ALTERNATIVE REPORT ON 2017 PROJECTED STATE BUDGET OF AZERBAIJAN

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The Alternative Report was developed by experts of the Public Association for Assistance to Free Economy

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Key changes and trends of the 2017 State Budget of Azerbaijan and the process of preparing, discussing and confirming the budget law are analyzed in this alternative report. The law on the State budget of 2017 and a package of documents presented to the National Assembly together with the State Budget (Budget Envelope), review of the Chamber of Accounts of this draft bill, other official information and independent analyses based on them have been used for compiling this alternative report.

Contents

Summary

As stated in the State Budget Law in 2017 of the Azerbaijan Republic, budget revenues are forecasted be 16.3 billion AZN, which is in fact 7.1% less than 2016 year's budget revenues. State budget expenditures, in turn are 16.9 billion AZN, which is 8.6% less than the previous year's indicator. The share of budget expenditures in GDP in 2017 is expected to be 27.4%, while the previous year it was 31%.

The formation process of the state budget in 2017 has coincided with a period of low oil prices. The most active phase of the budget project's processing covers the period from January to July. For the former part of 2016 the average price of oil was lower than $45 per barrel. Due to that, the government, while deciding on the parameters for the 2017 state budget, has set the average price for the next year as $40 per barrel.

The World Bank, in their global economic forecast,[1] has anticipated 1,2% real growth in Azerbaijan's GDP in 2017. However, experiences of world countries, which have faced economic crises within different periods of time, reveal that in a situation of limited collective demand, it is hard to set back an economic crisis and to obtain an economic growth in a short period.

In times of crises one of the main sources that stimulates demand and economic growth are budget expenditures. It should be considered that in 2017, in comparison with the previous year budget expenditures are projected to have a 10% reduction, including 16.5% reduction in budget investments.

The state budget's shrinking trend has been consistant in Azerbaijan since 2014, which is due to reduced oil revenue. The most remarkable feature of the state budget for 2017 is that, compared to previous years of the budget revenues, the decline is continuing. As noted before, in 2017, the revenues of the state budget are forecasted to be 16.3 billion AZN, which, compared to last year's budget revenues, is expected to be 1.2 billion AZN or 7.1% less. This in turn means that, starting from 2014, the state budget revenue rate continues to fall each year for the fourth consecutive year. In 2017, the state budget revenue's forecasted rate is the lowest in the last six years.

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[1]   http://www.worldbank.org/en/publication/global-economic-prospects

The drop in the state budget revenue rate is particularly acute when expressed in US dollar equivalent. If we take actual rate[2] by the time 2017 state budget project's draft was in prepararion, that is as follows: 1 USD = 1.75 AZN, then the amount of budget revenues will be around $9.3 billion, which is in turn 2,6 times less than the 2013 budget revenue expressed in USD, which means that, this is our country's lowest[3] indicator of budget revenue as expressed in USD.

In 2017 the amount of 6.1 billion AZN is planned to be transferred from the State Oil Fund of the Republic of Azerbaijan (SOFAZ) to the state budget, which is 515 million AZN less than 2016, and 2.03 billion less than 2015 respective amount of transfer. This is the lowest rate since 2011. The government says that they will continue the policy of reducing the amount of transfer to state budget from SOFAZ in the coming years (in 2020 the transfer is planned to be 4 billion AZN). Along with that, according to the presidential decree of December 27, 2016 on application of the law on the state budget 2017, the Cabinet of Ministers is delegated to prepare, within 6 months, and submit proposals related to the new fiscal regulations, in order to regulate the upper limit of transfers from SOFAZ to the state budget and to improve fiscal stability.

Proportionally to the sharp decline in oil price, 2015 has been the last year of prognosed increase in state budget spendings and the following two years budget expenditures have been significantly reduced. As it can be seen, spending planned for 2017 are 842.4 million AZN less than 2016 budget expenditures. Over the last 10 years, the highest amount of budget expenditures recorded was in 2013, although in 2014-2015 spendings were forecasted to increase, it, apparently, was not the case during the implementing process. Taken in US dollar equivalent the 2017 budget expenditure is projected to be the lowest since 2008, when oil revenues significantly increased. At the same time, compared to 2013, when the highest spendings were observed, expenditures will be reduced by 2.5 times in 2017.

The social costs have been forecasted with notable reduction. As stated in the 2016 budget law, 5,358.7 million AZN or 32.9% of the total budget expenditures have been allocated for the financing of the state budget's main 3 social functions. It includes education, health and social protection services. Respectively, 2.698.7 million AZN for social protection, 1,830.2 million AZN on education, and 830.8 million AZN for healthcare have been predicted. In 2017, estimated amount allocated from the state

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[2] http://apa.az/maliyye_xeberleri/vergiler-nazirliyi-gelen-il-ucun-hesablamalarinda-dollarin-mezennesini-1-75-AZNdan-goturub.html

[3] The calculation of the state budget revenues based on the official exchange rate of the Central Bank of Azerbaijan in the mentioned period.

budget for these 3 programs is 4,734.3 million AZN, which is 624.4 million AZN or 11.6% less compared to the previous year.

Public investment spendings have been reduced significantly. In 2017, from state budget has been administred 2,521.2 million AZN for investment expenditures, this amount is 503.4 million AZN or 16.6% less compared to the previous year.

Agricultural costs have been axing. Thus, in 2017, 517.4 million AZN has been allotted form the approved budget for this sphere, which is 167.1 million AZN or 24.4% less compared to the previous year.

Maintenance costs for the supreme government bodies, included in the maintenance expenditures for the administrative apparatus of the state, have been increased, funding of the central and local executive power bodies reduced. In 2017, compared with the previous years, 6.7 million AZN maintenance expences have been allocated for the 3 "higher" (according to the budget's classification) authorities: Presidential Administration, Parliament and the Cabinet, and being increased for 6.5% have reached 110.2 million AZN.

The largest increase is in spendings for defense. In 2017, defense spendings will be 2,642.1 million AZN. Compared to the previous year's amount this is 413.8 million AZN or 18.6% more. Spendings on defense, for their share in 2017 state budget, are the second biggest item of expenditure. Thus, the share of this functional component in the total budget expenditure will be 15.6%, while the previous year it was 12%.

Costs for maintenance of law enforcement bodies also have been significantly increased. Analysis of budget report suggests that, in 2017, for maintenance of law enforcement bodies will be 927.4 milllion AZN, which in comparison with the previous year is 64.6 million AZN more. The funds for financing the law enforcement system this year will be 5.5% of the total budget expenditure.

In 2017, for the government debt service costs from the state budget have been allocated 1,641.8 million AZN. In total for the debt service costs' share in the budget expenditures is planned at the level of 9.7%, which is the highest in 15 years. From the information[4] provided it is clear that, this year 96.3% or 1,580.6 million AZN of debt service costs will be allocated for the foreign debt, and respectively 3.7% or 61.2 million AZN will be assigned for meeting the domestic debt. One of the main reasons for the high foreign debt service costs is related to repayment of the state guarantee loans given to the

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[4]   The Budget Envelope of the Government of Azerbaijan for 2017. Volume V

state owned companies (e.g. "Azeraluminium" OJSC, "Azerenerji" OJSC, AZAL).[5]

Rapid increase in both, domestic and foreign public debts creates the risk of a sharp increase in the debt service costs from the state budget, and the fact that there is an excessive share of this cost in the total budget expenditure in 2017 confirms this approach. In 2016, foreign public debt increased 15% and reached $8 billion, while domestic public debt increased up to 60%. and reached 7.3 billion AZN. Particularly, for the improvement of the problematic assets of the International Bank of Azerbaijan the domestic loan was defined as the direct obligation of the state budget.

Planning of the 2017 state budget project has been accompanied by a number of procedure violations during the processes of parlament's approval and discussions. The draft law and a package of additional documents attached to it have been submitted to the National Assembly one month later than the date specified in the legislation. According to the law on the budgetary system, draft law and package of additional documents related to the 2017 state budget should have been submitted to the National Assembly not later than October 15, 2016, whereas it was submitted one month later, on November 15, 2016. At the same time, the project after it was submitted to the National Assembly has been subjected to change by the government without Parliament's approval. The bill on the state budget, which was submitted to the National Assembly and published in the press in November 2016, has been amended by the government: the budget revenue and expenditures increased by 300 million AZN.

As in previous years, parliamentary discussions about the state budget draft have been of formal character. The draft law on the state budget of 2017 have been dicussed in the National Assembly for a very short period of time – only within 3 days of plenarty meetings. The draft law passed the first reading, and approved by the National Assembly without discussion during the 2nd reading.

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[5]   The review of the Chamber of Accounts on 2017 state budget, page 297

1. Introduction

According to the law on the state budget of the Republic of Azerbaijan in 2017, the revenue of the state budget of Azerbaijan has been forecasted as 16.3 billion AZN in 2017, which is 1.23 billion AZN or 7.1% less than the actual budget revenues of 2016. It is expected that the state budget revenue will be 26.5% of the annual GDP, which is 2.7% less than the same figures from 2016.

State budget expenditures of the current year have been defined as 16.9 billion AZN, which is 8.6% or 1.6 billion AZN less than the official figures of the last year. The weight of budget expenses in GDP is expected to be 27.4%, whereas the same figure from the previous year was 31%.

The government of Azerbaijan had no difficulty in maintaining macroeconomic stability during the period of high oil prices conjuncture in the world in 2005-2014. In a situation when gross domestic product (GDP) and investments in the economy were constantly growing and a balance of payments with high surplus was provided, keeping a stable currency and low (one-digit) inflation rates was not problematic for the government.

GDP annual growth rate was not less than 2.5% in 2010-2014. However, compared to the previous year in 2016, the real amount of GDP decreased by 3.8%. At the same time, non-oil GDP decreased by 5.4% and investments in fixed capital decreased by 26%.

The Inflation rate was also quite low from 2012-2014 and the processes evolving in the oil market resulted in two-digit inflation in the economy. According to the State Statistics Committee, in 2012-2015 the average annual inflation varied between 1.1-4%, however, it reached 12.4% in 2016.

Balance of payments was the main guarantee mechanism to maintain macroeconomic stability in Azerbaijan before 2015. A surplus had emerged in both current accounts and the general balance of the balance of payments from 2012-2014. From 2012-2014, a surplus of $3.8-4.9 billion had emerged as the outcome of the balance of payments, whereas a deficit of $11.3 billion and around $5 billion emerged in the

general balance of the balance of payments in 2015 and 2016 respectively. As a result, the strategic currency reserves of the country went down from $53 billion in the end of 2014 to $37 billion by the end of 2016 and the currency reserves of the country decreased by 30% in two years.

One of the main factors forming the state budget of 2017 was a sharp decline in the money supply of the economy. High inflation and the risk of severe devaluation of the national currency resulted in the strict money-loan policy of the Central Bank. The centralized discount rate raised from 3% to 15% in 2016 and the Central Bank continued to keep the money supply of the economy very low during the year within its strict money-loan policy. The monetization level of the economy (the ratio of the M2 monetary aggregate to GDP) was 29.4% in 2014, whereas in 2016, this figure dropped to 16.6%. It is notable that currently, the monetization level of the economy in developing countries of the world is not below 45% and it is even above 100% in a number of developed countries.

Finally, the formation of the state budget of 2017 coincided with a period of low oil prices. The most active phase of processing the state budget is from January till July. Average oil price during the first half of 2016 was below $45. For this reason, the government considered the average annual oil price as $40 for the next year when defining the budget parameters of 2017.

2. Economic expectations for 2017

The socio-economic development forecast for 2017[6] that the government has presented to the parliament seems dramatically optimistic. According to the official prospects, the pace of GDP decline will not only stop, but a 1% economic growth is expected in 2017. Non-oil GDP growth of 2.5% is forecasted. According to the forecasts, the declining pace of investing in main capital will significantly slow down and investments will increase by 3.5% compared to 2016.

The government forecasts that the deficit that emerged in the balance of payments in 2015-2016 will be replaced with a surplus and that there will be a trade surplus of $867 million by the end of the year.

Finally, the official forecasts also predict that the inflation rate will significantly decrease and drop to a one-digit figure (7.3%).

The World Bank is also expecting a 1.2% GDP growth in Azerbaijan in 2017, according to their new forecast announcements about global economy[7]. However, the experience, which has been gained with the economic crises that different countries of the world faced at different times, shows that in a situation when the aggregate demand is restricted stopping the economic crisis and achieving economic growth becomes quite difficult. As a key component of the internal demand, a continuing decline pace in investments is expected. Another element is the household consumption, and even according to the official forecast, a real growth of this indicator is not expected in 2017. On top of this, in a situation when investment activities, employment, consumer lending, and real income of the population is significantly decreasing, expansion of household consumption levels and it has an impact on the growth of demand consequently is impossible.

Budget expenditures are some of the key resources stimulating demand and thus,

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[6] Social-economic development forecasts of the Republic of Azerbaijan for 2017 and the following 3 years. The Budget Envelope for 2017, Volume II

[7] http://www.worldbank.org/en/publication/global-economic-prospects

indirectly stimulating economic growth during crises. We should keep in mind that compared to the previous year a decline of 10% in budget expenditures and 16.5% in budget investments has been forecasted.

One of the key components stimulating aggregate demand is increasing export. However, according to the official forecasts, a 2.5% decline in exports is expected in 2017. In addition to this, non-oil export has seen a 28% decline in 2016, when the national currency lost its value by more than twice compared to 2014 and a favorable conjuncture for stimulating export existed from a theoretical perspective. It is very difficult to come up with any real economic arguments justifying that the decline in non-oil exports will stop in 2017 under such conditions.

One of the elements limiting the stimulation of general demand and professional activity is adoption of a decision which made the monetary policy even stricter in 2017. According to the "Monetary Program"[8] approved by the Financial Stability Council that consists of the leading institutions of the government, the main goal in 2017 will be targeting the monetary base and increased money supply will not be allowed to neutralize inflation risks. Because of the sharp fall in the money supply the crediting of economy has fallen by 25% from 2014-2016 and restoration of the increase in lending does not seem real under this ongoing strict monetary and credit policy.

The main factor to affect the stabilization of the macroeconomic situation in Azerbaijan in 2017 can be the fulfillment of expectations related to increasing oil prices. Various international institutions forecast that average oil prices in 2017 will settle around $53-55 per barrel. We should note that the average annual price of Brent crude oil was close to $45 per barrel in 2016. In their statement about the main directions of the monetary policy in 2017, the Central Bank emphasizes that the possibility of a surplus that will be enough to cover the capital deficit in the current balance of payments and financial flow accounts is still low, if the global oil prices do not increase significantly. It is true that the Central Bank does not mention if the amount of oil prices will be enough for the fulfilment of this purpose. However, independent assessments based on the evaluation of the structure of the balance of payments and the level of dependency of the consolidated budget on oil revenues in Azerbaijan show that the appropriate limit of oil prices for Azerbaijan must be above $60 per barrel both for fiscal balancing and for maintaining stability in balance of payments.

In case the oil prices do not rise, it is expected that the government will use the

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[8]   http://www.azerbaijan-news.az/index.php?mod=3&id=113224

reserves of the State Oil Fund (SOFAZ) as an alternative. The position[9] of the Central Bank of Azerbaijan Republic (CBAR) is that maintaining stability in the balance of payments depends on possessing large currency and funds for payments of foreign credits of the government's public sector and liabilities on energy projects. According to the recommendations of CBAR, neutralizing elements that cause tension in the currency market through targeted regulation of several liabilities in foreign currency is important and these measures will allow for minimizing the macroeconomic risks (inflation, financial stability etc.) by significantly neutralizing the pressures on the rate of AZN. This recommendation has already been considered and a decision about 7.5 billion AZN (approximately $4.2 billion) of support to CBAR through the Oil Fund has already been adopted. Thus, even if the average annual oil prices remain in their 2016 level, using strategic currency reserves of the country can contribute to the stability of the balance of payments. No doubt, these steps will cause a rapid loss of strategic currency reserves of the country in middle and long term and are considered a tactical measure to support macroeconomic stability only during one year.

Hence, no new targets in the budget policy of the government for 2017 are attractive:

- Approving the budget rule to maintain macroeconomic stability. This rule should regulate the usage of oil revenues, as well as budget expenditures in accordance with the parameters defined by the monetary policy. The Cabinet of Ministers has been assigned to prepare and present the recommendations regarding the new fiscal rules for regulating the upper limit of SOFAZ transfers to the state budget and strengthening fiscal sustainability within six months with the Order of the President of Azerbaijan about the implementation of the "2017 state budget bill" adopted on December 27, 2016;

- Gradual limitation of the share of government financing in several fields of economy in the country. Wide financial opportunities created a "displacement effect" during the period of big oil money and the government became the dominating investor. However, increasing activity in attracting private investments has become one of the new priorities of the government under the conditions of limited public financing.

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[9]   http://www.azerbaijan-news.az/index.php?mod=3&id=113224

3. Main trends in the formation of budget revenues

According to the law, the 2017 state budget revenues will be formed with 6.1 billion AZN transfers from SOFAZ, 4.14 billion AZN value-added tax (VAT), 2.18 billion AZN income tax of legal entities, 1.17 billion AZN income tax of individuals, 608 million AZN excise tax, 454 million AZN customs fees, 344 million AZN simplified tax, 178 million AZN corporate property tax, 89 million AZN road tax and 90 million AZN revenues from fines and sanctions on tax violations.

Diagram 1. The composition of the revenue sources of 2017 state budget

REVENUES – 16,255 MLN AZN

37.5%
25.5%
13.4%
7.2%
3.7%
2.8%
2.1%
7.8%

- Transfers from the Oil Fund
- Value-added tax
- Profit tax of legal entities
- Income tax of individuals
- Excise tax
- Customs fees
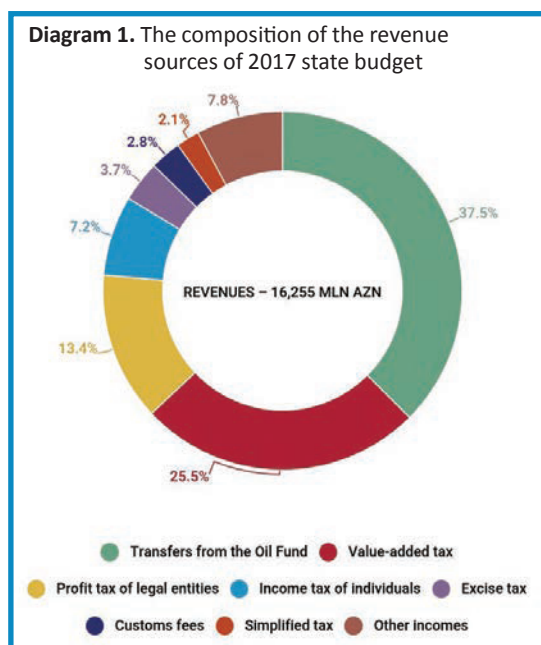- Simplified tax
- Other incomes

Diagram 1 shows that 83.6% of the 2017 state budget revenue will come from four sources – SOFAZ transfer (37.5%), VAT (25.5%), profit tax of legal entities (13.4%) and income tax of individuals (7.2%). At the same time, if SOFAZ transfer is excluded, then 79.7% of the budget revenue comes from taxes – VAT (40.7%), profit taxes of legal entities (21.5%), income taxes of individuals (11.5%) and excise tax (6.0%).

According to expectations of the government, the state budget of 2017 will be formed with 7.86 billion AZN (48.3%) income derived from the oil sector and 8.4 billion AZN (51.7%) non-oil sector revenues.

Compared to the forecast of 2016, it is expected that additions to the state budget from oil sector will be 1.37 billion AZN (14.9%) less and revenues from non-oil sector will be 803 million AZN (10.6%) more in the forecast of 2017.

According to forecasts of the government, the state budget of 2017 will consist of 7.51 billion AZN through the Ministry of Taxes, 2.2 billion AZN through the State Customs Committee (SCC), 6.1 billion AZN through the transfer of the State Oil Fund and the remaining 445 million AZN through other resources (Diagram 2).

The law suggests that 15.63 billion AZN (96.2%) of the state budget will come from the centralized revenues and 620.3 million AZN (3.8%) from the local revenues.

i) The shrinking trend of the state budget of Azerbaijan that started in 2014 is ongoing and this is due to the decreasing oil revenues. The most remarkable feature in the state budget of 2017 is the continuing trend of decreasing budget revenues compared to the previous years. As mentioned before, the state budget revenues of 2017 have been forecasted as 16.3 billion AZN and budget revenues are expected to decrease by 1.25 billion AZN or 7.1%. This indicates that starting from 2014 it is already the fourth year that the revenue level of state budget revenue continues to fall from year to year. The forecasted revenue level of the state budget of 2017 is the lowest in the last 6 years.

Diagram 2. The structure of 2017 state budget revenue per institutions

13.5%

46.2%

37.5%

2.8%

REVENUES – BY INSTITUTIONS

● Ministry of Taxes   ● State Customs Committee   ● Transfers of SOFAZ
● Other Sources

ii) The falling level of the state budget is felt more acutely when expressed in USD. Based on the 1 USD = 1.75 AZN exchange rate[10] used for compiling the state budget of 2017, the budget revenues equal $9.29 billion which is 2.6 times less than the budget revenues of 2013 expressed in USD and is the lowest indicator of the state budget revenues of the country in USD over the last 10 years.[11]
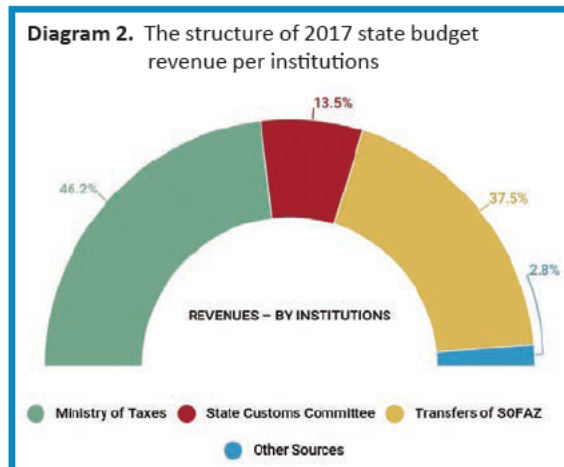
Such decrease in state budget revenues is directly related to the diminishing revenues from the oil sector: thus, both the falling tax revenues to the state from the oil sector during the past years and the cutback of the transfer from SOFAZ to the state budget from year to year is still happening.

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[10] http://apa.az/maliyye_xeberleri/vergiler-nazirliyi-gelen-il-ucun-hesablamalarinda-dollarin-mezennesini-1-75-AZNdan-goturub.html

[11] Based on the official exchange rate of the CBAR for that period for calculating the state budget revenues expressed in dollars.

Diagram 3. Changing of the state budget revenues in AZN and USD in 2007-2017

iii) 6.1 billion AZN is expected to be transferred from SOFAZ to the state budget in 2017, which is 1.52 billion AZN less than the corresponding figures of 2016 and 2.03 billion AZN less than those of 2015. This is also the lowest figure since 2011. Notably, the biggest transfer from SOFAZ to the state budget was 11.35 billion AZN in 2013. This means that the SOFAZ transfer to the state budget to take place in 2017 will be 46.3% less than that of 2013.

Considering that SOFAZ revenues are mainly expressed in USD, then it would be more reasonable to follow the changes of the annual transfer to the state budget in dollars. Thus, the amount of SOFAZ transfer to the state budget will be approximately $3.5 billion this year. This means that SOFAZ transfers have been cut by four times compared to 2013 (approximately $14.19 billion), when the highest level was noted. This is also the lowest indicator in dollars since 2008, when the transfer from the Oil Fund to the state budget significantly increased. The reduction in the transfer amount from SOFAZ to the state budget from year to year is due to the sharp decline in revenues resulting from the falling oil prices in global markets and the intention of the government to preserve the currency reserves at a certain level.

Notably, the government has declared that the policy of reducing the transfer amounts from SOFAZ to the state budget will continue in the upcoming years (it is expected that the amount of transfer will be 4 billion AZN in 2020). In addition to this, the Cabinet of Ministers has been assigned to prepare and present a proposal about new fiscal rules for regulating the top limit of SOFAZ transfers to the state budget and strengthening fiscal sustainability in six months with the Presidential Decree regarding the implementation of the law on state budget of 2017 adopted on December 27, 2016. At the same time processing and implementing fiscal rules for the regulation of relations between SOFAZ and the state budget is planned in the "Strategic roadmap on national economy prospects of the Republic of Azerbaijan"[12].

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[12]   http://www.e-qanun.az/framework/34254

iv) The amount of direct revenues in the form of tax payments from oil and gas sector (taxes of SOCAR and profit tax of foreign contractor companies on Production Sharing Agreements - PSAs) to 2017 state budget is forecasted to be 1.76 billion AZN, which is 145 million AZN more than those of 2016. This increase is due to the fact that the state budget of 2017 has been calculated with the price of oil being $40 per barrel in global oil market[13]. Foreign contractor companies on PSAs are expected to pay 475 million AZN profit tax to the state budget 2017, which is 105 million more than the forecasts for 2016, but still 3 times less than those of 2013 and 2.3 times less than those of 2014.

v) Even though the revenues from the oil sector have significantly decreased in the composition of the state budget, more than half of the state budget revenues of 2017 still come from the oil sector. The Ministry of Finance seems inclined to "artificially" increase the role of the non-oil sector in the composition of the state budget revenues.[14] As mentioned before, 7.86 billion AZN or 48.3% of 2017 state budget revenues will be formed with the revenues of the oil sector.[15] However, our analysis shows that these figures do not fully reflect the role of the oil sector in the composition of the state budget revenue. The Ministry of Finance does not assign the income tax of foreign and local contractor companies on PSAs and the income tax from the revenues generated from employment at contractor and subcontractor companies on PSAs, as well as SOCAR to the revenues of the oil sector. However, these resources directly reflect the contribution of the oil sector to the state budget.

The forecasts of the government suggest that the foreign subcontractor companies will pay 274.9 million AZN profit tax on PSAs and the revenues from the income tax for employment at contractor and subcontractor companies on PSAs will be 310.9 million AZN in 2017[16]. If these funds are considered, the amount of revenues from the oil sector to the state budget must be 8.44 billion AZN in 2017, which makes 51.9% of the budget revenues. Nevertheless, this is the lowest figure for the past 12 years.

As it can be seen from the Diagram 4, the highest share of the oil sector in the state budget revenues was 74.4% in 2011.
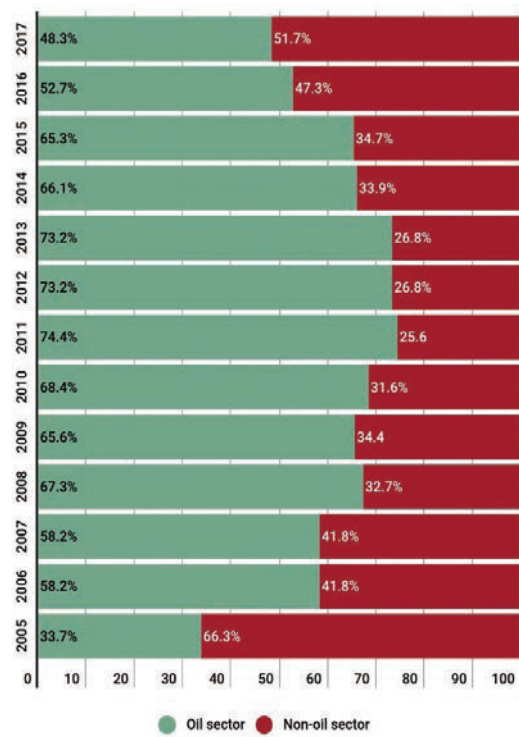
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[13] The state budget of 2016 has been prepared with the consideration that price of a barrel of oil is $25.

[14] The classification of state budget revenues. The package of documents presented to National Assembly together with the draft state budget bill of the Republic of Azerbaijan for 2017.

[15] The presentation of the Ministry of Finance about 2017 draft budget bill. The collection of documents presented to National Assembly together with 2017 draft budget bill of the Republic of Azerbaijan

[16] The classification of state budget revenues. The collection of documents to be presented to National Assembly together with the draft state budget bill of the Republic of Azerbaijan for 2017.

Year	Oil sector	Non-oil sector
2017	48.3%	51.7%
2016	52.7%	47.3%
2015	65.3%	34.7%
2014	66.1%	33.9%
2013	73.2%	26.8%
2012	73.2%	26.8%
2011	74.4%	25.6
2010	68.4%	31.6%
2009	65.6%	34.4
2008	67.3%	32.7%
2007	58.2%	41.8%
2006	58.2%	41.8%
2005	33.7%	66.3%

Oil sector ● Non-oil sector

vi) According to the studies the forecast of the state budget revenues of 2017 from the non-oil sector is complicated and does not correspond to reality. This can be explained through several aspects:

- According to the explanation of the government[13], revenues from the non-oil sector are forecasted to grow by 803 million AZN or 10.6% in 2017 compared to the forecasts of 2016. In other words, 390 million AZN (48.6% of the growth) and 355 million AZN (44.2% of the growth) of which will be the shares of SCC and the Ministry of Taxes accordingly. Apparently, nearly half of the growth is expected from import taxes and customs duties: an increase of 339 million AZN VAT on imported goods and a 66 million AZN custom fees, as well as a 150 million AZN excise tax on imported goods are expected in 2017 compared to the forecast of the previous year. Consequently, we can say that the increase in budget revenues at the expense of foreign trade is mainly a result of the changes[17] in USD/AZN exchange rate in the current situation when the government carries out a policy limiting import. A 355 million AZN increase of revenues from the non-oil sector compared to the previous year is planned by the Ministry of Taxes and 300 million AZN of this has been added to the state budget at the last moment – when the draft budget was being discussed at National Assembly.

- The amount of budget revenues from the SCC are expected to be 2.2 billion AZN in 2017, which is 390 million AZN or 21.5% more than the forecasts of 2016. However, according to the information of the Ministry of Finance regarding the implementation of the state budget of 2016, 2.29 billion AZN

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[17] The state budget of 2017 has been compiled with the consideration that of 1 USD = 1.75 AZN average annual exchange rate. In 2016, the average annual exchange rate was 1 USD = 1.60 AZN

has been collected to the state budget through SCC and this is 26.6% more than what was considered with the forecasts for that year.[18] Apparently, the actual amount that entered the state budget through SCC in 2016 is 91.6 million AZN more than the amount forecasted for 2017. If we consider that imports will not decrease in 2017 according to the socio-economic development forecasts of the government, no additional tax discounts have been applied to the imported goods, in contrary some exported products will have export taxes applied to them, then the revenue decrease to the state budget through SCC is not real in 2017. The amount of excise collected through SCC to the state budget is expected to fall by 15 million AZN and the other funds of the organization are expected to grow in 2017. Thus, problems in the budget forecast of 2017 are obvious.

vii) The Ministry of Taxes will have a bigger share – 46.2% – in compiling budget revenues of 2017, but despite this, issues of concern still remain in the forecasts about tax revenues and the structure of tax revenues. 7.51 billion AZN of the state budget revenues must be produced through the Ministry of Taxes in 2017. As a comparison, we should note that the level of these indicators was 34.2% in 2013 and 49.7% in 2015. This means that as the amount of SOFAZ transfers to the state budget decreases, the role of the Ministry of Taxes increases in the compilation of the state budget. The total amount to be collected at the state budget through the Ministry of Taxes consists of 40.2% indirect tax (33.3% VAT and 6.9% excise), 49.0% income tax (29.0% profit tax, 15.6% income tax from individuals and 4.4% simplified tax), 5.6% property tax and 5.1% other revenues. Despite this, the following issues about the revenues of the state budget of 2017 draw attention:

- The growth forecast of funds to be involved in the state budget through the Ministry of Taxes does not seem realistic: compared to the forecasts of 2016, the contribution of the Ministry of Taxes to the state budget is forecasted to be 500 million AZN or 6.6% more. Even though the Ministry of Taxes fulfilled the forecast by 100.1% and collected 7.02 billion AZN, this is 103 million AZN less than the funds collected by the Ministry in 2015. At the same time, the funds collected by the Ministry in 2015 were only 4.6 million AZN more than those collected in 2014. This is despite the second devaluation of AZN in the end of 2015 and losing 12% value in comparison with the USD rate in 2016 resulting in a significant price increase across the markets of the country (the official announced rate of inflation was 12.4%[16]).

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18   http://maliyye.gov.az/node/2010

Additionally, although the forecasts of the past year were made considering that the price of 1 barrel of oil will be $25, in fact the average annual sale price of Azerbaijan oil in the global markets was $40 throughout the year, the amount of funds collected through the Ministry of Taxes to the state budget have been 103 million AZN or 1.4% less than those of 2015. In such a case, it does not seem realistic that the funds to be added to the state budget in 2017 through the Ministry of Taxes will increase by 500 million AZN. Even with the changes to the Tax Code, which entered force on January 1, 2017, seem doubtful. It is not accidental that even the government has added 300 million AZN of this 500 million AZN while the draft budget was being discussed at National Assembly.

- The forecasted growth of revenues through the Ministry of Taxes will happen due to three types of taxes – VAT, profit tax and the income tax from individuals, which does not seem realistic under the ongoing economic crisis in the country. Compared to the forecasts of 2016, the Ministry of Taxes forecasts collecting additional 264.4 million AZN profit tax from legal entities, 155 million AZN VAT, 88 million AZN income tax of individuals, 44 million AZN simplified tax, 3.8 million AZN corporate property tax, 2 million AZN road tax, 800 thousand AZN royalty and in total an additional 558 million AZN in 2017. The amount of excise collected by the Ministry of Taxes in 2017 is expected to fall by 14 million and other revenues by 44 million AZN. Forecasts on corporate land tax and government fees are kept at the level of 2016. Thus, the main burden of growth falls on VAT and income tax from individuals. Many businesses and workplaces have been closing over the past two years because of the economic crisis in the country. In such a situation, achieving such a serious increase on individual and corporate income tax does not seem realistic even by improving tax administration and calculations.

- The increase of revenues on simplified tax is due to expanding the tax base of this tax. Revenues of simplified tax are forecasted around 344 million AZN in 2017, which is 44 million AZN or 14.7% larger than the forecasts of 2016 and 176 million AZN or twice as much as the actual amount registered in 2015. Such a rapid increase of revenues with this type of payment can be explained by the expansion of the list of tax payers based on the changes to the Tax Code on January 1, 2017, and the introduction of a fixed tax amount on a variety of activities on a monthly basis.

- A decrease in excise tax revenues seems controversial from the standpoint of the latest decisions adopted by the government. Excise revenues entering the budget through the Ministry of Taxes are expected to fall by 14 million AZN (as well as 15 million AZN on excise entering through SCC) in 2017, despite expanding the list of goods subject to excise duties and increasing the level of duties on some goods based on the amendments to the Tax Code, as well as the changes to the rules for selling some alcoholic beverages and tobacco products (changes are aimed at the legalization and elimination of the hidden turnover in the sales of these products). However, for some reason the government has not given a grounded explanation for this decrease.

- Not changing the amount of revenues to the state budget on land tax from legal entities contradicts the relevant policies of the government. Thus, it is not comprehendible why revenues to the state budget do not increase due to the land tax from legal entities and leasing land despite setting the target of ''increasing the coefficient of budget entrance of the revenues from the lease of government lands'' is one of the main directions of the budget-tax policy, changes about the land tax in the Tax Code, applying an additional tax from this year for not using agricultural lands, as well as opening a number of large agricultural production units on state-owned lands during the past years.

viii) Finally, there is no detailed information about the budget commitments of the government agencies. Information regarding the budget commitments of the state-owned companies and status of the implementation of those responsibilities are not reflected in the documents added to the draft state budget of 2017. However, the role of those companies, which get financial support from the state budget from time to time in various forms, in the economic and social life of the country, the effectiveness of the performance of these companies and the level of implementation of their budget obligations should always be at the center of attention for the government and the parliament

4. The main expected budget expenditure trends

Diagram 5. The composition of the 2017 state budget expenses on functional units
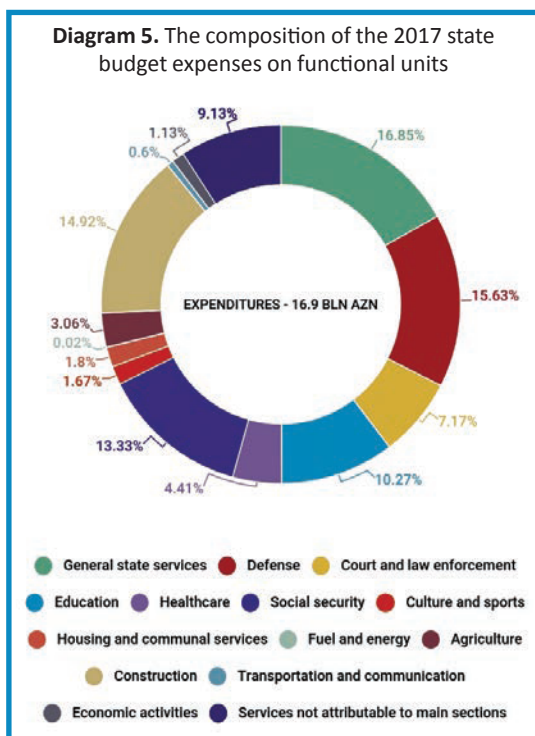
State budget expenditures of 2017 have been allocated as follows: 16.85% or 2.85 billion AZN for general state services, 15.63% or 2.64 billion AZN for defense, 7.17% or 1.21 billion AZN for court and law enforcement authorities, 10.27% or 1.74 billion AZN for education, 4.41% or 745.3 million AZN for healthcare, 13.33% or 2,253 million AZN for social security, 14.92% or 2.52 billion AZN for public investments (construction) and the remaining part for other fields.

The three directions with the biggest share in the expenditures of the state budget of 2017 are general government services (16.85%), defense (15.63%) and public investments (14.92%).

Overall, 39.65% of the state budget expenditures of 2017 is going to be spent on public administration and defense, 29.68% on the social sector and 30.66% for economic purposes.

ix) Proportional to the acute decrease in oil prices, 2015 was the last year the state budget of which was forecasted with a growth and the spending part of the budget was significantly reduced during the following two years. Apparently, the forecasted expenses of 2017 are 842.4 million AZN less than the budget expenses of 2016. Over the past 10 years the highest level of budget spending has been recorded in

2013. Although the expenses were expected to grow in 2014-2015, this was not implemented. And in the USD equivalent, budget expenses of 2017 will be the lowest since 2008, when the oil revenues saw a dramatic increase. At the same time, the expenses will have been cut by 2.5 times compared to 2013 when the expenses were the highest in 10 years.

x) According to the budget classification of 2017, the expenditure considered for the maintenance of three "higher authorities" – the Presidential Administration, the Parliament and the Cabinet of Ministers – have been increased by 6.5% and reached 110.2 million AZN, compared to the previous year. However, the costs of all ministries, committees, agencies and other government organizations have been cut by 1.1% and approved for the level of 345 million AZN. The funding of regional and city executive powers have also been decreased by 15.7% and settled at 98.2 million AZN. The overall

Diagram 6. The breakdown of the main directions of the state budget 2017

29.68%

39.65%

30.66%

EXPENDITURES - 16.9 BLN AZN

● Public administration and defense   ● Social sector

● Economic directions

maintenance costs for authorities of power consist of 3.2% of the entire budget spending.
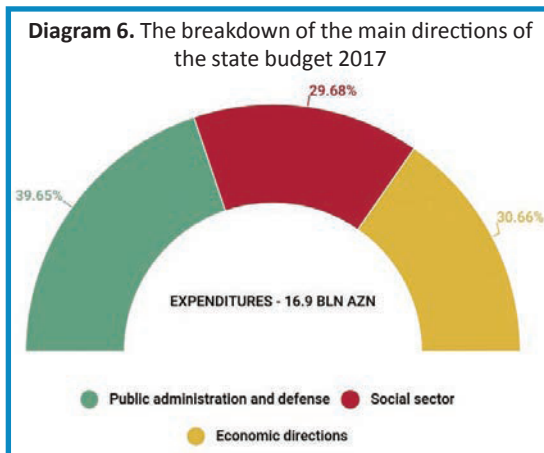
xi) The spending of the Science budget has been cut significantly. The amount of Science spending has been cut by 12.3% in comparison to 2016 and the total amount of all costs will be 118.6 million AZN. The share of science spending in the budget expenditures of 2017 is at 0.7%.

xii) The highest growth will be in Defense spending. Defense expenditures in 2017 will be 2.64 billion AZN. This is 18.6% more compared to the previous year. Defense costs also have the second largest share in the state budget of 2017. Thus, its share in the general budget spending of the functional section will be 15.6%, which was 12% last year.

xiii) A significate increase has also been registered in the expenditures for law enforcement authorities. According to the analysis of budget documents, 927.4 million AZN were be allocated to the law enforcement authorities in 2017, which is 7.5% more than the previous year. The total funds for financing the law enforcement system of the country in the current year will be 5.5% of budget expenditures.

Diagram 7. Changing of the state budget expenditures in AZN and USD

xiv) Social spending is planned to fall significantly. 5.36 billion AZN or 32.9% of the total budget expenditures were allocated to financing three key social tracks of the state budget in 2016. These are healthcare, education, and social security. Funds allocated to these three functions in 2017 are 4.73 billion AZN, which is 11.6% less than the previous year. Consequently, social security spending of 2017 is 2.25 billion AZN, which is 16.5% less compared to the previous year. Education spending of the current year is 1.74 billion AZN and 5.1% less than that of 2016. Healthcare spending of 2017 is 745.4 million AZN 10.2% less compared to last year.

xv) Public investment spending has been cut significantly. This expenditure in the budget for 2017 has been forecasted as 2.52 billion AZN, which is 16.6% less, compared to the previous year. The amount of forecasted funds for the budget investments of the current year is the lowest figure since 2007. In 2007, the approved amount from the budget for this purpose was 1.93 billion AZN and in 2008, it was 4.29 billion AZN. The share of budget investments in 2017 is 14.9% of total budget expenditures. The same indicator was 16.4% in 2016 and 28-40% in 2007-2015.

xvi) Spending for the working section of agriculture has been cut significantly. Thus, the approved budget on this sector has been 517.4 million AZN, which is 24.4% less than the last year.

xvii) The amount of local spending has fallen significantly and this is due to the limited scope of these costs. Thus, the amount of local costs in the budget of 2017 will fall twice and drop from 1.54 billion AZN in 2016 to 718 million AZN. The main reason for this reduction is that education, culture and sport expenses in the regions and cities of the country will be removed from the composition of regional costs and added to centralized expenses starting this year. This was the result of the reorganization of educational and cultural departments at regional level.

5. The budget deficit and its funding sources

Budget deficit of 2017 will be 645 million AZN, which equals 1% of the GDP forecasted for this year. The current state budget deficit is 61.5% or 1.03 billion AZN less than the forecasted indicator of 2016.

According to the Chamber of Accounts, five sources will be used for financing the budget deficit.[19] 200 million AZN of this amount will come from the privatization of state property, 20 million AZN from foreign grants and 425 million AZN from domestic debts, foreign debts and the treasury stock of the state budget.

xviii) In the current situation, financing the budget deficit of 2017 will not create serious problems for the government. Firstly, this is because the forecasted deficit for the current year is not very big and is the lowest figure in the past 5 years. On the other hand, the Ministry of Finance has approximately 1.4 billion of treasury remainder[20] and this remainder can be used for covering the budget deficit of 2017 in accordance with the legislation. Apparently, the amount of treasury stock is twice as much as the amount of the forecasted budget deficit of 2017 and constraints with covering this deficit even without using other financial resources are not expected.

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[19] The review of the Chamber of Accounts on 2017 state budget. See pages 303-307 http://sai.gov.az/upload/files/r_LAYIH%C6%8F-2017-R%C6%8FY-FINAL.pdf

[20] The review of the Chamber of Accounts on 2017 state budget. See page 139 http://sai.gov.az/upload/files/r_LAYIH%C6%8F-2017-R%C6%8FY-FINAL.pdf

6. The service to state debts through the budget

The expenditure of the service for state debts has been defined as 1.64 billion AZN in 2017. Overall, the share of this expenditure is forecasted as 9.7%, which is the highest figure in the past 15 years. The budget documents[21] describe that 96.3% or 1.58 billion AZN of debt service expenses of the current year will be spent for covering external government debt and 3.7% or 61.2 million AZN for covering domestic debt. According to the Chamber of Accounts, one of the main reasons for high cost of service to foreign debts is related to returning government guaranteed loans of state-owned joint-stock companies (e.g. "Azeraluminiun" OJSC, "Azerenerji" OJSC, AZAL)[22]. The Chamber of Accounts openly stresses that some of these companies that have taken government guaranteed loans are unable to meet their obligations and therefore, these obligations are taken from the state budget.

Costs of domestic debt services will be spent on financing loans from the Central Bank and payments of government bonds.

The rapid increase of both foreign and domestic debt creates the risk of a rapid increase in debt service spending from the state budget in the near future and the extreme rise in the share of this spending in the general budget expenditures of 2017 confirms this approach. Foreign state debt increased by 15% and reached $8 billion in 2016 and the domestic debt increased by 60% and reached 7.3 billion AZN in 2016. Particularly, domestic debt related to remediation of problem assets of the International Bank of Azerbaijan (IBAR) has been defined as a direct obligation of the state budget.

Apparently, in a situation where the potential of the state budget is becoming limited, a rapid increase in the debt burden on the budget stands in front of us as a serious problem. The lack of transparency and public scrutiny necessitates evaluating the

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[21] The Budget Envelope presented to the Parliament by the government of Azerbaijan. Volume V

[22] The review of the Chamber of Accounts on 2017 state budget. See page 297 http://sai.gov.az/upload/files/r_LAYIH%C6%8F-2017-R%C6%8FY-FINAL.pdf

increase of the debt burden as a serious risk. The Chamber of Accounts also pays attention to this problem and emphasizes that establishing a management system of debt risks and state debt strategy is very crucial for the current situation.[23]

23   The review of the Chamber of Accounts on 2017 state budget. See page 302 http://sai.gov.az/upload/files/r_LAYIH%C6%8F-2017-R%C6%8FY-FINAL.pdf

7. The preparation and parliamentary debate of 2017 state budget

Several procedural violations have been observed in the preparation, parliamentary discussions, and the approval of the draft budget bill of 2017.

xix) The draft law on the state budget of 2017 and the related package of documents were presented to the National Assembly a month later than the specified time. According to the law on the budget system, the draft budget law and related documents were supposed to be presented to the parliament no later than October 15, 2016, but this happened with a month delay, i.e. on November 15.

xx) After being presented to the National Assembly, the draft law has been subject to changes by the government without the consent of the parliament. The government has made changes to the draft law on the state budget after being presented to the National Assembly in November 2016 and being published in the media: both the revenues and expenditures of the budget have been increased by 300 million AZN. Besides this, after the approval of the National Assembly and before being signed by the president the income part of the state budget has undergone some changes (property and land taxes of legal entities) have been reduced, forecasts on VAT and profit tax revenues have been increased).

xxi) The parliamentary discussions of the draft state budget were held only formally, just like in the previous years. The state budget of 2017 was discussed at the National Assembly for just a very short time – only three days of plenary sessions. The draft law had only one reading and was approved by the National Assembly without discussions immediately at the second reading.

xxii) Amendments to the Tax Code were discussed and adopted at the National

Assembly after the draft bill about the state budget was confirmed. Based on best experiences and public administration logic, amendments to the Tax Code should be discussed and adopted before the budget law. Because the forecasts of 2017 state budget revenues are somehow related to the changes proposed in the Tax Code. The proposed 201 changes to the Tax Code were adopted without wide discussions and came into force on January 1, 2017.

8. Conclusions and Recommendations

The analysis of the 2017 state budget of the Republic of Azerbaijan shows that the state budget diminishes as the oil revenues decrease.

- In the end, the government has decided to limit the amount of SOFAZ transfers to state budget and has even announced its intention of compiling fiscal rules for systematic regulation of SOFAZ-budget relations as a result of the sharp decline in oil revenues and the threat to fiscal durability;

- Despite the sharp decline in the revenues from the oil sector to the state budget, more than half of the revenues of 2017 state budget (51.9%) are coming from the oil sector;

- The weight of revenues from non-oil sector in the formation of the state budget has been increasing over the past several years, however, so far, this growth has been due to the falling oil revenues on one side and the rising prices in the country because of the sharp devaluation on the other. In other words, these increases do not have any real substance yet;

- 2017 state budget forecasts for revenues from the non-oil sector are not sufficiently substantiated by the government;

- The expenditures of the 2017 state budget are not aimed at specific results, like they were in the previous years;

- Even though the government is forced to cut several costs because of the limited state budget resources, in general, no serious changes towards increasing productivity and effectiveness in the budget activities of the government can be observed;

- Like 2016, high level of service expenses of state debts in the budget of 2017 increases concern about the level of government debt in 2017;

- The process of presenting, discussing and adopting of 2017 state budget at the parliament has been accompanied with serious procedural violations identified in budget legislation.

The following are the recommendations for forecasting the state budget and improving the management of state finances in the following years:

1. Provide a more accurate, detailed and grounded assessment of the contribution of oil and non-oil sectors to the formation of state budget revenues.

2. Disclosure of the forecast of budget revenues on private and public sectors (particularly by giving more detailed information about big state-owned companies) by distinguishing them on all payment types.

3. Establish a legal and regulatory framework for providing the coordination of all strategic and budget planning, as well as making all budget orders agree with socio-economic development forecasts of the government.

4. Switch to mechanisms ensuring result-oriented budget planning.

5. Establish legal mechanisms ensuring the adoption of the draft budget bill by being discussed by professional civil society organizations and public institutions representing the interests of various social groups.

6. Allow the introduction of the budget packet to the public on the internet to ensure the accessibility of budget information.

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www.opengovernment.az
opengovaz@gmail.com