



**National Budget Group**  
*Within the National Budget Office project*

**“Research on the state budget of 2011”**

**Gubad Ibadoghlu**  
**Kanan Aslanly**

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## **Abbreviations**

AIOC	Azerbaijan International Operation Company
SOFAZ	State Oil Fund of Azerbaijan Republic
OJSC	Open Joint Stock Company
SCC	State Customs Committee
SCS	State Committee on Statistics
SSPF	State Social Protection Fund
CA	Chamber of Accounts
NBG	National Budget Group
NBO	National Budget Office
OBI	Open Budget Index
CJSC	Closed Joint Stock Company
GDP	Gross Domestic Product

## Content

### Introduction

- Evaluation of raising dependence of the state budget on oil sector from the point of fiscal sustainability and analyses of fiscal risks occurred by such kind of dependence;
- Changes on tax rates with incomes on important types of taxes and identification of clause – sequence relations with other relevant economic events;
- Analyses of mutual relations between the state budget and out of budget foundations (as well as specific foundations);
- Analyses of increase of expenditures on budget classification directed to fields context of which is not completely clarified and maintained as indefinite;
- Investigation of mutual relations between implementation of state programs and the state budget and possible impacts to the state budget;
- The analyses of the structure of incomes and expenditures of centralized and local budget from the point of development of regions and implementation of state programs;
- Analyses of deficit of state budget and sources of its covering;
- Analyses of transparency of budget in Azerbaijan from the point of results of Open Budget Index 2010;
- Attitude to statements of Chamber of Accounts and procedural issues;
- Outcomes and proposals.

## Introduction

The state budget<sup>1</sup> for 2011 is analyzed on the presented report upon the aspect of fiscal sustainability, also it is focused on the issues such as risks occurred and leading to increase of dependence between the state budget and Oil Fund, structural analyses of incomes and expenditures of the state budget, relation between implementation of state programs and budget policy, access to information on budget and budget transparency. The following inclinations and trends had been revealed as a result of research:

1. The research is proving that provision occurred with transfers from the SOFAZ in formation of budget is increasing the fiscal sustainability risk. The expertise of the state budget for 2011 and evaluation of budget policy is showing that the decrease on important types of taxes as well as increase of tax debts has resulted to the decrease in the coefficient of direct tax income collection in supply of budget supply. Thus there is a loss of previous position of earnings on income tax from legal entities in formation of tax incomes of the state budget. On the other hand the as 40 % of the predictions of the Ministry of Taxes is shared by the oil sector and increase of special weight of SOFAZ in budget incomes is leaving behind the payments related to non oil sector. It was revealed as a result of analyses of trends that if the contribution of the Ministry of Taxes in formation of state budget in 2008 was 52.9 % but the income from this source decreased to 36,6 % in 2011 and the share of the oil fund in budget incomes is predicted to be increased from 35.3 % to 53.7 %.
2. The research conducted by the NBG is showing that while taking into account the relation of the state budget and out of budget foundations dependence of the SSPF on the state budget is a special trend attracting attention. Thus the expected incomes of the SSPF for the next year is going to be formed 35 % from the transfers from state budget which is 4.7 % more in comparison to relevant figure of the current year.
3. The applied analyses of budget expenses are showing that the share of expenses directed to non clarified directions and indefinite expenses are increasing. This group is consisted of the industrial building and fossils, defense, expenses not related to the core parts and others which makes finally 51,9 %. These are the items of expenses that it is only possible to get general information on where and how they are going to be spent in 2011. The analyses are showing that the share of expenses which are not clarified in context through functional classifications are increasing in comparison to previous years. This however limits the access to the detailed budget information on those directions.
4. One of the issues attracting attention on the research is evaluation of existence of correlation between the implementation of state programs and the state budget. Evaluations conducted in these directions are showing that there is no direct correlation between the funding of implementation of state programs. Also dependence among the results obtained from implementation of programs in formation of budget receipts is weaker. The analyses of the structure of incomes and expenditures of centralized and local budget from the point of development of regions and implementation of state programs are showing that local incomes do not have important role in formation of budget incomes. The estimations have shown that the regions are going to provide only 2,7 % of state income in 2011. At the same time the experts of NBG have examined the funding of the state budget on programs and come to conclusion that application of new

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<sup>1</sup> According to the draft legislation on the state budget for 2011 the incomes of the state budget for the next year are considered to be 12.061 billion manats which is going to be 30 % of GDP for that year. In comparison with forecast indicators of tax incomes in income part of the state budget of 2010 along with decrease for 2.5 percent in 2011 the transfers from the SOFAZ to the state budget has increased to 9.6 % and become the basic income source of the budget in amount of 6.480 billion manats (53.7 % of total income). Estimations are showing that there is a trend for decrease in specific weight of non – oil incomes of the state budget in comparison to non – oil GDP. During the budget estimations for 2011 the oil revenues have been calculated as 60 US Dollars per barrel and currency rate for US Dollar is accepted as 0.8 manat.

funding mechanisms related to several programs requires forecasting financial resources in one paragraph and improvement of disbursement mechanism.

5. The research was also evaluated within the state budget for 2011, existing budget policy and budget transparency context. The results have shown that Azerbaijan has gained 43 points from possible 100 points on the “Open Budget Index 2010”.
6. The expertise of the statements of the Chamber of Accounts and observation of procedure requirements during discussion of the budget the supreme control body to the state budget is still involved in single analyses of figures of the budget. This is limiting the opportunity to have real control over the execution of the budget. Finally the state budget for 2011 had experienced the shortest discussion in comparison with the previous composition of parliaments. The discussion of the budget reviewed only during 2 days in parliament is showing that the need for regalement of budget process in Azerbaijan Republic is increasing day by day.

### **Rising dependence of the state budget from oil sector is increasing the risk of fiscal sustainability.**

It is hard to evaluate the budget model in the country already formulated during the recent years without taking into account relation of SOFAZ and the state budget. The transfers from the Oil Fund to the budget starting from 2003 have launched beginning of this relation. The volume of these transfers raising year by year and 53,7 % its share in the budget is significantly increasing this relation. Obviously it is leading to some concerns on its turn. Thus this increase is strengthening dependence of the budget form the Oil Fund and weakening motivation of tax collection. Estimations are showing that at least 2 manats of each 3 manats of predicted budget incomes is going to be formed from the oil fund and direct budget receipts from oil sector.

Increase of volume of transfers is directing focus to the SOFAZ and creating necessity to adopt fiscal policy guideline based on serious arguments for “fund – budget” relations. Estimations are showing that the relevant figure in limitation for Azerbaijan is 30 % of assets<sup>2</sup> of the SOFAZ. Disbursement of huge part of assets especially obtained by the Fund during the period of the crisis is related with the policy of existence of intentions for more simplified solution of lack of funds in state treasury in inconvenient economic situation. It should be emphasized that the incomes of the SOFAZ for 2011 is predicted to be 9.1 billion manats and expenses are going to be 6.8 billion manats, share of transfers to the state budget within its expenditures is supposed to be in a level of 94 % - in highest amount in the history of the Foundation.

**Table 1. Transfers of SOFAZ to the state budget**

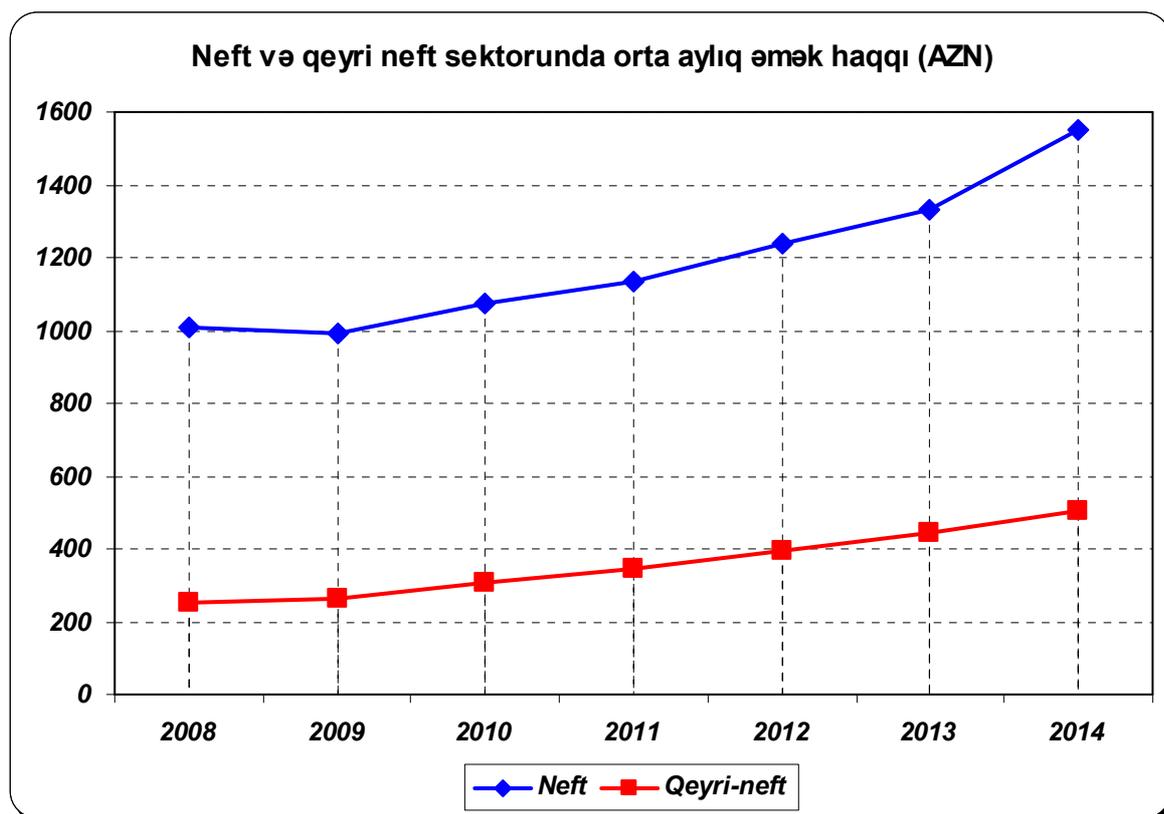
Years	Transfers from SOFAZ to the state budget (million AZN)	Dynamics of increase	Share within the budget	Share within the expenses of SOFAZ
2003	100	--	8.2%	41%
2004	130	30.0%	8.6%	77%
2005	150	15.4%	7.2%	70%
2006	585	290.0%	15.6%	59.6%
2007	585	0.0%	9.7%	55.1%
2008	1100	88.0%	35.3%	88.5%
2009	4915	346.8%	40.4%	92.8%
2010	5915	20.3%	51.4%	90.5%
2011	6480	9.6%	53.7%	94.9%

<sup>2</sup> “Global Economic Crisis and State Budget: Example of Azerbaijan”. National Budget Group, Baku 2010.

Source of statistics: <http://www.oilfund.az>

If the government is intending to provide fiscal sustainability there will be a need to review the plan of expenditures for medium terms in conditions of low oil prices for long terms. The expenses of the state budget of Azerbaijan should be maintained in a level of 40 percent of GDP with the aim to make the country ready for the period of limited oil revenues from long term perspective. Azerbaijan might expect periodically fiscal oil revenues (including tax payments from oil companies) in amount of 5.9 billions USD per year (with the prices of 2007). On this basis the Oil Fund has to collect 78 billions USD for 2030. Several other economic parameters for medium terms, including serious differences in disbursement of average monthly salary on oil and non oil sectors might be still continued.

Chart 1.



### Monthly average salary in oil and non oil sectors (AZN)

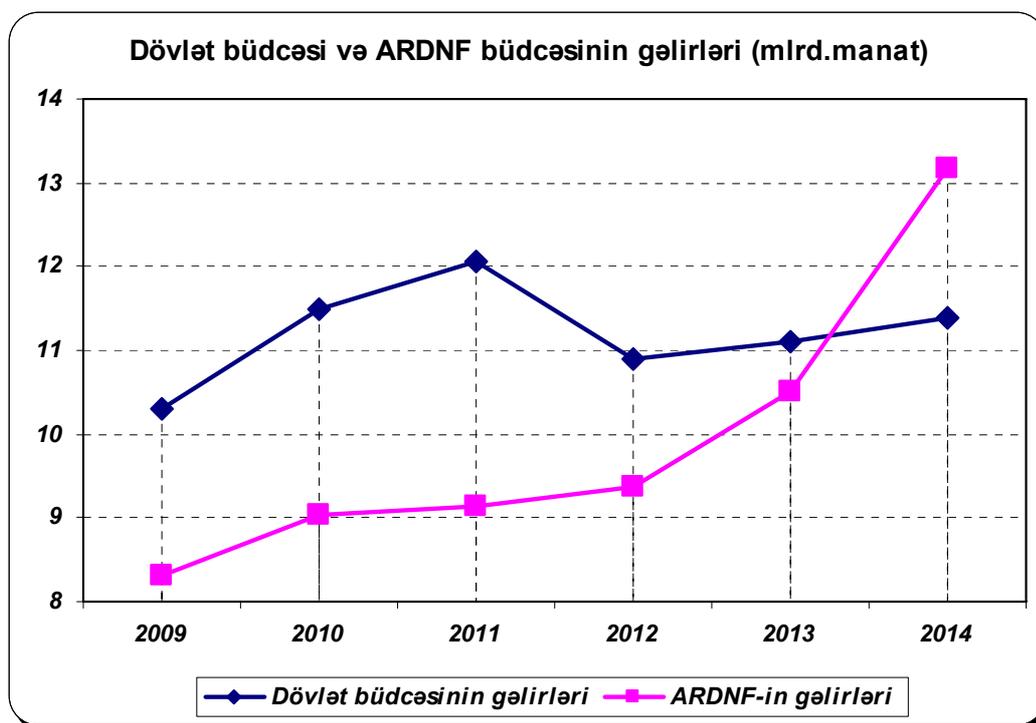
Oil, Non – oil

Source of statistics: *The state budget package for 2011 (2<sup>nd</sup> Volume), Baku 2010*

This *permanent income hypothesis* estimated by the World Bank for Azerbaijan is first of all competitive for short term changes of oil revenues according to survey of the bank: forecast of oil prices for short term perspectives is very complicated and thus especially for next two years the correspondence of annual expenditure plans with annual forecast of oil prices is also complicated. The best policy is a long term policy which is smoothing the short term price variability. Secondly, this approach is regulating variability of price and offer for long term perspective: in case if any change happens at any year in extraction or oil prices it will not be resulted with significant increase of level of expenditures recommended for today. Stimulation conducted by the World Bank for permanent income approach of Azerbaijan is showing that it is not required full decrease of necessary state expenditures for provision of fiscal sustainability as a reply to the shock occurred in oil prices or extraction. However, if such cases are repeated during certain period of time after the shock it might be given reaction to this fiscal shock with minor correction of state expenditures. So, permanent income approach is providing stability of expenses even if crisis is continuing. Although the medium term expenditure plan is corrected

again with long intervals the permanent income equivalent has to be regularly estimated by the government<sup>3</sup>.

**Chart 2.**



**Incomes of the state budget and SOFAZ (billions of manats)**

**Incomes of the state budget**   **Incomes of SOFAZ**

*Source of statistics: The state budget package for 2011 (2<sup>nd</sup> Volume), Baku 2010*

*Although in fact it is mentioned necessity of focusing on this approach in long term use strategy of oil revenues in Azerbaijan (the principle of non changed real expenditures are taken into account as basis during the forecast of expenses for a long term period based on oil and gas revenues and annual limit is defined for expenses considered during the time covered by this strategy) the government is not using this tool for provision of fiscal sustainability on its budget policy. As a result a competitiveness of the state budget towards external economic changes and shocks is weakening and level of vulnerability is raised.*

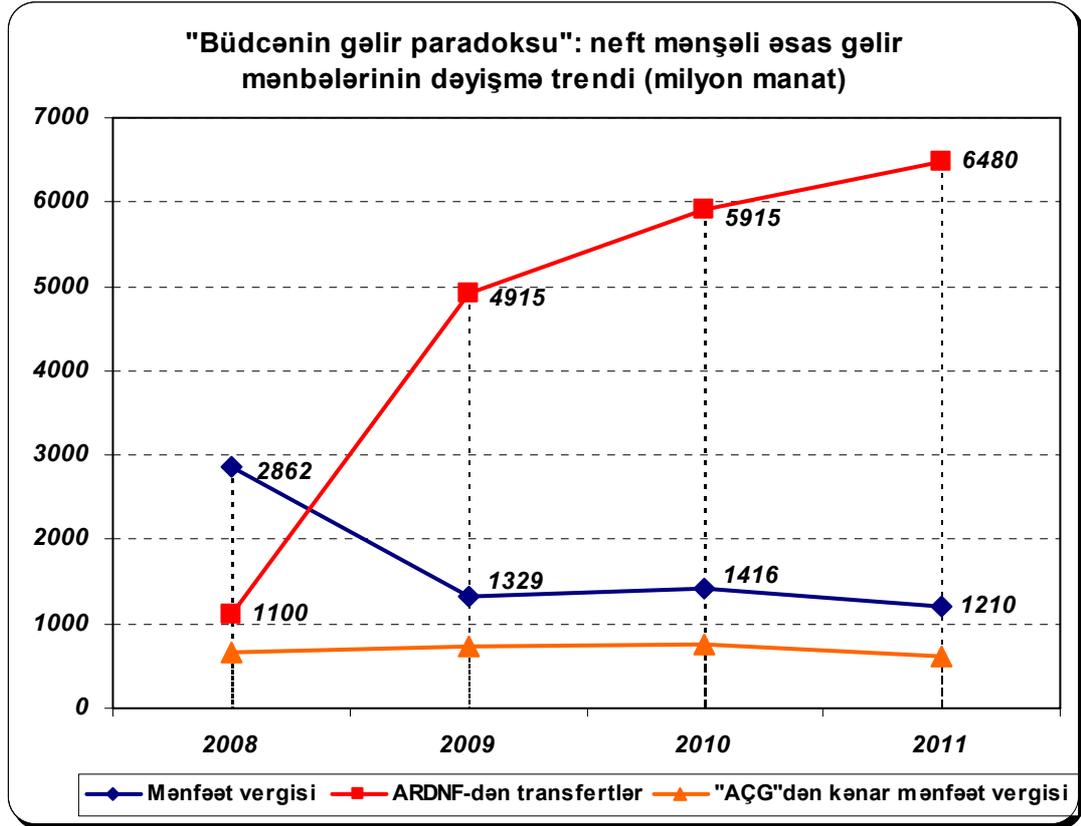
### **Decrease in income is expected on important types of taxes**

The incomes of the state budget for 2011 are higher for 556 million manats or for 4.8 % in comparison to the forecast of 2010. It is predicted the budget receipt from the source of the Ministry of Taxes in amount of 4.42 billion manats and it is lower than the gross tax receipt of approved for 2010 for 50 million manats or for 1.1 %. Close to 40 % of budget receipts forecasted from the Ministry of Taxes belongs to oil sector. Generally, if 52,9 % of budget receipt was supplied by the Ministry of Taxes during 2008, in predictions for 2011 this figure has decreased to 36,6 %. The share of the State Oil Fund in budget incomes is predicted to be increased from 35,3 % in 2008 to 53,7 % in 2011 correspondingly<sup>4</sup>.

<sup>3</sup> “Country Memorandum of the World Bank on Azerbaijan”. Baku. December 2009.

<sup>4</sup> The State Budget Package for 2011 (Volume 1), Baku, 2010

Chart 3.



Static source: 2011 state budget package (volume 1 and 2), Baku 2010

**“The income paradox of the budget”: trend of variations of oil based major income sources (million manats)**

**Income tax \ Transfers from SOFAZ \ Income tax from ACG**

The key reason of decrease of tax receipts from oil sector, in the review of the government, the consideration of less accrual of profit tax to the state budget in 2011 as a result of write-off of accounts receivable in the amount of AZN 1.65 billion owed by “Azerbaijan Hava Yollari” Close Corporation and “Azerenerji” OJSC to SOCAR. Beside mutual debts of large tax payers, the funds they receive directly from the state budget caused tension in state financial system. With the purpose of mitigating the situation The Cabinet of Ministers adopted a resolution that fundamental investments by state budget and other off-budget funds to state enterprises must be indicated as the increase of the authorized capital. The resolution also included FY 2007-2009.

The receipt on profit tax form legal entities in 2011 draft budget is forecasted AZN 1,2 billion (10%) of the state budget, which is AZN 206 million or **14,5%** less as compared to 2010 forecast. The government explains main reasons of decrease with the AIOC intention to increase the investments on “ACG” agreement next year, as well as the profit tax decrease from 22% to 20% and the decrease of profit tax of SOCAR. However, nondisclosure of precise figures to show the amount decreased in forecast of profit tax income as a result of change in profit tax rate and the fact that 50% of overall profit tax is received only from one oil agreement (“ACG” PSA) serve as the basis to indicate that the decrease in this type of tax is more connected with activities and events in oil sector. Thus, next year non-oil private sector is not going to bring much benefits to the profit tax receipts either. In average, half of the profit tax in previous 2 years and the current one was paid by the contractor under “ACG” agreement.

It is forecasted that the excise tax which makes 4,1% of 2011 state budget receipts will make AZN 495 million which is AZN 57 million or **10.3%** less in comparison with 2010 forecasts. The government explains the decrease in excise tax receipts (11.5%) with the decrease in range and volume of oil products proceeded by the SOCAR. Respectively, the main reason of decrease in excise tax collected by customs offices by 3.7% is explained with the decrease in import of excise products next year.

Extraction Industry taxes revenues are forecasted AZN 129 million for the next year, which is AZN 1 million or **0.8%** less as compared to 2010 forecast. The decrease in this type of tax is reasoned with the decrease of the volume of raw oil extracted by SOCAR.

Revenues on other taxes collected by the Ministry of Taxes is expected AZN 326 million, about 90% (290 million manat) of which is covered by oil sector. Revenues on other taxes other than oil sector remains unchanged with the approved forecast of 2010. In comparison with 2010 budget, the increase by 1.5% is forecasted in income tax revenues from individuals (AZN 690 million), 15.6% in value added tax collected by tax offices (AZN 1.304 million), 2.5% in value added tax collected by customs offices (AZN 818 million), 1% in property tax (AZN 102 million), 5.6% in simplified tax (AZN 95 million), 16.4% in state due (AZN 85 million, 0.7% in customs duties (AZN 215 million) in 2011 state budget. Turnover taxes are significant part of taxes with respect to growth and their increase may be realized through the inflation.

At the same time, it should be considered that high inflation can decrease the state income, as well. Thus, high rate of consumer price index between the period of taxes accrued and forecasted and period of their actual payment reduces the value of payments ("*Tanzi-Oliveri effect*"). In this respect, during the recent years of relative decrease of inflation rate the government gained special opportunities to increase non-oil tax revenues. However, these opportunities may gradually disappear from 2011.

In general, as observed from types of tax with forecasted decrease in receipts, the impact of oil sector to the budget is not limited with the transfers if SOFAR. There is a serious dependence of types especially with forecasted decrease on oil and fuel sector. *Every change in oil sector seriously decreases budget revenues in several types of tax simultaneously, which ultimately hinders the establishment of fiscal stability.*

**Table 2. Some sources of 2011 state budget revenues with more serious changes expected in comparison with previous years**

Budget revenue name and code	Income forecast for 2011 (AZN)	Compared to expected implementation in 2010 (%)	Compared to actual implementation in 2009 (%)
<i>Profit tax (111200)</i>	<b>1.21 bln</b>	<b>- 14.5</b>	<b>- 9</b>
<i>Road tax (114710)</i>	<b>28 mln</b>	<b>- 17.6</b>	<b>+ 70.1</b>
<i>Excise tax for products produced in the country (114510)</i>	<b>416 mln</b>	<b>- 11.5</b>	<b>- 0.3</b>
<i>Dividends (141200)</i>	<b>1.38 mln</b>	<b>+ 7.8</b>	<b>- 96.5</b>
<i>Interests on deposits from state-owned financial institutions (141111)</i>	<b>16.6 mln</b>	<b>+ 833</b>	<b>0</b>
<i>Revenues from goods and services (142000)</i>	<b>88.5 mln</b>	<b>+16.9</b>	<b>- 55.2</b>

*Static source: 2011 state budget package (volume 1), Baku 2010*

Based on official statement of the government, measures to increase collection ratio of tax and nontax revenues, improve tax administration and decrease of tax debts will cover the major role in 2011 tax policy.

#### **Relation between state budget and off-budget and on-budget funds is indefinite**

While speaking about the relation between state budget and off-budget funds, it is to note that dependence of State Social Protection Fund (SSPF) on state budget is continuously increasing as the dependence of state budget on SOCAR. Transfers from state budget to SSPF is considered in the amount of AZN 691 million, which is **29%** more<sup>5</sup> than 2010 forecast indicator. Specific weight of these revenues will make 35.1% in 2011, which is 4.7% more than respective indicator of the current year.

In 2011 95% or AZN 6.480 billion of SOFAR budget will, as indicated above, directly be transferred to state budget. Transfers from Oil Fund to state budget should be limited according to the transfer share of the fund in its own expenses, as well as its assets. Revenues of SOFAR is budgeted AZN 9.133 billion and expenses AZN 6.829 billion next year. Besides, following the large sum of money allocated from SOFAR budget to infrastructure projects in previous years, it is considered to allocate great financial flows to the projects in 2011 budget, as well, which occurs in the condition of public unawareness on the feasibility study documents of these projects and effectiveness of utility of allocated funds. Furthermore, despite the complete preparation of SOFAR budget, discussion of the bill on state budget and other relative documents were conducted later while they were put on discussion in the parliament earlier. NBG assesses it as a policy contradicting to the budget legislation.

Legal adjustment of relations between state budget and domestic funds needs more improvement. "Road" Purpose Budget Fund which is forecasted in the amount of AZN 170 million in 2011 is formed thanks to road tax, simplified tax paid by motor vehicle owners or users carrying passengers and goods, excise tax applied to import motor vehicles, custom duty applied to import vehicles, state duty for international motor vehicle transits through the territory of the country and state due for the annual maintenance checkup of vehicles.

"Security fund of loan got with State Guarantee" which is defined in the amount of 100 million in 2011 is formed on the following sources:

- *Revenues on loan got with State Guarantee from loan organizations (2.8%);*
- *Revenues to Security Fund on repaired facilities (3.9%);*
- *Fund allocated from centralized revenue of state budget (93.3%);*

As shown in the figures above, 93% of Security Fund for the loan got with State Guarantee is formed directly from state budget, which is again formed on the same income sources and means the next "black box" with hidden application by the expressions like "other expenses" and "other different expenses" in the related expense item. *NBG invokes the government to express the application of purpose funds precisely in the budget documents while establishing them and take measures in order not to have them become additional encumbrance within budget. Furthermore, it is necessary to develop additional adjusting law project and guidelines on "Purpose budget funds".*

### **Share of non-assigned and non-classified expenses is growing**

State budget expenses of Azerbaijan republic is approved in the amount of AZN 12 748 billion in 2011. Trend analysis of investment budget of 2011 shows that, investment expenses will start to decrease from the next year, while the expenses on "Industry, construction and mineral resources" item will become expense priority within the budget. In fact, AZN 3396.5 million capital expenses forecasted in 2011 budget project is considered in "Industry, Construction and mineral resources" item of functional classification of budget expense while AZN 1982.8 is in the other items. Considering investment purpose of these expenses, they should also be concerned within "state capital investment" item. Estimations shows that, unit weight of expenses only on "Industry, construction and mineral resources" item is 8.4% in GDP, while its share is 26.5%. However, these indicators were forecasted respectively 10.3% and 33.8% in 2009 and 11% and 33.9% in 2010. It characterizes decrease of investment budget not only by relative meaning but also by absolute expression. Though this decrease increases investment opportunities from budget to other directions, consideration of the fund in the amount of AZN 1909.7 million on "Services other than major items" item limits important investment opportunities on other fields. Unit weight of this item (without application and classification) within total budget expense is 15% while its share is 4.8% in GDP. The fund allocated for this item is 7.8% more than in 2011.

Trend analysis of investment budget in 2011 shows that investment fund in the amount of AZN 1909,2 from state capital investment was forecasted for the projects on infrastructure while AZN 683,9 million for social projects, AZN 1.3 million for institutional projects, AZN 297.4 million for the improvement of material-technical base of defence and law and enforcement agencies, 1049 million for the other projects and AZN 384,7 million was considered as reserve (undistributable). Undistributable reserve in the amount of AZN 384,7 ( 11.4% of investment expenses) has increased in comparison with that in last year. In fact in 2011 Reserve fund has increased in the amount of AZN 184.7 million comparing to that in 2010. Incomplete fund distribution might be assessed in some projects as not implementation of feasibility studies, design-expense estimates and contract price calculations on timely

basis, which means infringement of requirements of “Rules on development, execution, monitoring and assessment of state investment program in the Republic of Azerbaijan” and establishment of great opportunity for corruption.

Analysis of investment budget of 2011 upon fields shows that, 56,5% of state investment expense has been forecasted for financing infrastructure projects, AZN 1102 million out of which is considered for transportation sector, AZN 266,6 million for public infrastructure, AZN 283,3 million for water resources and irrigation sector, AZN 15,2 million for agriculture, AZN 169,3 million for power engineering and industry, AZN 72.2 million for ecological sector. Calculations show that, AZN 3959,6 million out of investment expense item of state budget was allocated on transportation sector in the last 3 years.

Due to elimination of natural disasters and its aftereffects a result of floods in the Kura and other rivers, the fund in the amount of AZN 50 million has been considered on reinforcement of material-technical provision of infrastructure objects of amelioration field including capital and current repair works, procurement of machinery as well.

Expenses within several items have been revised in order to improve structure, development and implementation process, ensure transparency, efficiency and addressability in 2011. Expenses were preferred to be forecasted not got field structure but for functional direction. In fact, expense structure of law and enforcement agencies was amended and education, health, culture and sport expenses serving them were included into related expense items. Consequently the fund in the amount of AZN 30,509,000 was withdrawn from expenses for law and enforcement agencies and distributed respectively among health, culture and sport expenses.

In 2011 total state service expense will be implemented by 14 ministries, 10 committees, 7 agencies, 8 departments, 4 commissions, 3 offices, 3 councils and 7 other agencies and totally 56 budget organizations.

Expense program classification within the budget of 2011 is mainly carried out in several directions of education and health sectors. In fact, the fund in the amount of AZN 47 518 thousand or 3.6% of education expense was considered for 14 state programs and events in education sector, which is 0.5% more in comparison with related indicator in 2010. Unit weight of programs within expenses on health sector is 0.5% less than in 2010, which is 14.2%. That is, the fund in the amount of AZN 77 million 462.6 was allocated from the budget of 2011 for implementation of state health programs, which is 6.6% more than that in 2010.

The most fund within program classification of education was allocated on financial provision of State Program on “Informatization of education system in the Republic of Azerbaijan in 2008-2012 years” which covers 34.5% of expenses considered. The most allocations is directed on implementation of “State Program on haemophilia and thalassemia heritable blood diseases”, which comprises 25.3% of the fund allocated under program classification in education sector. Expenses due to financial provision of “Program of measures against tuberculosis” was first considered in the project of 2011.

**Table 3. Expense distribution of 2011 state budget**

<i>Expense</i>	<i>Share in total budget expense (%)</i>	<i>Specific weight in GDP (%)</i>
<i>Industry, construction and mineral products</i>	26,5	8,4
<i>Expenses other than main for main items</i>	15,0	4,8
<i>Education</i>	10,5	3,5
<i>Defence</i>	10,4	3,3
<i>Social Protection and security</i>	10,2	3,2
<i>General state service</i>	8,7	2,8
<i>Court authority, law and enforcement and prosecutor's office</i>	5,6	1,8
<i>Health</i>	4,3	1,4
<i>Agriculture, forestry, fishery, hunting and environmental protection</i>	3,5	1,1
<i>Housing office</i>	1,8	0,6
<i>Culture, art, mass media and physical training</i>	1,6	0,5
<i>Transportation and communication</i>	0,5	0,2

<i>Economic activity</i>	0,9	0,3
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*Static source: 2011 state budget package (volume 1), Baku 2010*

Structural analysis of state budget 2011 shows that economic, functional and administrative classification of expenses forecasted in “General state services” section and social fields is traditionally carried on and Structure of expenses distributed in defence expenses and state investment expenses section is shown in general directions. State investment expenditures have been grouped under infrastructure projects, social projects, defense and law and enforcement agencies, other projects and reserve sub-directions. Distribution of budget investments under projects is mentioned neither in budget package nor in attachments and reviews. One of the factors which draw much attention in Expenses section of Next Year budget is the increase of expenses not related to main divisions by 78% as compared to amended budget in 2010. Therefore, specific weight of expenses in these divisions increased in 15% in 2011 and became the second major expense item. Unfortunately, neither economic nor functional classification of expenses is provided under that division, which means share of not-classified expenses is increasing while access to detailed budget data is getting restricted.

**Relation between the impelmentation of some state programs and state budget is rather weak.**

State budget is one of financing sources of some state important programs being implemented in the Republic of Azerbaijan. Budget allocations on the implementation of these programs is carried out directly or indirectly. The fund allocation in the amount of AZN 111570 thousand (AZN 70 thousand more than in previous year) is forecasted for the implementation “State program on reliable provision of population of Azerbaijan Republic with food products”. Meanwhile, it is decided to optimize the distribution of investment among regions for the implementation of “State program on socio-economic development of regions of Azerbaijan Republic in 2009-2013”. This is mentioned as one of the “main directions of state investment policy for 2011-2014”.

Essential allocations from budget project is planned in 2011 in order to reconstruct main highway and streets, construct new roads, continue the constructions of different road junctions and pedestrian crossings considered in “Additional Measures Plan for the improvement of transportation system in Baku during 2008-2013”. Though “The rules on development, implementation, monitoring and assessments of state investment programs of the Republic of Azerbaijan” requires the inclusion of projects, feasibility studies and feasibility calculation of which were carried out, to state investment programs, assessment of efficiency of these projects and their examination, these requirements are infiringed in most cases ewspacially during implementation of above mentioned Plan. Therefore, it has become necessary to prepare normative document on assessment and examination of projects included into investment programs.

As result of implementation of “State program on improvement of insurance and pension system in 2009-2015”, measures related to social protection of disabled, job-seekers and unemployed and expenses for the provision of these organizations were withdrawn from the budget of State Social Protection Fund (SSPF) and given to state budget. Nevertheless, approximately 60% of total SSPF will be covered by direct transfer from state budget and social allocations from budget organization. Weak participation of private sector in social insurance system which produces more than 80% of GDP is considered as an economic paradox within availability of political statement related to the provision of new works places for 1 million people by state policy ensuring employment.

52.2% of “social protection and social welfare expenses” of state budget in 2011 is consisted of transfers to Social Protection Fund. This indicator is AZN 157 295 200 or 30% more than that in 2010. Thus, dependence SSPF gradually on state budget on one hand is contradicting to the conception of State program on development of insurance and pension system while on the other hand shows generally hard condition of private sector. NBG emphasizes this negativ tendency to continue increasingly in the next years.

Based on the decree no 220, dated February 10 2010 of the President of Azerbaijan Republic, as a result of commencement of applying new financing method in high education enterprises, budget based financing in high education enterprises functioning on state order is decreasing. In fact funds allocated for high education will be 9.1% less in 2011 as comparing to that in 2010. This will mainly happen upon the reduction of direct expenses allocated for state high education institutions.

Though there is opposite relations between new financing method in high education enterprises and education section of 2011 budget project, sometimes is contradictious in the relation towards different high schools. It is also considered to decrease the funds allocated for some high education institutions (ASOA, ASEU, BSU etc) in 3-5% in budget project. Calculations on the amount of education expenses per each student of bachelor's and master's degrees of high education institutions by state order allocated in the decision dated June 24, 2010 of Ministry of Cabinets of the Republic of Azerbaijan on "Application of new financing method in high educational institutions" shows that, there some inconformities between funds to be allocated for high education institutions and new financing method. In fact, funds to be allocated for Azerbaijan State Medical University will be increased in 0.12% and defined in the amount of AZN 12.8 million. However, considering that SCSA forecasts student admission to high education institutions by state order for 2010/2011 education year, students admitted in the current year comprises 15-17% of total students, is apprimately will be about 5.5-6.3 million AZN. Simultaneously, based on new financing method approximately AZN 2 million is required for Baku branch of Moscow State University named after M.V.Lomonosov, the fund allocated for this university will increase in 23.9% and reach AZN 4.3 million. Though Azerbaijan Diplomatic Academy which offers payment-based education is not available in SCSA student admission forecast by state order to high education institutions, the fund allocated for this university is increased in 41.77% and is AZN 4.4 million in the project. *This shows the availability of problems in efficient co-ordination of reforms commenced in financing field of high education with the budget and optimization of expenses in this purpose.* As result of application of new financing method in high education institutions based on Azerbaijan President's Decree no 220 dated February 10, 2010, financing in high education institutions functioning under state order is considered to open not by cost items of economic classification but by unit cost item. Pursuant to the new financing method, it has become necessary to determine distribution mechanism of funds, considering that the fund is forecasted in one clause.

### **Regions are able to cover only 2.7% of state budget**

The structural analysis of centralized and local budget revenues and expenditures with respect to the implementation of development of regions and other state programs show that there still exists disbalance of economic development and growth among the regions. As a visual evidence, it should be noted that tax withholding from Baku will occupy 97% of centralized revenues of state budget in 2011. It will be equalled to AZN 4 billion and cover 33% of state budget revenues. Only 3% of tax revenues from Baku which is about AZN 121 million is considered for city budget expenditure. Local income of all other cities and regions makes approximately AZN 326 million, in other words, 2.7% of state budget 2011 revenues<sup>5</sup>.

In order to control local revenues and expenditures over AZN 858.4 million or USD 1 billion will be allocated from state budget 2011. If, in response to billions of money allocated from state budget through state program on the development of regions and other lines, the regions of Azerbaijan can cover only AZN 2-3 of each AZN 100 of state budget, there emerges a necessity to reevaluate the effectiveness and address of amounts spent in the regions, and should be a serious alarm for the government. In particular, according to the official statistics, only in the first year of "State Program on social and economic development of Azerbaijan regions in 2009-2013" approved by the decree of President, dated 14 April 2009, 74 thousand job vacancies were opened in the country. 70% of these jobs reportedly opened in the regions. It would be logical if such a positive economic background reflected in the participation of regions in state budget.

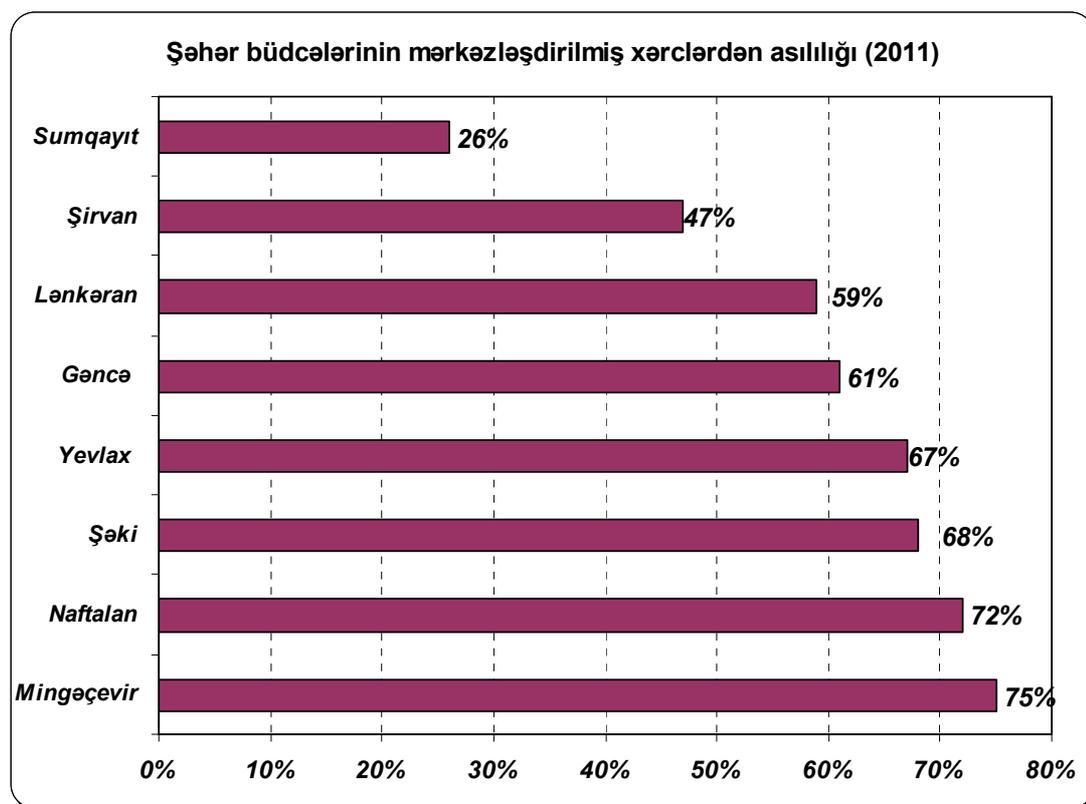
When calculating the local income of cities and regions, after the deduction of 97% of centralized income, there is a need to gradually increase the remaining 3% share of Baku. However, article 11 of state budget 2011 considers only 2% of this norm. Gradual change to increase the limit can be an extra motivation for the government to increase the share of regions in state budget. It is very important to reduce the dependence of local budgets of regions with potential in industrial, agrarian and service fields on centralized expenditures.

On the contrary, there is a need to seriously increase fiscal discipline over regions with less or without land (refer to territories under occupation). Some decrease in local income of several regions is expected in 2011, as compared to that of 2010.

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<sup>5</sup>Bill on "2011 state budget" of Republic of Azerbaijan (01.10.2010)

Chart 4.



*Static source: state budget 2011 package (volume 1), Baku 2010*

#### Dependence of city budgets from centralized expenditures (2011)

#### Sources to make up state budget deficit are traditional

The ratio of state budget deficit to GDP made 0.5% in 2009, and was forecasted 2.4% for 2010 and 1.7% (AZN 687 million) for 2011. The upper limit of state budget deficit considered for 2011 is **10.8%** less than the deficit for 2010 (AZN 770.3 million), but **3.9** times more than actual deficit amount in 2009<sup>6</sup>. The receipts from privatization of state property which is one of the most important points to make up the state budget deficit make about AZN 35 million in state budget of next year, which is 36.4% less than respective forecast of 2010, and 40.3% less than actual implementation in 2009. Consolidated budget deficit in 2011 is set in the amount of AZN 8.7 billion, not considering the revenues of State Oil Fund.

The delay of amounts to enter state budget under privatized objects and areas, increase of balance in receipts from this field must be rewarded as a factor to increase corruption risk and hinder the effective activity of private ownership. Furthermore, there still remain serious problems in the implementation of receipts from paid service of state-funded organizations, which is mentioned as the source of budget deficit financing in budget documents. The receipts from paid services is considered AZN 152 million for 2011, whereas it was forecasted AZN 145 million in 2010, and AZN 96 million to AZN 137 million was executed in 2009.

Although the single treasury account balance of state budget as of 1 January 2011 was noted as the budget deficit financing source, it is not possible to predict the specific weight of this source. The disbalance between the upper level of internal and external indebtedness and actual level of indebtedness, 12.3% decrease of income from placement of securities abroad as compared to that of 2010 are the points to be focused on. The receipts from placement of securities abroad is estimated AZN 500 million in state budget 2011 which is 5.1 times more than approved amounts of receipts from sale of state bonds (AZN 98 million), analogic source of state budget financing in 2009, and AZN 70 million less than that of 2010. Failure to submit any information on distribution of amount on the source of state budget deficit financing

<sup>6</sup> 2011 state budget package (volume 1 and 3), Baku 2010

according to foreign and local indebtedness instate budget 2011 documents was underlined in the review of Chamber of Accounts.

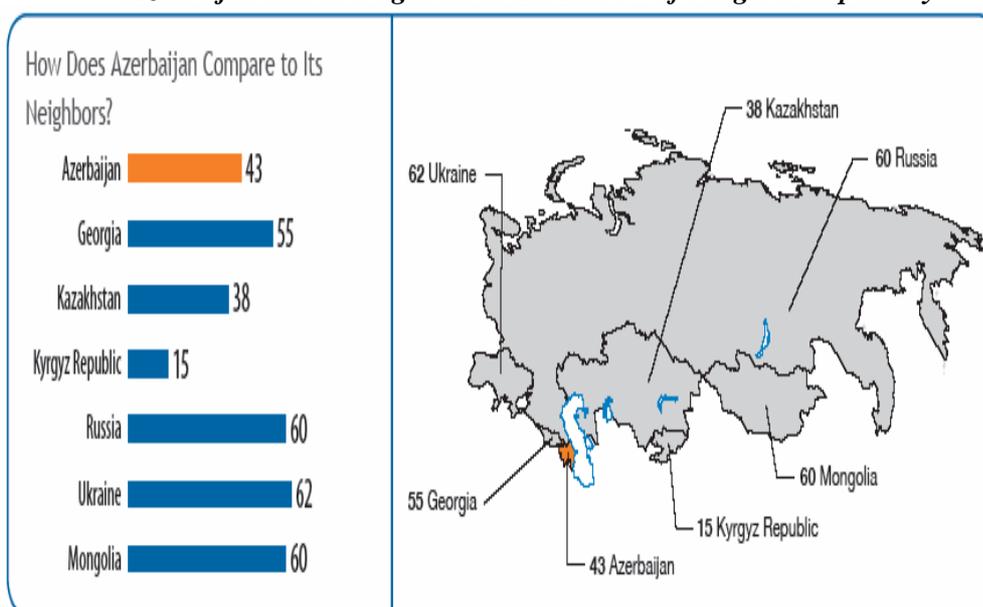
The government must agree indebtedness policy with its fiscal policy. There is some problem in forecasting of budget deficit, well as all fiscal parameters of state budget, which is connected with gaps in implementation of the budget and general forecasting base in economic bloc of the government. Besides, *the government almost has no policy in managing the budget deficit in medium-term period, and balancing it according to annual or economic cycles.*

### **“Open budget index 2010” showed the budget transparency in our country problematic**

Open Budget Index (OBI) is the index which, via a special survey, gives an opportunity to measure overall transparency of budget processes of the countries and compare it with others. The index is prepared by the US organization of International Budget Partnership. The index assesses the transparency on 8 budget documents of high importance. Azerbaijan has scored 43 points out of 100 and ranked the 52<sup>nd</sup> among 94 countries in OBI 2010 (OBI 2008 - the 50<sup>th</sup> among 85 countries, OBI-2006 – 45<sup>th</sup> among 59 countries).

It is 1 point more than the average level (42 points) in OBI 2010, and 17 points more than average level (26 points) of 24 countries with dependence on oil and gas revenues. One of the main reasons is the fact that the reviews on bills on state budget and SSPF budget were intensively placed on the official website of Chamber of Accounts. The explanation of state budget was gone into further details in budget package, and distribution of oil and non-oil sector was carried out in tax revenues. Ministry of Finance released mid-term reports on implementation of state budget several times in 2008 and 2009.

#### *Azerbaijan and its neighbors in the mirrow of budget transparency*



Key recommendations to Azerbaijan as a result of OBI-2010 are as follows: “Citizens budget” and “Pre-budget statement” should be prepared and released; content and comprehensiveness of bills on state budget, mid-term budget reports and reports on executed budget should be further enriched; open budget hearings should be conducted in the Parliament in large composition with the participation of community representatives, Parliament should possess controlling authority not only to discuss and approve the draft budget, but also over its implementation; reviews and audit reports of the Chamber of Accounts should include all off-budget funds. *Currently, the review of the Chamber of Accounts on SOFAR budget is not released and no information is delivered to the public about any audit there.* Besides, supreme audit institutes in many countries establish a “hot line” and receive appeals on any violation of financial discipline. It gives more opportunities to conduct parallel financial reviews and audits and partially ensures the participation of citizens.

## **Accounts Chamber review cannot be considered sufficient for draft budget assessment.**

In this document NBG also comments on the reviews of the Chamber of Accounts (CA), the authority to play an exceptional role in supervision of budget analysis and budget in the country. So, the major part of CA review on 2011 draft state budget and budget of SSPF includes the presentation of figures, whereas as a supreme financial controller and union of experts in the field CA should focus not on “stale” figures, *but investigation of compliance of budget policy with budget legislation, proposals on improvement of budget documents from the viewpoint of its content, proposals on improvement of classification of budget revenues and expenditure as well as, professional examination to base and clarify possible changes in budget trends.* However, in its reviews CA faces difficulty to present its own approach, analysis and proposals by quoting only budget package on figures and grounds, especially the explanation part of draft budget of 2011 in budget package. Consequently, it becomes impossible to get real control over budget implementation.

## **Procedural requirements are violated during budget discussion**

As for the parliament discussion of state draft budget 2011, its duration was the shortest among last 5 discussions. Thus, the main financial document of the country was discussed only 2 days by the MPs, whereas it had been considered to review and discuss it 3 days without a break. Furthermore, the second submission of draft budget 2011 was approved by the parliament without any discussion. *It makes no doubt for the need in the law on State Budget System of the republic of Azerbaijan, as well as to improve the regulation of budget processes in the parliament.* It is because in the legislation of many countries that I conducted the expertise thereof, the period to discuss state draft budget is longer and readings on its discussion have been regulated.

## **Results and proposals**

- Based on the bill on state budget 2011, provision of growth temp of state budget revenues for the next year thanks to SOFAR transfers increases the risk of fiscal stability. Therefore, NBG considers it expedient to approve fiscal policy guideline to have serious grounds for “fund-budget” relations, and restrict SOFAR transfers by 30% of its total assets. NBG suggests that while forecasting expenses based on oil and gas revenues principle of unchanged real expenses be prevailed and annual be set for considered expenses during the period of this strategy.
- The loss of significant position of receipts from legal entities in the formation of tax revenues of state budget in the draft budget 2011, especially The loss of important position of earnings on income tax from legal entities in formation of tax incomes of the state budget in draft budget of 2011, especially regulation of creditor and debtor debts on big tax payers is considered as a result of existing problems in the field of its payment.
- Therefore, NBG recommends increasing the ratio of tax collections in the provision of budget revenues, improving tax administration and investigating the sources of occurrence of tax debts.
- The researches show that dependence of SSPF on state budget becomes a trend as the dependence of state budget on SOFAR. NBG shares this concern and suggests that beside the application of limits to transfers from SOFAR to state budget, reform-featured measures (establishment of limit non-governmental pension fund etc.) be accelerated in connection with the application of insurance and pension system.
- NBG urges on the government to express the purpose of establishment of purpose funds accurately in the state budget documents, and take appropriate measures to escape possible additional encumbrance. Moreover, it considers that there is a necessity to develop an additional regulatory bill and guidances on “Purpose budget funds”.
- The research is proving that along with dependence of state budget from SOFAZ the dependence of the State Social Protection Fund from the state budget is

developing as a trend. The NBG is sharing this concern and proposing that along with application of limitation for transfer from SOFAZ to the state budget the actions directed to reforms considered on the implementation of the state program regarding application of social insurance – pension system (establishment of non – governmental pension foundation etc.) have to be accelerated.

- The NBG is calling the government to define precisely their role on budget documents in establishing specified foundations within the state budget and take actions on prevention of their transformation to additional load within the budget. Also it considers that there is a need for preparation of additional regulating draft laws and guidelines on “Specified Budget Foundations”.
- The surveys are showing that the share of uncovered expenditures through classifications on the draft budget of 2011 is increasing in comparison with previous years and access to the detailed budget information is becoming limited. Thus, the NBG is considering as complementary the initiatives in a way of disbursement of expenditures in the fields of healthcare and education through specified budget programs and simultaneously considering relevant much detailed presentation of existing program classification and application of it on other expenditure items.
- The NBG is expressing its concern regarding the increase of non assigned “expenditures not related to main parts” for 78 % in comparison with the transparent budget of 2010 and that the practice of increase of special weight of expenditures on this part of the budget on state budget for 15 % of the next year’s budget and transformation of it to the second huge budget item can lead to corruption of budget resources through hiding them and offer to define the directions of expenditures with corresponding decision of the Cabinet of Ministers.
- The NBG is emphasizing the weak mutual relations between implemented state programs in Azerbaijan Republic and state budget and advising to suitably connect their implementation with the state budget and research possible impacts of them to budget policy.
- The analyses of the structure of incomes and expenditures of centralized and local budget from the point of development of regions and implementation of state programs are showing that the disbalance between economic development of regions is still continued. The estimations have shown that the regions are providing only 2,7 % of state income. Thus, NBG is advising the expansion of decentralization policy in the field of fiscal and administrative management.
- The surveys are showing that there is problem in prediction of budget deficit as in all fiscal parameters of the state budget. It is related mainly with the shortcomings existing in execution of the budget as well as with the weak base of general forecasting in economic block of the government. At the same time the government does not have policy on how to manage the budget deficit for medium terms and how to balance it annually and on economic cycles. The NBG is considering that the government should coordinate loan policy with general fiscal policy.
- The NBG is emphasizing that the need for improvement of budget process from the point of regulation in parliament is increasing and it is inviting the Milli Mejlis to adopt “Budget Code” and cooperate with the experts of NBG in order to fill this legal gap precisely regulate this process.
- The NBG is considering that the conclusions of the Chamber of Account and audit reports should cover all the foundations out of the budget, the Chamber of Account should prepare statements on the budget of the State Oil Fund and has to present it to the public.

- The NBG is considering that there has to be prepared and disseminated annually the “citizens budget” and “pre – budget statement” with the aim to increase public participation in budgeting process. The context and comprehensiveness of the draft laws on the state budget, interim budget reports and reports on executed budget has to be much more enriched.