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Armenia: Pursuing Export-Led Industrial Growth

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Abstract

In 2011, Armenia adopted its first-ever industrial policy (IP) strategy for 2012–2020 aimed at stimulating export-led industrial growth and focusing on 11 manufacturing subsectors in the initial phase. With only limited funding, the Strategy envisions the government's role primarily as a facilitator and aims at making full use of cooperation with the private sector and international donors. While Armenia has managed to significantly increase the share of exports in its GDP, this achievement is attributable mainly to the growth in exports of lower-sophistication goods such as tobacco products, agricultural produce, food and beverages, and textiles and apparel. Among non-manufactured exports, an impressive success story is the Armenian IT sector, which has been prioritized by the government already since 2000 and has benefited from the support of diaspora investors. The free economic zones launched in Armenia have so far performed below their potential. The new government under Prime Minister Pashinyan is in the process of revising and updating the IP strategy.

Introduction

During Soviet times, Armenia boasted a well-developed industrial potential, with its key strengths in chemicals, electronics, and the light industry. Following independence, Armenia's GDP plummeted, and massive deindustrialization took place. While growth resumed in 1994 and intensified in the 2000s, the recovery was driven by the construction and services sectors rather than manufacturing. In 2010, the share of the industrial sector in Armenia's GDP stood at 14.9%, and in total employment, at 7.3%. Armenia's exports were poorly diversified and lacked sophistication, with the mining industry's products occupying the largest share, followed by processed food and diamonds. The economy also strongly depended on remittances from labour migrants (peaking at 22 percent of the GDP in 2004), mainly those working in Russia. As a result of Armenia's dependence on global commodity prices and remittances, it was hit hard by the 2008 economic crisis, with the GDP shrinking by nearly 16 percent in 2009. The failure of this growth model became the main impulse for the government to consider a targeted industrial policy strategy aimed at expanding and diversifying manufacturing exports. The new approach was meant to complement Armenia's positive experience with sectoral promotion policies in tourism and the IT sector since the early 2000s.

This article will discuss the development of Armenia's industrial policy (IP), using IT, textiles and apparel as examples. It will also address Armenia's experience with free economic zones (FEZs), a widely used instrument to promote export-oriented manufacturing, and discuss the impact of Armenia's membership in the Eurasian Union on its manufacturing exports. The article will conclude by briefly dwelling on the potential implications of the 2018 change in government in Armenia for its IP strategy.

The 2011 Strategy for Export-Led Industrial Growth

The 2008 global crisis sparked a renewed interest in industrial policy worldwide, and Armenia was no exception. The overarching goals for Armenia, with its small domestic market of only 3 million consumers, were to (1) promote export-driven industrial growth and (2) diversification, (3) move up the value chain, and (4) create new jobs. Given its budgetary constraints, the government was determined to engage the private sector and donors to achieve those goals, using public-private partnerships (PPP) as the preferred form of cooperation.

In December 2011, Armenia adopted the Export-Led Industrial Growth Strategy for 2012–2020, developed by the local consultancy EV Consulting with support from the World Bank. The first implementation phase of the Strategy (2011–2013) focused primarily on removing constraints and scaling up existing capacities in 11 export sectors (most of them established but also several nascent ones): brandy, wine, canned foods, water, juices, diamond cutting, gold and jewellery, watches, precision engineering, pharmaceuticals, and textiles. The plan for the following phases was to move towards new "horizons" by focusing on higher-value activities and promoting diversification. Judging from expert interviews, however, there has been a lack of visibility and effort in the subsequent phases of the Strategy implementation. Thorough monitoring and evaluation of the IP Strategy have also been lacking, especially in recent years.

The IP Toolkit

The industrial policy toolkit in Armenia combines instruments to improve the business and investment climate with instruments that should a) help to identify latent comparative advantages and b) overcome market and coordination failures by improving access to finance and markets and providing better training opportunities. Armenia's policies include (Armenia Development Strategy, para. 187):

1. *Special tax and customs regimes*: special tax regimes for exporting companies, deferred VAT for imported investment goods; setting up free-trade zones with special tax and customs preferences.
2. *Financing tools*: concessional loans for certain types of activities, export and credit guarantees, own capital funding and participation in investment funds.
3. *Improving access to markets*: setting up trade representations, support for participation in exhibitions and fairs, organization of conferences and visits, branding activities.
4. *Capacity building*: training programs, technical and financial assistance to companies implementing quality assurance systems, support for technology and knowledge transfer (in particular from the Armenian diaspora in industrialized countries)
5. *Research and Development*: establishing technoparks and industrial parks, providing research grants, creating venture funds.

The division of responsibilities in the IP strategy is somewhat complicated. In addition to the Department of Industrial Policy at the Ministry of Economic Development and Investment, several other bodies have played a role. The main coordinating body for public-private partnerships was the Industrial Board (or Council) adjunct to the Prime Minister,¹ which met until 2014 and then gradually became inactive (possibly reflecting the reduced attention given to the Strategy in recent years). Sectoral boards were also set up to promote public-private cooperation. The executing agencies were initially the Industry Development Fund and the Armenia Export Financing Insurance Company, established in 2013. In 2015, the two organizations merged into the Development Foundation of Armenia (DFA), which became Armenia's national authority for investment and export promotion. DFA was rebranded Business Armenia in 2018.

Budget allocations for the Strategy were first approved in 2012 and were very modest: in 2013, the amount was 1.14 million USD, and in 2014 it was 1.32 million USD, less than 5 percent of Armenia's state budget. One-third of the budget was spent on co-financing the participation of Armenian producers in international expos and fairs (World Bank, 2015, p. 49). Funding in subsequent years has apparently been similar.

In 2015, the World Bank conducted an evaluation of the first phase of the Strategy (which remains the only publicly available IP evaluation to date) and found that the target sectors did grow faster than the rest of the economy, with a 17 percent compound annual growth rate (CAGR) for 2010–2013; their share in Armenia's total exports increased from 23.3 to 26 percent. The best performing sectors were brandy and watch-making, as well as textiles and apparel (see Table 1 overleaf). There were also increases in productivity that outperformed the economy as a whole (12 percent CAGR in the target sectors, as opposed to the processing industry generally at 9 percent and the entire economy at 8 percent, respectively). Lastly, the report found that the number of workers in the target sectors went up by 38 percent between 2010 and 2013 (World Bank 2015). However, it was still too early to attribute these results to the programme itself.

Free Economic Zones

Free economic zones are a common tool used by governments to attract FDI and facilitate export-oriented manufacturing and thus can function as an instrument supporting industrial policy. In June 2011, as the IP strategy was still being discussed, Armenia adopted the Law on Free Economic Zones. In addition, the 2014 Law on Industrial Policy identifies "industrial zones" (both with and without FEZ status), technoparks and clusters as instruments of industrial policy. Today, there are four FEZs in Armenia, offering investors the usual set of preferences: exemptions from the profit tax, VAT, customs duties, real estate and property taxes, and corporate income tax. The Alliance FEZ was established in 2013 with a focus on high-tech and pharmaceuticals. The second zone, Meridian (2015), focuses on jewellery and watch-making. In December 2017, Armenia opened the Meghri FEZ on the border with Iran, in an effort to take advantage of its geographic position as Iran's gateway to the Eurasian Economic Union (EAEU).² The most recent FEZ is ECOS, launched in October 2018 and tasked with hi-tech cluster development, including projects related to

1 The Industrial Council/Board is no longer found on the website of the Prime Minister of Armenia. However, a 2012 snapshot of the website shows the list of members: <https://web.archive.org/web/20121114002955/http://www.gov.am/ru/councils/members/19/>

2 In May 2018, Iran and the EAEU signed a temporary agreement establishing a free-trade zone between them; negotiations on the final deal are ongoing.

Table 1: Export Indicators, Target Sectors

Sector	2013 (mln. USD)	2010-13 CAGR (Percent)	Share of Sector Export in Total Exports (Percent)	2015 Target* (mln. USD)	2013 as Pro- portion of 2015 Target (Percent)	2020 Target* (mln. USD)
Pharmaceuticals	6.9	13	0.5	22.5	31	95
Wine	4.2	14	0.3	10.7	40	29
Brandy	181.3	24	12.4	180	101	300
Textile & apparel	38.5	81	2.6	66	58	133.5
Footwear	2.1	17	0.1	16.2	13	47.7
Jewellery	21.3	17	1.4	30	71	76
Diamond-cutting	88.1	-1	6.0	111	79	151.7
Watch-making	14	53	1.0	12	116	28
Precision engineering	25.3	14	1.7	47.5	53	150
Total	384	17	26.2	496	82**	1,1011

Source: UN ComTrade, sectoral strategies

Note: 2015 targets for pharmaceuticals, textiles and apparel, jewelry and precision engineering sectors include outsourcing orders by MNCs.

*For textiles and apparel, target is for 2018 and for footwear 2023.

**Does not include textiles, apparel and footwear.

Note: This table is reproduced from the World Bank evaluation report (2015), Table 1.9, p. 29.

artificial intelligence and machine learning, data mining and blockchain. While data on Armenian FEZs are difficult to obtain, there is a general consensus that they are still performing significantly below their potential. As for job creation, the Alliance FEZ had created 314 jobs as of September 2018 and Meridian 181 jobs (Sputnik Armenia 2018b), while the Meghri FEZ still stands empty. The new government has vowed to redouble its efforts to make FEZs thrive (especially in the high-tech and bio-tech sectors) (The Armenian Weekly 2019).

The IT Sector: Armenia's Success Story

While not a manufacturing sector that would be the object of traditional industrial policy, the booming IT sector in Armenia showcases the benefits of thought-out, sustained cooperation between the government and industry. Between 2010 and 2018, the sector has grown at an average of 25.6 percent annually. In 2018, total revenues reached 7.4 percent of Armenia's GDP (12.4 billion USD) (EIF 2018: 33). The sector's share in Armenia's total exports increased from 8 percent in 2010 to 16 percent in 2017, with most exports (ca. 70%) going to the US and Europe. Armenia is no longer merely an outsourcing destination but has moved on to attract multinational corporations, develop global IT solutions and venture into the latest trends, such as AI and big data analysis. Two factors have played a key role in the IT sector's speedy development: the Soviet legacies of the engineering and science potential, and the involvement of diaspora investors from the West (in fact, to this day most start-ups in the IT sector have a diaspora connection).

Employment in the IT sector has been growing at very fast rates in recent years, reaching 19,552 in 2018 (EIF, 2018, p. 30), yet there is room for much more, and industry insiders name the lack of skilled resources as a key growth constraint. In 2018, some 800 companies were active in the IT sector (EIF, 2018, p. 3). Wages in the sector are higher than the average for Armenia.³

Successive Armenian governments have demonstrated sustained commitment to promoting the sector for nearly 20 years. After declaring IT a priority in 2000, in 2001 the government teamed up with the World Bank and other stakeholders to draw up the ICT Master Strategy and ICT Development Implementation Plan. Another milestone was the establishment, in 2002, of the public private partnership called the Enterprise Incubator Foundation (EIF). A broader ten-year programme was adopted in 2008, focusing on the development of the infrastructure (including setting up techno-cities in Gyumri and Vanadzor), better training for IT graduates, and creating new financing mechanisms for start-up companies (EIF 2017). In late 2014, the government adopted a legislative package providing attractive tax preferences for IT start-ups (0% profit tax and 10% flat payroll tax for 3 years), leading to rapid growth in

3 A junior technical specialist in a local company earns ca. 260 USD on average, with the amount increasing to 588 USD for senior specialists; the figures for those employed by foreign companies are 387 and 744 USD, respectively. Source: EIF 2018 report, p. 31.

their number. In 2017 alone, 431 companies benefited from the new provisions (EIF 2017). The law was amended in 2018, granting the same privileges also to engineering companies and extending the tax exemptions until 2022 (Sputnik Armenia 2018a).

The government and EIF have also partnered with key global IT companies and obtained USAID funding to establish top-class training facilities, such as the Microsoft Innovation Center Armenia (2011) and the IBM Innovative Solutions and Technologies Center (2015).

Textile and Apparel Industry

The textile and apparel industry is a prime example of a sector that enables quick expansion of employment in the low-skilled job sector and provides backward and forward linkages to the rest of the economy. The sector played an important role in Soviet Armenia, employing some 120,000 people, but production collapsed in the post-Soviet period. Today, it is an emerging sector with fast export growth rates: from ca. 805,000 USD in 2010 to 155 million USD in 2018 (thus outperforming the 2020 target of 133.5 million USD, see Table 1 on the previous page). Estimates put total employment in the sector between 6,000 and 7,000, and there are five large companies and ca. 60 small and medium ones (Arzumanyan 2018). However, most textile and apparel manufacturers in Armenia have been operating on a toll (contract) manufacturing basis, making clothes from the raw materials supplied by foreign companies, usually from Italy—which leads to limited domestic value creation.

In December 2013, the Industrial Council approved a strategy (until 2023) for developing light industry, such as textiles, apparel and shoe manufacturing. The first action plan for 2014–2016 had a budget of 2.5 million USD. Government support in the sector has generally taken the form of co-financing participation in major exhibitions (e.g., *Textillegprom* in Moscow), facilitating business-to-business contacts with potential investors, and tax incentives such as zero or deferred VAT on investment goods (e.g., modern equipment for textile companies). Reportedly, however, the government has failed to deliver on a number of commitments in the sectoral strategy, such as providing investments, low-interest loans, or setting up a dedicated warehouse in Russia (Arzumanyan 2018a). In 2014, the Government partnered with the UN Industrial Development Organization (UNIDO) to implement a Russian-funded project aiming at building “local technical capacity to support the development and modernization of SMEs and to position Armenian products as high-end design goods” (UNIDO, n.d.).

Membership in the Eurasian Union

Although the main reason Armenia joined the EAEU in January 2015 was geopolitics, there have also been hopes that membership in the bloc would allow Armenia to increase its manufacturing exports and achieve industrial growth—something that is expressly stated in Armenia’s Development Strategy for 2014–2025 (para. 183). (The European Union, on the other hand, is the chief destination for Armenia’s raw material exports, mainly metals). The Eurasian Union expressly emphasizes the importance of industrial policy in its founding Treaty.⁴ The stated goal is to promote intra-Union trade in industrial goods, attract investment, and foster innovation and import substitution (Eurasian Economic Commission 2015). Potential opportunities for Armenia, in addition to simplified customs procedures, could include access to EAEU-wide public procurement tenders and benefits from common markets for goods requiring special certification, such as pharmaceuticals or jewellery. Armenia has been able to negotiate a longer phase-in period—until 2022—for implementing EAEU tariffs (which are significantly higher than those applied by Armenia in the past). Armenia’s trade with EAEU members has grown faster than that of any other member of the Union. After a slow start attributed to the impact of the 2014 economic crisis in Russia, Armenia’s trade with the EAEU grew by 45 percent in 2017 and by 21 percent in 2018.⁵

So far, however, Armenia’s lower-sophistication exports (especially agricultural produce, food, alcoholic beverages, textiles, apparel and footwear) have benefited the most from Armenia’s entry to the EAEU. One exception is pharmaceuticals, a small but rapidly growing export-oriented sector in Armenia. Due to investment in high-tech equipment and the leading Armenian companies’ obtaining the internationally recognized GMP certificate, Armenia has been able to increase its pharmaceutical exports (primarily generics, vaccines and herbal medicines) from ca. 5 million USD in 2010 to nearly 22 million USD in 2017, with roughly half of them going to Russia.

4 Relevant provisions are contained in Article 92 (Industrial Policy and Cooperation) and Annex 27, as well as in Article 93 (Industrial Subsidies) and Annex 28 to the Treaty on the EAEU.

5 Eurasian Commission, Intra-EAEU Trade, Statistical Spreadsheets. http://www.eurasiancommission.org/ru/act/integr_i_makroec/dep_stat/tradestat/tables/intra/Pages/2018/12.aspx

Industrial Policy after the 2018 Velvet Revolution

Armenia's Velvet Revolution) and the advent to power of Nikol Pashinyan's My Step bloc, followed by the sourcing of new staff in many ministries from the civil society sector, will likely lead to revisions, re-prioritization, and a changed mode in the implementation of Armenia's IP. The economic strategy unveiled in February 2019 adopts a market-oriented approach, envisioning a flat income tax, a much leaner government apparatus, lower taxes for small businesses and special tax breaks for foreign investors. It also promises government support for export and industrial modernization and for implementing quality assurance and certification mechanisms with the goal of accessing new markets (Mejlumyan 2019). In addition, the government has announced its commitment to invest into skills development, especially in STEM subjects at the school level, and is planning to actively develop domestic defence industry, significantly increasing budget allocations for this purpose.

Conclusion

Armenia's high growth rates in the 2000s were driven by the construction and services sectors, as well as by the high prices for commodity exports. The drastic effects of the global economic crisis of 2008 on Armenia exposed the vulnerabilities of such a growth model, leading the government to pay greater attention to manufacturing. Close cooperation with the private sector has been an important feature of the 2011 IP strategy, which has enjoyed only very limited allocations from the state budget. On the whole, Armenia has been able to significantly increase its exports as a share of its GDP (from 24% in 2011 to 37% in 2017⁶); however, the growth took place mostly in the lower-sophistication segment and in traditional markets. This increase in exports has not been accompanied by significant increases in manufacturing value added, showing that Armenia still has much work to do to move up the value chain. The extent to which the growth in exports is attributable to the IP strategy is questionable. In fact, the subsector that has grown the most in recent years and accessed the new (Middle Eastern) markets—the tobacco industry—has received no special government support. Armenia's membership in the Eurasian Union has benefited the agriculture, food processing, beverage and textile, apparel and footwear sectors, but thus far there has been no measurable impact on higher-sophistication exports, with the exception of pharmaceuticals. The IT sector has been a definite success story, yet its linkages to the rest of the economy are weaker than the linkages of manufacturing. Currently, the IP strategy is being revised by the new government.

About the Author

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Components and Priorities of Industrial Policy in Azerbaijan

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Abstract

This article examines industrial policy in Azerbaijan and its link with the broader development agenda with respect to its periodization, priorities, and instruments. The article finds that despite the government’s attempts to diversify the economy and exports by promoting non-oil industries, the imbalance between the mining and manufacturing industries remains a challenging issue. Additionally, the high level of oil-gas dependence negatively affects the quality of policy formulation and implementation in industry.

Introduction

The oil and gas sector of the mining industry has been historically dominant in the economy of Azerbaijan. The national economy’s dependence on oil and gas remains high, with the hydrocarbon sector representing 44% of GDP, 90% of goods exports and at least 50% of fiscal revenue in 2018. As a consequence of the high dependence on hydrocarbon resources, Azerbaijan’s economy faced (i) negative implications of the “resource curse”, as reflected in a gradual slow-