York, 2012 (p.37); 2) <http://www.economy.gov.az>; 3) <http://www.stat.gov.az>

and investment for non-oil sectors and coordination in economic policies. Benefiting and self-sufficient largely from the oil export, the country has taken very little step to open up trade of services and commodities through institutional reforms.

Chart 2: Merchandise and service trade in Azerbaijan (% of GDP)



Source: World Banks's Metadata

Chart 2 shows that the ratio of the merchandise trade to GDP increased after starting the boom in 2005. At the same time, on the other hand, the ratio of trade in services started decrease.

According to the 2013 Enterprise Survey of the World Bank about the business entities face many severe constraints, including corruption and a business environment that was not conducive to international trade. For example, 32% of the firms in Azerbaijan reported unofficial payments to public officials to get things done compared with an average of 17% Eastern European and Central Asian countries.³

³ <http://blogs.worldbank.org/psd/unofficial-payments-barriers-to-trade-and-other-obstacles-to-running-a-business-in-azerbaijan>

Azerbaijan's Accession to WTO

On 1 January 1995, the General Agreement on Tariffs and Trade (GATT) was replaced by World Trade Organization as the world's biggest overseeing the multilateral trading system. GATT was established in 1947 after World War II in the wake of other new multilateral institutions dedicated to international economic cooperation. The majority of the WTO's current work comes from the 1986-94 negotiations called the Uruguay Round and earlier negotiations under the GATT.

The main principles of the WTO are following: most-favored-nation (MFN): treating other people equally (under the WTO agreements, countries cannot normally discriminate between their trading partners; national treatment: treating foreigners and locals equally (imported and locally-produced goods should be treated equally); prioritization of tariff quota administration method; elimination of quantitative restrictions; transparency (negotiations and process must be fair and open with rules equal for all); domestic markets are covered by WTO rules; promoting fair competition; freer trade through negotiations. The key principle of the WTO that supervises 95% of the world's global trade is to prevent discrimination in the foreign trade and provide free access to the markets of the member nations. The principle of non-discrimination in the foreign trade is aimed at identifying trade rules for the all the WTO members and avoiding discrimination of imported goods in the national markets⁴.

Azerbaijan officially applied WTO for full membership in 1997 and WTO Secretariat decided to set up Working Group on country's application⁵. Also a Working Party on Azerbaijan's accession to the World Trade Organization was established on July,16 1997 with its first meeting held in June 2002. The main goals of Azerbaijan in WTO membership were as follows: acceleration of integration process into the world economic system; benefit from the preferences mutually provided by WTO member countries; carrying out trade operations with many world countries based on common rules adopted by WTO; succeed in the increase in the amount of the aids provided by international organizations and countries for the economic reforms carried out in

⁴ <http://eap-csf.eu/en/news-events/articles-analytics/az-wto-accession/>

⁵ "Free movement of commodities, investment and people in the Black Sea Region: case studies of Azerbaijan, Georgia, Ukraine", PAAFE, BST, 2013

the country; attract even more direct foreign investments upon application of WTO rules; gain the possibility of using dispute resolution mechanisms of WTO⁶.

As a matter of fact, the World Trade Organization (WTO) defines rules of international trade. The role of the organization is huge since its members account for 92.7% of the world merchandise trade⁷. Adjustment of economic policies to the WTO principles encompasses steps in trade liberalization (including reduction of import duties, elimination of quotas and licenses), approximation of trade rules (such as rules of origin, trade remedies) to the WTO norms and practices, and changes in general economic policies (in the spheres of technical regulation, sanitary and phyto-sanitary control, subsidies, intellectual property rights protection etc.). The legal basis for cooperation in the framework of the WTO includes primarily the Uruguay Round agreements including the General Agreement on Tariffs and Trade (GATT 1994), the General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), the Agreement on Technical Barriers to Trade (TBT), the Agreement on the Application of the Sanitary and Phyto-sanitary Measures and many others.

Bilateral negotiations between Azerbaijan government and WTO members on market access are underway since the formation of the Working Party. It also held bilateral negotiations with Brazil, Canada, the European Union, Japan, Norway and the United States on the margins of the meeting of the Working Party. Representatives from China, the European Union, India, Japan, the Kyrgyz Republic, Norway, Pakistan, Switzerland, Turkey and the United States welcomed the substantive inputs submitted by Azerbaijan and expressed their support for this accession. During the negotiation members requested clarifications on Azerbaijan's economic policies, state-trading enterprises and privatization, pricing policies, investment, competition policy, VAT exemptions, application of excise taxes, and enactment of the Customs Tariff Law. Members also requested clarifications on fees and charges for services rendered, customs valuation, rules of origin, export bans, industrial subsidies, and agricultural export subsidies, technical barriers to trade, sanitary and phyto-sanitary measures, government procurement and intellectual property⁸.

⁶ <http://wto.az/indexENG.htm>

⁷ In 2011, by value, including intra-EU trade. Source:

http://www.wto.org/english/res_e/statis_e/its2012_e/charts_e/chart07.pdf

⁸ http://www.wto.org/english/news_e/news12_e/acc_aze_07dec12_e.htm

There is clash of the multilateral and the bilateral trade arrangements where trade agreements are sometimes shaped by political considerations rather than pure welfare estimations. Other format of trade agreement is Deep and Comprehensive Free Trade Area (DCFTA) with the European Union as a normative power. DCFTA is likely to enhance particular country's trade prospects and boost economic growth by enhancing the country's export potential, especially to developed markets. The DCFTA have been regarded as forcing European norms and standards on partner countries by aligning legislation to the EU⁹. Azerbaijan as a part of the Eastern Partnership Program of the EU also involved to the negotiation for the accession to the DCFA. But one of main requirements for the joining to the DCFA is the full membership of the WTO.

The negotiation between Azerbaijan and the WTO contributed to designing accession-related legislative packages in areas such as customs valuation, rules of origin guidelines, tariff bindings and trade remedies. It also led to the serious change in tariff rates in Azerbaijan. However, Azerbaijan's accession to the WTO still uncertain. On February 5, 2014 the President of Azerbaijan Ilham Aliyev states that Azerbaijan does not intend to join the WTO in the near future. In his speech at a national conference on economic development of regions the president underlined that each country must protect its market and Azerbaijan is on this path.¹⁰

Despite the position of the president Azerbaijan continues its negotiation for the accession to the WTO. During the last years, a number of important trade and trade-related measures have been implemented by Azerbaijan in order to boost economic development in the country¹¹. These measures include *implementing certain trade facilitation measures*;

- *temporary elimination of import tariffs and VAT on certain products to be used in the development of non-oil sector*;
- *implementing certain measures simplifying customs procedures*;
- *temporary exemption from import tariffs and VAT on certain material and capital goods to be used by cement factories*;

⁹ Marie-Luise Raul, "Conquering the EU market with new comprehensive trade agreements – Simulating DCFTAs between the EU and neighbor countries", Agricultural Economics Research Institute, The Hague, Netherlands, 2014 (p.2)

¹⁰ http://www.contact.az/docs/2014/Economics&Finance/020600068182en.htm#.VbqTY_lfdB8

¹¹ <http://www.ubis-geneva.ch/foreign-trade-policy-azerbaijan-achievements-prospects/>

- *temporary exemption from VAT imports of wheat, wheat flour or wheat-rye flour; exemption of VAT for imports of machinery, technological equipment and installations for specified purposes, temporary elimination of import tariffs and reduction of import excise duties on petroleum oils (February 2014);*
- *Exemption of import tariffs and VAT for certain goods used in foreign economic activities in the non-oil sector (exemption extended in March 2014 until March 2017) and etc.)*

Table 1. Tariff rates in Azerbaijan

Indicators	2002	2005	2007	2008	2009	2011	2012
Share of tariff lines with international peaks, manufactured products (%)	0.2371747	0.1499977	42.22218	42.09972	41.76134	41.23279	0
Tariff rate, applied, simple mean, manufactured products (%)	9.69	10.48	8.41	8.18	8.09	8.02	8.13
Tariff rate, most favoured nation, simple mean, manufactured products (%)	8.71	9.19	8.85	8.53	8.36	8.34	8.34
Share of tariff lines with specific rates, manufactured products (%)	1.838916	1.283057	1.094444	1.094444	0.9277311	0.9831461	1.092194
Tariff rate, applied, weighted mean, manufactured products (%)	7.32	6.01	4.08	4.07	3.96	3.88	4.55
Tariff rate, most favoured nation, weighted mean,	7.32	6.01	5.67	5.6	5.35	5.19	5.83

manufactured products (%)							
Share of tariff lines with international peaks, all products (%)	3.973199	0.1257545	47.92019	47.39631	46.46426	47.27915	0
Tariff rate, applied, simple mean, all products (%)	10.38	10.68	8.63	8.39	8.27	8.24	8.28
Tariff rate, most favoured nation, simple mean, all products (%)	9.21	9.32	9.11	8.8	8.66	8.65	8.63
Share of tariff lines with specific rates, all products (%)	6.700292	2.831273	2.436797	2.433804	2.279222	2.139861	2.520192
Tariff rate, applied, weighted mean, all products (%)	6.64	5.86	4.01	3.93	3.93	3.89	4.48
Tariff rate, most favoured nation, weighted mean, all products (%)	6.64	5.86	5.85	5.75	5.68	5.64	6.22
Share of tariff lines with international peaks, primary products (%)	15.88321	0.0405877	68.37942	66.41216	62.47328	66.73042	0
Tariff rate, applied, simple mean, primary products (%)	14.65	11.98	10.16	9.85	9.5	9.69	9.43
Tariff rate, most favoured nation, simple mean, primary products (%)	10.94	9.79	10.05	9.77	9.69	9.73	9.64

Share of tariff lines with specific rates, primary products (%)	22.19921	8.279893	7.263722	7.249966	6.885496	5.871103	8.016063
Tariff rate, applied, weighted mean, primary products (%)	5.34	5.44	3.71	3.4	3.8	3.88	4.02
Tariff rate, most favoured nation, weighted mean, primary products (%)	5.34	5.44	6.63	6.4	7.28	7.94	9.09

Source: World Bank Metadata

Currently in Azerbaijan import customs duties range from 0% to 15%, while their average rate is about 10.6%. The average rate of initial bound tariffs (proposed highest rates) set out in the market access document submitted to WTO Secretariat is 13.2% and average rate of final bound tariffs is 11.7 % . The main principle when preparing proposals and fixing higher tariff rate for the protection of sectors considered vital for the economy of Azerbaijan was reduction of tariff rates at other sectors and thus maintaining average tariff balance¹². The fact also was taken into account that new acceding countries are requested to bind all tariffs - while many developing countries continue to have a large portion of their tariff schedule outside agriculture unbound. Ceiling bindings have been accepted, but there is pressure to bind close to applied rates. The ultimate test of the fairness and adequacy of the terms of accession is the capacity of acceding small countries to fully implement their commitments¹³.

Azerbaijan has harmonized, according to the relevant legislative action plan, approximately 14 out of 34 national legislation with the WTO requirements. Totally, 39 normative legal acts were considered in the "Action Plan" approved on August 2, 2006¹⁴. Taking into account the necessity to diversify the economy and develop non-oil sectors such as information technology and others, Azerbaijan has joined to the following non-compulsory WTO sectoral initiatives:

¹² <http://wto.az/indexENG.htm>

¹³ Olivier Cattaneo, Carlos A. Primo Braga "Everything You Always Wanted to Know about WTO Accession (But Were Afraid to Ask)", WB PRWP 5116, 2009 (p.27)

¹⁴ http://economy.gov.az/index.php?option=com_content&view=article&id=292&Itemid=182&lang=en

information technology agreement, chemical tariff harmonization agreement, medical equipment, construction equipment¹⁵.

Costs and benefits of accession to WTO for Azerbaijan

The WTO as a main trade regulating international institution has accepted new members since its creation in the wake of the GATT in 1994. Voituriez (2007) classifies some arguments for benefiting from the WTO full membership especially for small countries¹⁶:

1. *Efficiency argument (associated WTO principle is reciprocity)*. Trade agreements serve as exogenous constraints for economic reforms that governments would not dare to pass against the interest of some specific groups. The political economy argument for a small country to join the WTO is basically an efficiency argument.
2. *Wealth argument (associated WTO principle is non-discrimination)*. When liberalizing their own trade following the most favored nation (MFN) principle, WTO member countries increase the extent of the market to all WTO member countries, the extent of the market-argument is basically a wealth argument.
3. *Investment and innovation argument (associated WTO principle is transparency)*. Locking-in trade liberalization through binding tariffs and domestic supports stabilizes expectations, reduces uncertainty associated with unexpected changes in policy, and hence bolsters investment and growth. WTO acts herewith as an insurance mechanism for worldwide traders and investors. The investment and innovation argument is basically a dynamics argument, for countries to turn static welfare gains into growth.

Trade liberalization can be an engine of poverty alleviation and inequality reduction, but “trade and poverty” and “trade and inequality” still nexus remain by far country specific. In the medium to long-term trade reforms may result in improved growth, but trade liberalization alone

¹⁵ https://www.wto.org/english/news_e/news15_e/acc_aze_06mar15_e.htm

¹⁶ Tancrede Voituriez, “WTO Entry and Beyond: Accession Benefits and the Cost of Membership. A Preliminary Analysis in the Case of Vietnam”, MALICA Seminar 2007 (p.4-6)

is insufficient to reduce poverty and inequality. New member states and developing countries have been increasing their participation in the world trading system and also the dispute settlement processes of the WTO. Securing enforcement improves predictability and promotes free trade, business and economic growth. The four previous arguments can be considered conditionally with the enforcement-securing argument. Some of the effects of WTO membership may not be explicitly embedded in the lower tariff levels but concern intangibles (e.g. access to the dispute settlement body of the WTO) that are important for establishing a level playing field with WTO members.

Table 2. A summary of arguments for a small country to join the WTO

Arguments for a small country to join the WTO	Expected effect	Underlying WTO principle
Increase the extent of the market	Wealth	Non discrimination
Foster investment	Growth	Transparency
Counter domestic protectionist lobbies	Efficiency	Reciprocity
Reduce poverty and inequality	Development	None
Secure enforcement	Accountability	Enforceable commitments

The main obstacles to the exports of small developing countries like Azerbaijan appear to be in the nontariff area (sanitary, phyto-sanitary standards) which increasingly originate from the private sector and are not dealt with under the Doha Round framework of the WTO. But the most important effect certainly is the “development” effect. Also it is still questionable that whether FDI causes trade to whether trade can boost FDI inflows and what kinds of trade can boost FDI inflows. One of the most important component of WTO accession for new member countries in terms of the welfare gains can be liberalization of its barriers against FDI in services sectors¹⁷.

¹⁷ Thomas Rutherford, David Tarr “Regional Household and Poverty Effects of Russia’s Accession to the World Trade Organization”, WB, Policy Research Working Paper 4570, 2008 (p.4)

Bhagwati (2001) argues that the primary gain from growth could be more than offset by the induced loss from a deterioration in the terms of trade¹⁸. In a Harrod-Domar growth model, the growth rate depends on two variables: the (average) saving ratio divided by the (marginal) capital-output ratio. Free trade will minimize the latter but may reduce the former, thus lowering the growth rate on balance. Consequently, free trade and WTO membership is not only about benefit, it is also about the cost.

Table 3. The cost of WTO membership

Expected gains from accession	Potential cost of memberships
Increase market access (wealth)	Margin erosion Rising nontrade barriers (SPS, TBT)
Foster investment (growth)	No systematic positive effect
Counter lobby (efficiency)	No systematic positive effect
Reduce poverty (distribution)	No systematic positive effect Loss of tax revenues
Secure enforcement (Accountability)	Cost of litigation Cost of (non) compliance

In addition, domestic opponents of Azerbaijan's WTO accession have argued that additional gains from membership would be limited, since the country already enjoys most favored nation (MFN) status with many WTO members, and some advanced countries have accorded preferential treatment to Azerbaijan under the Generalized System of Preferences (GSP).

There have been concerns over asymmetric treatment, as country's concessions (lower tariffs) on imports and a possible short-term output contraction would far outweigh any benefits for its exports. Some of the conditionality demanded during the accession process (e.g. liberalization of domestic energy prices) has been widely unpopular because of the perceived economic and social consequences. Finally, there has been a determined opposition to WTO entry

¹⁸ Jagdish Bhagwati, "Free Trade Today, Princeton University Press, 2001 (p.41)

from some sectoral lobbies, as well as from ideological opponents of “economic liberalism”¹⁹. Tangible long-term trade gains for Azerbaijan from its WTO accession, not least because of the highlighted friction between members and nonmembers.

Grynberg (2006) argues that since the formation of the WTO in 1995, “small states have become increasingly vocal in their criticism of what they see as onerous rules from which they feel that they have not benefited. What the export activities of small vulnerable states have in common is that a surplus or quasi-rent has been needed to cover the inherent cost disadvantage faced by the private investor who has chosen to locate in small vulnerable states”²⁰.

Joining WTO can theoretically boost economy of Azerbaijan: (a) cheaper imports helps contain inflation and increase consumer welfare; (b) improved access to world export and capital markets should help balance of payments; (c) some heavily protected industries and some services will need reforms to stay viable. All in all, WTO accession will facilitate Azerbaijan's further global integration.

Azerbaijan's exporters' access to foreign markets should improve as other WTO members are expected to remove remaining tariffs on imports from Azerbaijan. In the meantime, Azerbaijan will also face greater competition from foreign producers in its domestic market as it substantially reduces import tariffs and subsidies. In addition the agriculture sector should be ready for the free trade. Currently the agriculture of the country is weak regarding the productivity and institutional capacity.

Despite all the challenges it faces WTO accession should have positive long-run effects to the country. Although lower import tariffs can be expected to erode government revenue, cheaper imports should also help contain inflation and increase consumer welfare. Azerbaijan should take full advantages from market-friendly reforms it is currently required to meet WTO membership standards. One of these efforts should be unifying the regulatory framework for domestic and foreign enterprises and to harmonize rules on trading rights which would improve the investment

¹⁹ Bogdan Lissovlik, Yaroslav Lissovlik, “Russia and the WTO: The “Gravity” of Outsider Status”, IMF Staff Papers Vol. 53, No. 1, 2006 (p.7)

²⁰ “WTO at the margins: Small States and the Multilateral Trading System”, Edited by ROMAN GRYNBERG, Cambridge University Press 2006 (p.25)

climate in Azerbaijan²¹. Meanwhile, joining WTO can pave way for further deepening of bilateral trade with other trade partners where domestic demand is high including European Union. However, the negotiation has been a complex and time-consuming process²².

Conclusion

Alongside all costs like changing the market structure and decreasing the collections of custom duties, there will be three main benefits of Azerbaijan as a small-scale economy from WTO membership and free trade agreements like DCFTA:

- (a) strengthening of domestic policies and institutions for the conduct of international trade in both goods and services which is needed before accession into the new agreement can be accomplished;
- (b) improvements in the ease and security of market access to major export markets;
- (c) access to a dispute settlement mechanism for trade issues.

For small economies free trade arrangements can enable the country to forecast its trade policy, increase transparency, start cooperation with more international trade partners, and handle trade disputes constructively. For negotiating countries like Azerbaijan the strategy is (i) binding tariffs at the usually low currently prevailing levels or to agree to reduce and bind tariffs at low levels as part of the accession negotiations; (ii) agreeing to a liberal trade regime in agriculture and services; (iii) at early date after accession, participating in such agreements as the government procurement code - which increases competition and transparency in the operation of their markets.

Azerbaijan should move beyond routine to conclude accession negotiations and to take additional steps to bring its trade regime in compliance with WTO rules. The country should clarify the situation around the application of discriminatory tax exemptions, production sharing agreements, local content requirements and investment incentives, state trading enterprises, permit

²¹ <http://www.imf.org/external/pubs/ft/survey/so/2007/car051a.htm>

²² <http://www.news.az/articles/politics/88993>

requirements for alcohol and tobacco products, the commitment to join the information technology agreement upon accession, technical barriers to trade (standards and certification), transition periods to implement WTO agreements, and agricultural and non-agricultural export subsidies. Azerbaijan mainly focused on these issues during negotiations: trade in commodities, trade in services, intellectual properties, and exemption from liabilities.

For small countries new trade agreements under favorable conditions is not an aim, but just a means promoting further economic reforms within the existing market economy and thus speeding up the transition period in the short run. The most problematic field for small low or medium income countries in accession to WTO will be agriculture. Governments should also pay attention to financial, bank, insurance and other service sectors which have been regulated via foreign capital for many years.