


# Alternative Report on Implementation of 2016 State Budget



# ALTERNATIVE REPORT ON IMPLEMENTATION OF 2016 STATE BUDGET



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

June 2017

The government report on the implementation of the state budget for 2016 and the review of the Chamber of Accounts in this regard, and other related documents and data have been analyzed and evaluated in this Alternative Report.

# Contents

Summary .....	5
1. Macroeconomic factors contributing to the implementation of the state budget .....	9
2. Main trends in the budget revenues .....	13
3. Main trends in the performance of the state budget expenditures .....	21
4. Budget deficit and its financing sources .....	28
5. Service for the public debt through the budget .....	29
6. Evaluation of legal and procedural issues on implementation of the state budget .....	31
7. Recommendations .....	34



# Summary

For the government of Azerbaijan 2016 was the second consecutive year since the oil boom, when budget implementation was done concerning «cheap oil» and lower oil revenues. First of all, GDP, as the primary macroeconomic indicator, which directly affects the formation of the state budget's income and expenditure, fell by 4%.

In 2016, state budget revenues came to 17.5 billion AZN, while expenditures were originally calculated at 17.75 billion AZN. Compared to the forecast stated in the Law on the State Budget of the Republic of Azerbaijan 2016, budget revenues were fulfilled by 104.1% (or 683.7 million AZN more than quoted in the forecast), and the budget expenditures by 96% (or 743.7 million AZN less than in the forecast)

The decline in oil prices led to high inflation, along with a reduction in GDP. In 2012-2014, the annual inflation rate was quite low, between -1.1-2.4%, while in 2016, there was a double-digit inflation (12.4%). Due to the decline in crude oil prices and deterioration of the country's balance of payments, within the two years following 2014, the amount of foreign currency reserves at the government's disposal fell from \$53 billion to \$37 billion, (or by 30%) compared to 2014.

The declining trend in the amount of Azerbaijan's state budget revenue in USD terms, which began in 2014, continued in 2016: In the reporting year, the state budget revenue was equivalent to \$10.97 billion. Thus, revenue in 2016, in USD, was 35.7% less compared to 2015, and 2.1 times less than in 2014.

The role of the direct incomes from oil and gas sector in the formation of the state budget revenues, both in absolute and in relative terms, continues to decline, however more than half (52.7%) of the budget revenue is still being formed from this sector.

Along with that, although the oil price was higher than expected and despite the low rate of AZN, in the reference year, the number of payments to the state budget from Production Sharing Agreements (PSA) foreign contractors and SOCAR decreased by 338.3 million AZN, compared to the previous year. Particularly, the income tax paid by the foreign contractors on PSA proceeded with a 12.4 million AZN cut (357.6 million AZN compared to the estimated 370 million AZN).

In 2016, the total sum of tax payments from the state-owned taxpayers to the state budget came to 1.9 billion AZN. This amount is 197.7 million AZN (9.4%) less compared to

2014, and 302 million AZN (to 13.7%) less than in 2015. In the reference year, several payments from the largest taxpayer among state-owned companies, SOCAR (during the reported year 65.6% of this type of payments fell on this enterprise), as already noted above, fell by 157 million AZN, compared to 2015.

In comparison with the previous year, payments to the budget from the other large state enterprises, «Azerenerji» OJSC - decreased by 108.2 million AZN (31%), and «Azerbaijan Airlines» CJSC - declined for 3.1 million AZN (9.6%). Payments were made by the enterprises of the Ministry of Transport, Communications, and High Technologies, compared to the previous year, were more by 13.5 million AZN (or 36.1%). Payments from the Caspian Shipping Company 42 million AZN (2.7 times), and payments from «Azersu» OJSC 7.5 million AZN (30.7%), respectively, were more than the previous year's indicators.

In the reporting year, 35% of the budget expenditures were spent on public administration and security. This includes General government services, law-enforcement and prosecution, the defense and the court sections. In 2016, for areas as mentioned earlier, 6.2 billion AZN was allocated, which is in comparison with 2015, 1.6 billion AZN or 35.3% more.

In 2016, the ratio of the state investment expenditures to the general budget expenditures decreased by 15.2%, and the amount decreased to 2707.1 million AZN. In 2015, 5002.1 million AZN or 28.1% of the state budget expenditures were spent on the financing of investment costs. Thus, between 2006-2015 years, the share of investment costs in the state budget has remained in the range of 24-40%.

However, for instance, the amount of expenditures on sports, in comparison with the previous year, increased by 12.4 times and reached 447.3 million AZN. Such a rapid growth in sports expenditures connected with the Formula 1 European Grand Prix race, which was hosted by Azerbaijan in June 2016.

In the 2016 budget law, the amount of expenditures on «Social protection and social provision» section constituting 2.7 billion AZN was approved. However, according to the review of the Chamber of Accounts on the 2016 state budget, 567.7 million AZN from this section was routed to returning the state debts, improvement of the level of capitalization of the state-owned companies. These allocations were implemented with the decrees of the Cabinet of Ministers without any discussion in the National Assembly.

Also, significant sequester orders applied to many of the costs approved by the law. Consequently, the following functional sections and subsections have been implemented with a deficit:

- «Activities not related to other categories» subsection of the «Culture, Art, and Sport» functional section - 62.4%;
- «Other expenses not related to the main sections» subsection of the «Services not included in the main sections» functional section - 56.7%;
- «Other enterprises and events in the field of education» section of the «Education» functional section - 49%;
- «Initial vocational education» subsection of «Education» functional section - 17.3%;
- «Transport and communications» functional section - 31.4%;
- «Health» functional section -15.4%;
- «Agriculture» functional section - 14.5%;
- «Economic activities» functional sector -11.2%;
- «Industry and construction» (Public investment) functional section - 10.5%;

In 2016, the main elements of the government's expenditures policy stated to be comprised of the coordination of the state's programs and measures with the medium-term budget expenditures, improvement of the budget expenditures' structure, and an increase in the transparency of budget expenditures. However, in the process of implementation, there were two major adjustments, which can be distinguished, when analyzing expenditure policy related to the events, which were not considered in the law on the state budget, yet, financed in the execution process:

The compensation of the internal and external debts of the state-owned enterprises and companies came through the budget.

Financial support to the state-owned companies, under the financial improvement, was also through the budget.

In 2016, 2.3 billion AZN from the state budget was spent on debt services, which made 12.8% of the total expenses. Expenditures on the public debt service in the 2016 state budget set to be 17.8 billion AZN and all those expenditures were planned under the functional section of «General government services.» Over the year, 99.7% (1.77 billion AZN) of the approved forecast was fulfilled. Hence, an additionally 498.1 million AZN from the savings generated through the other sections was redirected to the returning of government debts.

Hence, 1.17 billion AZN from the Guarantee Fund for debts secured by the government guarantee, accumulated in previous years (1.48 billion AZN), was paid for the



returning of the state debts. Overall, during 2016, 3.44 billion AZN was allocated for repaying debt through the various budgetary sections and the Guarantee Fund. In 2015, state budget expenditures on state debt services came to 704.5 million AZN. As it can be seen, expenditures on the public debt services in 2016 were 3.2 times more than in previous year.

Finally, the Law on the Budget System suggests that amendments in the level of the approved budget allocations under the sections of functional classification, as well as within the sections, subsections, paragraphs, and details of the economic classification, may be done by relevant executive authority, if necessary (article 18.4). The government, in this case, continues to interpret those «if necessary» cases based on its own view. For example, the paragraph of «The reserve fund of the state budget» of the «Services not related to the main sections» had been performed with an increase of a factor of 6.5, compared with the forecast, while the complementary section of «Communication» of the «Transport and communication» sector increase had been executed with 12 times reduction. Concern related to such cases was also expressed in the Chamber of Accounts' review on the state budget for 2016.

# 1. Macroeconomic factors contributing to the implementation of the state budget

In 2016, the revenues of the state budget were 17.5 billion AZN, and expenses were 17.75 billion AZN. Compared to the forecast indicated in the Law on the State Budget of the Republic of Azerbaijan 2016, budget revenues were fulfilled by 104.1% (or 683.7 million AZN more than mentioned in the forecast), and the budget expenditures by 96% (or 743.7 million AZN less than in the forecast)

Because state budget revenues were more and spendings were less than stated in the forecast, in 2016, the budget deficit level was 6.8 times (or 1.43 billion AZN) less than mentioned in the forecast, as a result, in total, budget deficit reached 245.6 million AZN.

The amount of the budget revenues was 29% of the GDP, budget expenditures were 29.4%, and the budget deficit's amount, in turn, was 0.4% of GDP.

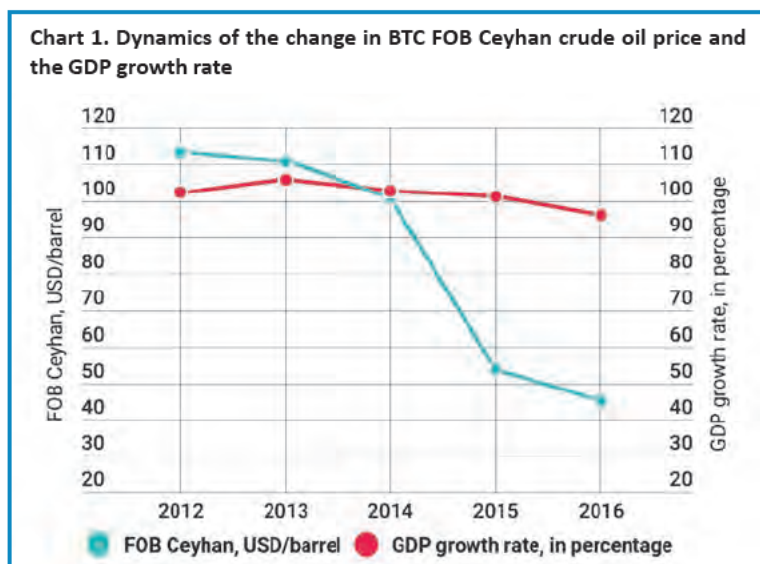
For the government of Azerbaijan, 2016 is the second consecutive year after the oil boom when budget implementation was done regarding «cheap oil» and lower oil revenues. The economy adapted to the high prices (\$100-115) of crude oil on world markets, between 2010-2014 years, has responded to the sharp fall in oil prices with an adequate decrease, concerning macroeconomic parameters, and deficit. Initially, a sharp decline was observed in GDP, the primary macroeconomic indicator, which directly affects the process of budget revenues and expenditures formation.

As can be seen from Chart 1, in Azerbaijan, GDP growth rate and the levels of oil prices on world markets are directly related. In 2012-2013 years, during the high prices of crude oil, GDP growth, compared with the previous year, was about 6%, in 2014, when reduction of prices started, GDP growth rate slowed down abruptly. In 2016 increase, already, has been replaced<sup>1</sup> by almost 4% decrease. The GDP decline is a signal of the

---

<sup>1</sup> Information related to GDP has taken from the State Statistics Committee, in turn, data on the price of BTC FOB Ceyhan crude oil has been collected on the website of the State Oil Company (SOCAR)

drop in consumer spendings and economic activity and, by these, narrowing down of the tax base, which makes budget shrinking inevitable.



One of the main macroeconomic indicators that affect state budget parameters is high inflation. High inflation, on the one hand, by increasing nominal indicators in the economy, and with the help of the turnover taxes expands budget and profit base. However, this reduces the purchasing power of the population and makes profit indexation inevitable. In such conditions, high inflation, by increasing salaries and social payments of the budget, causes government spending to expand to some degree.

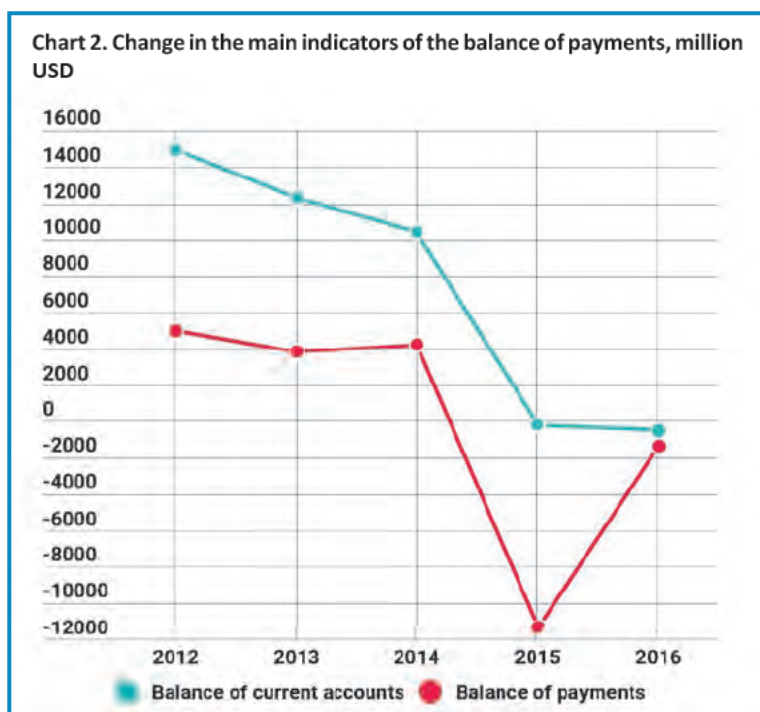
Oil price drop has led to the reduction in GDP, along with the high inflation. The sharp dependence can explain Azerbaijan's highly sensitive stance towards inflation from either the daily consumption goods or the production oriented imported goods.

The decline in crude oil prices led to the degradation of the country's balance of payments. Comparing to 2014, within the next two years, the amount of gold and foreign exchange reserves at the state's disposal fell<sup>2</sup> from \$53 billion to \$37 billion by 2016. A decreased of \$16 billion or 30%. Taking the situation, the devaluation which, in the period of 1 year, led to the national currency's devaluation of more than 75%, was an inevitable measure for the government. High devaluation has brought the economy, which strongly depends on import, face to face with the inflationary pressure.

<sup>2</sup> Data on foreign exchange reserves of has been taken from SOFAZ: [http://www.oilfund.az/az\\_AZ/hesabatlar-ve-statistika/hesabat-arxivi.asp](http://www.oilfund.az/az_AZ/hesabatlar-ve-statistika/hesabat-arxivi.asp), and from the Central Bank's website: [https://www.cbar.az/infoblocks/money\\_reserve\\_ab3a\\_dro](https://www.cbar.az/infoblocks/money_reserve_ab3a_dro)

From 2012-2014, the annual inflation rate was quite low, between -1.1-2.4%, in 2016, there was recorded a double-digit inflation (12.4%).

As already mentioned, the reason for pressure on the national currency and high inflation was the deterioration of the country's balance of payments, as the result of the sharp decline in oil revenues. Due to the inflow of big oil money till 2014, the deficit had been record<sup>3</sup> neither in the total surplus of the balance nor the current account surplus.

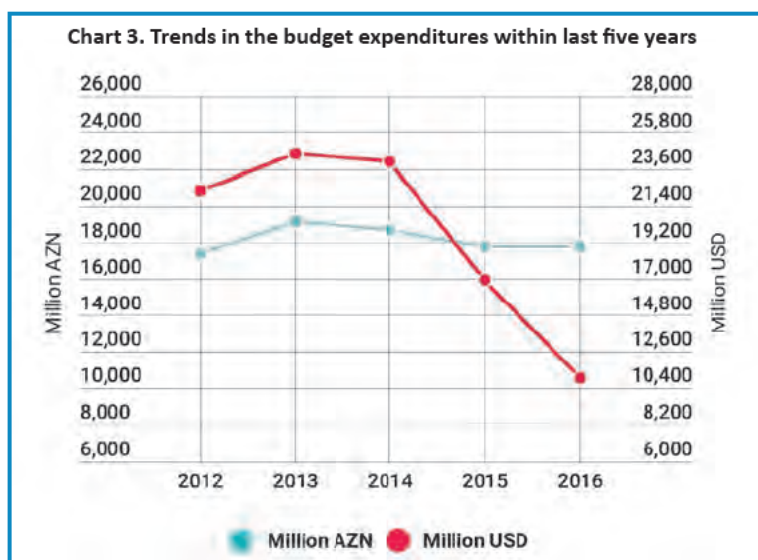


As can be seen from Chart 2, in 2012-2014 years, there was a surplus for the current year's account, as well as for the total balance. In 2015-2016 years, however, both for the current accounts, and for the overall balance a deficit was observed. Although in comparison with 2015, in 2016, the deficit significantly decreased, the current accounts surplus' deficit increased 2.4 times.

The impact of the economic downturn and degradation in the key macroeconomic indicators was also reflected in parameters of the state budget for 2016.

In 2013, the budget reached its record level (19.1 billion AZN) and later began to decline.

<sup>3</sup> <https://www.cbar.az/lpages/statistics/external-sector-statistics>



In the previous three years, budget expenditures decreased in AZN terms by 7.2% and fell to 17.75 billion AZN. Thus, the budget expenditures fell to their lowest level in the last five years specifically to the level of 2011. Depreciation of AZN has led to a reduction in the budget spending in USD terms. From 2013 to 2016, budget expenses were divided by 2.2 and fell from \$24.54 billion to \$10.96 billion.

## 2. Main trends in the budget revenues

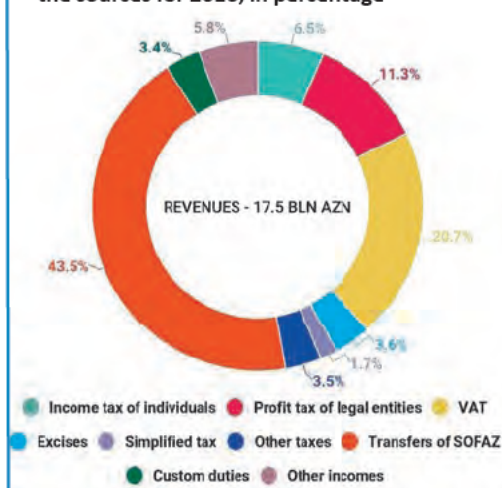
In 2016, the revenues of the state budget were 683.7 million AZN or 4.1% more than indicated in the forecast provided by the Law on the State Budget of the Republic of Azerbaijan 2016.

According to the income sources, the largest share in the formation of revenues, which is 7.62 billion AZN or 43.5% of the total budget revenues, was owned by the transfer from State Oil Fund (SOFAZ). The second place in the total share of the budget revenues belonged to VAT (20.7%) with 3.62 billion, and third place belongs to the profit taxes from legal entities with 1.98 billion AZN (11.3%) (Chart 4).

Also 1.15 billion AZN from the income tax on individuals, 625.1 million AZN from the excise tax, 600.2 million AZN from customs duties, and 303.8 million AZN from the simplified tax received by the state budget. Also, 174.7 million AZN from property tax of legal entities, 153.3 million AZN from road tax, and 114.1 million AZN received from the payment made from the difference in prices for wholesale and export-contract of the goods with regulated prices. During the year, from fines and penalties for violation of tax legislation 311.6 million AZN (1.9%) was transferred to the state budget, along with that, 239 million AZN received from the fee-based services of budget organizations.

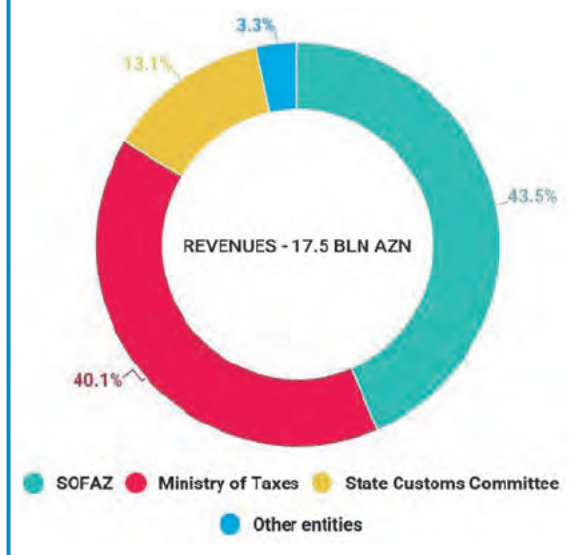
In 2016, dominant position in the formation of the structure-based budget revenues owned by State Oil Fund: 43.5%. Then, 7.02 billion AZN or 41.1% share belonged to the taxes collected by the Ministry of Taxes, and 2.29 billion AZN or 13.1% belonged to the income tax-related to foreign economic activity and duties collected through State Customs Committee. Only 3.3% constituted incomes from fee-based services of budget

**Chart 4. Budget revenues structure based on the sources for 2016, in percentage**





**Chart 5. The structure of institution -based budget revenues for 2016, in percentage**



organizations and the State Committee on Property Issues (Chart 5).

2016 budget revenues structure-based analysis, as well as previous years' comparative analysis, reveal the following trends:

i) The total nominal amount of income of the state budget in 2016 have increased only for 7.7 million AZN or 0.04%, compared to 2015. Given the annual inflation rate in 2016- 12.4%, one can assume that the real rate of the budget revenues has reduced. The downward trend in Azerbaijan's state budget revenues in USD terms, which began in 2014, continued in 2016:

In reference year, the state budget income was equivalent to \$10.97 billion. Thus, revenues in 2016, in USD terms, were 35.7% less than 2015, and 2.1 times less than in 2014.

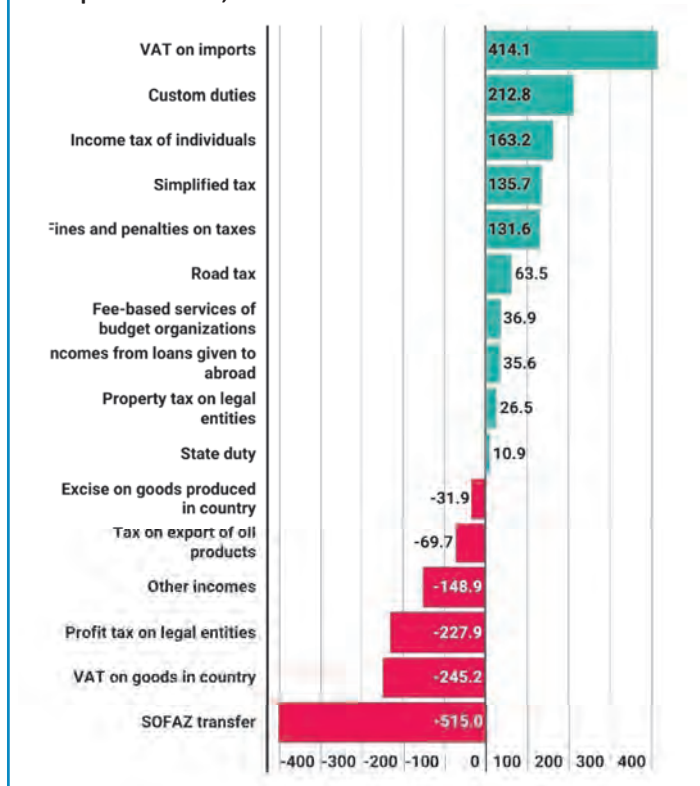
ii) In comparison with the previous year, in 2016, a sharp contrast can be observed within the budget's different income sources, some groups of income sharply increased, other groups seemingly declined. The largest increase based on the revenue streams were found in VAT on imported goods (37.6%), in customs duties (54.9%), and in income tax on individuals (to 16.6%).

At the same time, compared with 2015, in 2016, SOFAZ's transfer to the state budget decreased by 515 million AZN, revenues from VAT for goods and services produced in the country decreased by 245.2 million AZN (Chart 6), and income from tax profit of legal entities also dropped by 227.9 million AZN.

Although the amount of reduction in SOFAZ's transfer, as well as the reduction in income from tax profit of legal entities, had already mentioned in the budget's forecast, cut in the revenues from VAT for goods and services produced in the country was not expected. Also, compared with 2015, high growth in customs duties, VAT on imports, in revenues from fines and penalties for violation of tax legislation were not anticipated in projections.

iii) The role of the direct income from the oil and gas sector in the formation of the

**Chart 6. Discrepancies in the state budget revenues 2016 compared to 2015, million AZN**

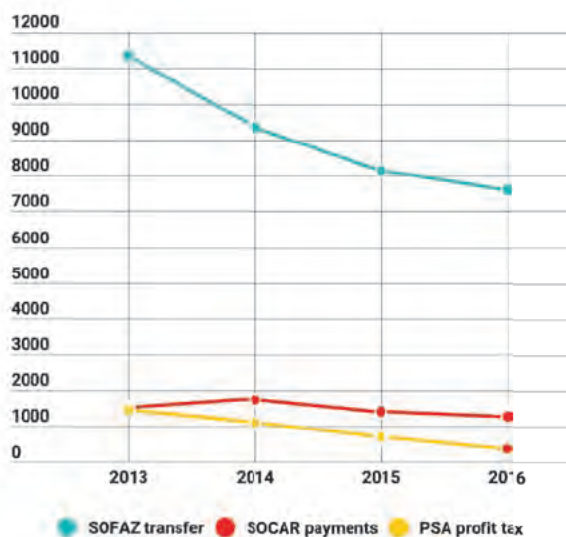


state budget revenues, both in absolute and in relative terms, continues to decline, however more than half of the budget revenues are still being formed from this sector. In the reporting year, direct incomes from the oil and gas sector to the state budget amounted to 9.23 billion AZN. This means that the share of the sector in the total state budget revenues amounted to 52.7%. The share of direct incomes from oil and gas sector in the formation of the state budget revenues was 73.2% in 2013, 66.1% in 2014, and 58.5% in 2015. This reduction, on the one hand, is happening due to a drop in the amount of income from each of these sources, and, on the other hand, because of increase in the revenues from non-oil sector.

As shown in Chart 7, the state continues its policy of reducing the number of transfers from the State Oil Fund (SOFAZ) to the state budget. The annual average price (45.1 dol./barrel) of Azerbaijani oil is higher than the price (25 USD/barrel) projected in the budget forecast, as a result, the annual income of SOFAZ was two times higher than forecasted.



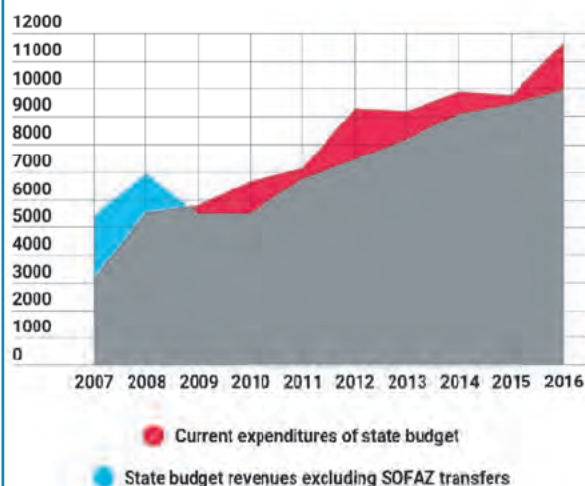
**Chart 7. Dynamics of the direct incomes from the oil and gas sector to the state budget, million AZN**



Despite the forecast of 4.6 billion AZN, revenue from the Fund amounted to 9.4 billion AZN. But, in spite of that fact, the Fund's income made more than it was projected to, for the first time in recent years, the number of transfers to the state budget had not been increased during the year.

Along with that, although the oil price was higher than expected and despite the low rate of AZN, in the reference year, the quantity of payments to the state budget from PSAs (Agreement on the joint development and production sharing of the extraction from oil fields in Azerbaijan), foreign subcontractors, and SOCAR decreased. This decline accounted for 338.3 million and 157 million AZN, respectively. In particular, the income tax paid by the foreign contractors on PSAs proceeded with the 12.4 million AZN cut (357.6 million AZN compared to the estimated 370 million AZN).

**Chart 8. Trends in the state budget revenues excluding SOFAZ transfers and current expenditures of the state budget, million AZN**



iv) As in previous years, in 2016, state budget revenues were less than the annual operating costs, excluding the transfer from SOFAZ. In 2016, without taking into account SOFAZ transfer, revenues of the state budget were 9.89 billion AZN, while operating costs amounted for 11.7 billion AZN. Thus, the number of current expenditures was 1.8 billion AZN (or 15.5%) more than the budget revenues, when excluding the SOFAZ

transfer. This situation, where the state budget's operating expenditures exceed its revenues was recorded for the first time in 2009 and has continued since then. The peak of this difference was registered in 2012. That year, operating costs of the budget exceeded budget revenues by 1.9 billion AZN, excluding the transfer from SOFAZ. For following years, this difference sum was gradually reduced and remained at the level of 395.1 million AZN in 2015. But in 2016 the figure again rose and reached 1.8 billion AZN (Chart 8).

v) The total amount of tax payments from the state institutions to the state budget decreased from the previous years. In 2016, the total sum of tax payments from taxpayers to the state budget amounted to 1.9 billion AZN. This amount is 197.7 million AZN (9.4%) less than 2014, and 302 million AZN (13.7%) less than 2015. In the reference year, the number of payments from the largest taxpayer among state-owned companies, SOCAR (during the reported year 65.6% of payments came from this enterprise), as already noted above, fell 157 million AZN, compared to 2015.

In comparison with the previous year, payments to the budget from the other large state enterprises, OJSC «Azerenergy» - decreased by 108.2 million AZN (31%), and «Azerbaijan Airlines» CJSC - declined by 3.1 million AZN (9.6%). The payments made by these enterprises to the Ministry of Transport, Communications and High Technologies (MTCHT), compared to the previous year, were increased by 13.5 million AZN (or 36.1%). Payments from the «Caspian Shipping Company» CJSC were 42 million AZN (2.7 times), and payments from «Azersu» OJSC were 7.5 million AZN (30.7%), respectively, were more than the previous year's indicators.

**Table 1. Dynamics of payments from the large state-owned enterprises to the state budget, million AZN**

State-owned companies	2012	2013	2014	2015	2016
Azerenergy	140.4	125.9	146.9	348.7	240.5
Enterprises of MTCHT	32.6	32.5	32.7	37.4	50.9
AZAL	23.0	11.0	14.6	31.9	28.8
Caspian Shipping	0.2	0.1	7.0	25.0	67.1
Azerbaijan Railway	2.0	1.9	3.2	6.7	22.8
Azersu	11.0	10.8	10.2	24.6	32.2

**Source: The Chamber of Accounts of the Republic of Azerbaijan**

Generally, the dynamics (Table 1) of payments to the state budget from the large state enterprises suggests that during the large oil revenue period the fiscal discipline of these companies was relegated to a lower priority and they paid very little money. However, with the decline in oil revenue, there was a sharp increase in their contributions to the state budget. For example, in 2013, the total amount of payments to the state budget

from the six largest state enterprises came to 182.2 million AZN, whereas in 2015 this amount was 474.3 million AZN, thus increased by 2.6 times in 2 years. Still, in 2016, this figure reached 442.3 million AZN, which is 32 million AZN less in comparison with the previous year.

During the period of large oil revenue, billions of AZN allocated from the state budget for strengthening the material-technical basis and increasing the capitalization of these institutions. Despite this fact, their contribution to the state budget still remains on a minimal level. Moreover, in many cases, the amount of annual funds allocated from the state budget to these enterprises was several times higher than their payments to the state budget. For example, although payments to the budget from «Azerenergy» had decreased compared to the previous year, in 2016, 412.1 million AZN was allocated through the Guarantee Fund to this enterprise and the «Azerishig OJSC», for their domestic and foreign debt recovery. Also, 776 million AZN was allocated directly from the state budget for the financial stabilization (by increasing capitalization) of these two companies.

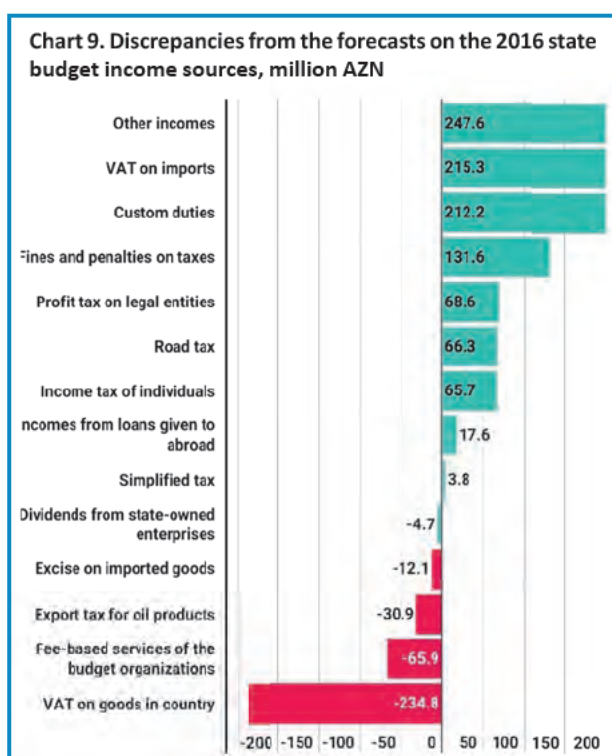
**vi)** In the reported year, for the most part, within the state budget's income sources there were deviations from the forecast. VAT from imports transferred to the state budget through the Customs Committee exceeded projection by 16.6%, while customs duties exceeded forecast by 54.7%. Among the funds collected by the Ministry of Taxes, the best performance recorded in fines collected was for the violation of tax laws: 131.6 million AZN or 73.1% more than the forecast (Chart 9).

During the year, 67.4% (234.8 million AZN) of the total deficit from the proceeding income sources accounted for VAT for the goods and services produced in the country, 18.9% (65.9 million AZN) accounted for the fee-based services of budget organizations. 8.9% (30.9 million AZN) of it accounted for the payments from the cost difference connected with the export of the goods with regulated prices and produced in the country.

**vii)** Deviations from forecast on the budget implementation of that scale suggest that there are shortcomings in the budget planning in Azerbaijan and economic processes in the country are not sufficiently considered. According to the 2016 budget policy, enterprises with a state share in their authorized capital or shares were supposed to increase their transfer of dividends (based on that share) to the state budget, but this did not happen. In 2016, revenues from this source were planned to be 5.29 million AZN, in fact, revenues accounted for 617 thousand AZN, which is 4.67 million AZN or 8.6 times less than the corresponding forecast envisaged.

The opinion provided by the Chamber of Accounts of Republic of Azerbaijan on the state budget implementation shows that, in 2016, income to the state budget through

the given source was paid with the profits from 2015's financial performance of the relevant institutions. Income from «Azerlotoreya» OJSC, non-financial organization, accounted for 500 thousand AZN, against the corresponding forecast of 1.86 million AZN. Dividends from «Agrarcredit» CJSC, non-banking financial institution, were 117 thousand AZN, compared to the forecast of 140 thousand AZN. Dividend payments from «Azer-Turk Bank» OJSC had not been made<sup>4</sup>, since it completed the 2015 financial year with a loss, while the forecast was 3.29 billion AZN.



Overall, in recent years, the forecast through this source was only exceeded in 2013 by 2.7 times, 5.5 million AZN was allocated to the state budget. Despite the increase in the forecast in the next three years, transfers to the budget were made with huge deficits: In 2014, 7.3 times less, in 2015, 4.1 times less, and in 2016, 8.4 times less money received than in the respective forecasts.

As can be seen from the Chamber of Accounts, the primary payers through this source «Azerlotereya» OJSC and «Azer-Turk Bank» OJSC completed 2015 with a loss<sup>5</sup>, but finished 2016 with a profit<sup>6</sup>.

As seen from their financial statements of 2015 and 2016, in each of these two years, which the organization finished with a profit, 500 thousand AZN in the form of dividends were paid through «Azerlotereya» OJSC to the state budget. It is also stated<sup>7</sup> that, Azerbaijan Table Tennis Federation, in its turn, made a sponsorship worth 200

<sup>4</sup> [http://sai.gov.az/upload/files/ICRA-2016-SON\\_FINAL.pdf](http://sai.gov.az/upload/files/ICRA-2016-SON_FINAL.pdf), p. 125

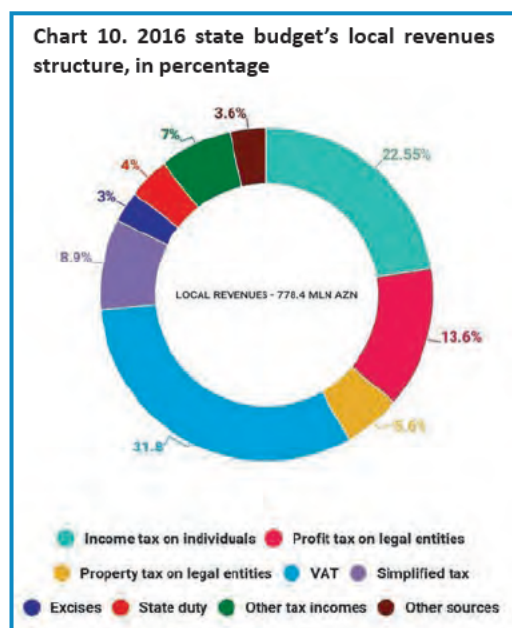
<sup>5</sup> [http://www.azerturkbank.az/docs/w/A3.1\\_Azer-Turk%20Bank\\_IFRS%20FS%20AZE%202015\\_PDF.pdf](http://www.azerturkbank.az/docs/w/A3.1_Azer-Turk%20Bank_IFRS%20FS%20AZE%202015_PDF.pdf)

<sup>6</sup> [http://www.azerturkbank.az/docs/w/illik\\_az\\_2016.pdf](http://www.azerturkbank.az/docs/w/illik_az_2016.pdf)

<sup>7</sup> <https://azerlotereya.com/az/content/index/138>

thousand AZN. It is important that the government brings clarification to the fact that, despite<sup>8</sup> the year-by-year growth in undistributed profit of OJSC, dividends designed to be paid to the state budget were not at the envisaged level. Along with that, attention should be paid to the fact that, financial statements from «Azerlotereya» OJSC are not following the international financial reporting standards.

**viii)** For the first time, the government in its' report released the structure based on payments types of the state budget's local revenues. These changes have come into force since January 2017, due to the adjustments in the Law on the Budget System. According to the statement, in 2016, the amount of local revenue of the state budget came to 778.4 million AZN. This revenue was received from the following sources: 247.7 million AZN (or 31.8% of the total amount of local revenues) from VAT, 175 million AZN (22.5%) from income tax on individuals, 106 million AZN (13.6%) profit tax of legal entities, 69.5 million AZN (8.9%) through the simplified tax, 54.7 million AZN (7%) from other tax incomes (fines and sanctions for violation of the tax legislation), 43.7 million AZN (5.6%) from the property tax on legal entities, 31 million AZN from the state duties, and 23.5 million AZN (3%) received from the excise taxes (Chart 10).



**ix)** In the reported year, the state budget's local revenues decreased. Along with that, in the reported year, 777.3 million AZN (4.4%) from the total income of the state budget belonged to the local revenues. Local revenues decreased by 50.5 billion AZN (or 6.1%), compared to 2015. Local revenues from the regions, without taking into account Baku city, came to 562.9 million AZN, which is, 30.5 million AZN (or 5.1%) less than 2015. In 2016, the total amount of funds allocated from the centralized expenditures for regulation of the local revenues and expenditures accounted

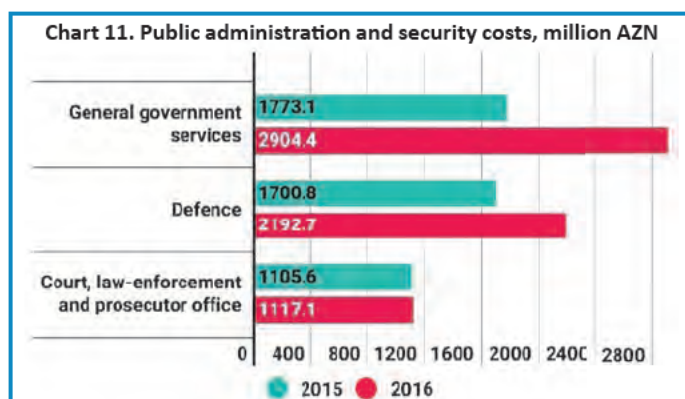
for 755.9 million AZN, which 9.7 million AZN (or 1.3%) more, compared to 2015.

<sup>8</sup> <https://azerlotereya.com/uploads/Kamran/Loqo/2016.pdf>



### 3. Main trends in the performance of the state budget expenditures

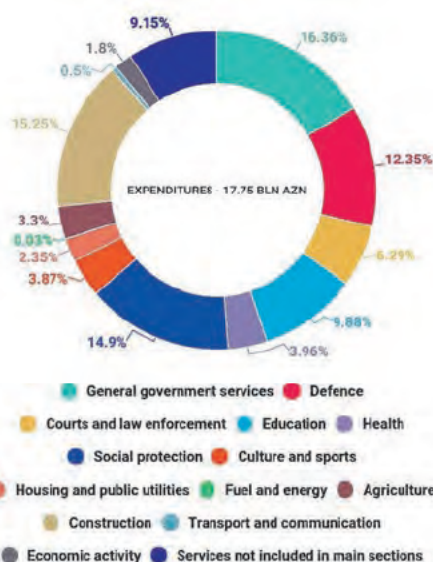
Most funds from the expenditures of the 2016 state budget were spent on the functional section of public service: 2.9 billion AZN or 16.36%. Thus, industry, construction, and minerals (state investments) section (to 15.25%), which in previous years had the dominant share of the budget, which gave way to the functional section of public service expenditures. In general, last year's expenses for the state investments decreased by 46%, compared to 2015. Along with that, the areas that have a high share of the 2016 budget are the social protection and social security (14.9%) and defense expenditures (12.35%) sector (Chart 11).



Overall, in 2016, 35% of the budget expenditures was spent on the public administration and security. This includes general government services, law-enforcement and the prosecutor's office, the defense and the court sections. In 2016, for above mentioned three areas 6.21 billion AZN were allocated, which is, in comparison with 2015, 1.62 billion AZN or 35.3% more (Chart 12).

In 2016, expenses for the state governance system came to 2.9 billion AZN (share of the budget - 16.4%), defense expenditures reached 2.19 billion AZN (share in the budget-12.4%), law-enforcement and the prosecutor office's expenditures came to 1.12 billion AZN (share

**Chart 12. Structure of the state budget expenditures based on the functional sections, in percentage**



of the budget - 6%). Costs per each functional section had increased in comparison to 2015.

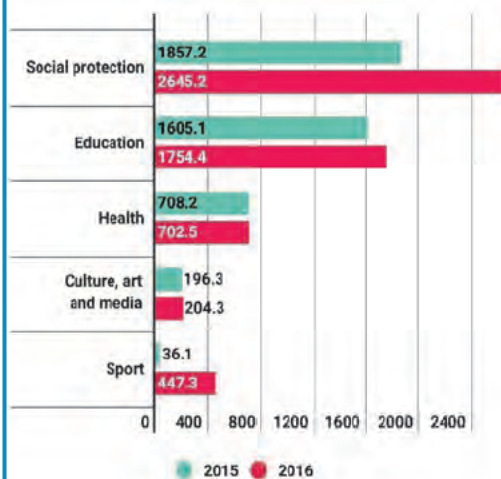
Financing for the social services in 2016 came to 5.79 billion AZN, which is 30.3% higher compared with the previous expenses. Overall, in 2016, 32.6% of the budget expenditures were directed to the financing of the social services.

As for the structure of social spendings, in 2016, expenses on social security accounted for 2.65 billion AZN (share in the budget - 14.9%), education expenditures – 1.75 billion AZN (9.9%), health expenditures - 702.5 million AZN (3.9%), culture-art and

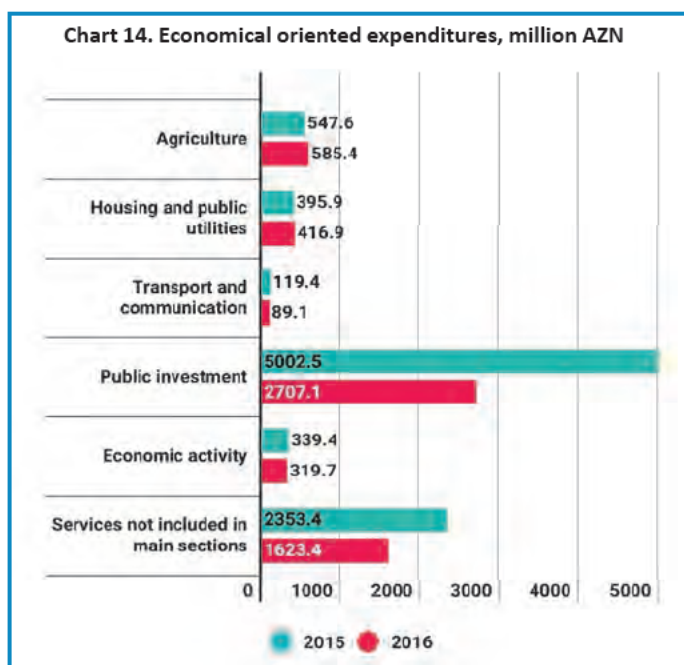
expenses - 204.3 million AZN (1.1%) expenses on sports - 447.3 million AZN (to 2.4%). Compared with the last year, social security expenses increased by 788 million AZN, spending on education rose by 149.3 million AZN, culture, art, and media expenditures

increased by 8 million AZN, sport expenses increased by 411.2 million AZN, health expenditures, in turn, dropped by 5.7 million AZN (Chart 13).

**Chart 13. Expenditures on financing of social spheres, million AZN**



Finally, last year, economically viable expenditures from the state budget amounted to 32.4% of all the costs in general. This includes costs of the agricultural sector, transport and communication field, socially significant investments, and expenses on the financing of the economic development. In 2016, for the areas mentioned above, 5.75 billion AZN was spent, which is 34.3% less than the last year (Chart 14).



Most of the economically oriented expenditures were connected with the investments. In 2016, for the budget investments, 707.1 million AZN (15.2% of the total budget expenditures) was spent, which is 34% lower compared to the previous year. Investment expenditures include 352.2 million AZN for social infrastructure (education, health, construction and reconstruction of cultural and sports facilities), 712.7 million AZN for road infrastructure (including underground transport), 306.7 million AZN on irrigation system, 523.9 million AZN on financing of the share of Azerbaijan in the «Southern Gas Corridor» (SGC) project, and 541.5 million AZN on defense, law-enforcement, and financing of the administrative sector.

416.9 million AZN was spent on housing and the utility industry, 89.1 million AZN for transport and communications sphere, and for the agricultural sector 585.4 million AZN was spent. The costs associated with economic activities accounted for 319.7 million AZN. This complementary sector includes business loans, leasing for the agricultural sector, and mortgage lending.

From the section of other services not included in the main sections, 828.9 million AZN directed to the budget's Reserve Fund, 281.1 million AZN channeled to the Reserve Fund of the President, and 261 million AZN directed to the Highway Trust Fund.



Analyses based on the state budget expenditures' subsections and paragraphs shows that top 5 allocations with the highest share of the 2016 state budget are as follows: state investment expenses, repayment of public debts, social security spendings, education expenditures, and defense spendings. Thus, in the total budget expenditures share of the investment spendings was 15.2%, services for the public debt -12.8%, defense expenditures -12.4%, social benefits, and pensions -11.6%, education -9.9%.

In 2016, the classification of the state budget expenditures included 3.64 billion AZN for the wage costs, 3.32 billion AZN for the purchase of non-financial assets, 3.17 billion AZN on the costs of goods (works and services), 2.07 billion AZN for the pensions and social benefits expenses, 1.39 billion AZN for the financial transactions on commitments expenses, and 2.76 billion AZN for the other expenses.

In 2016, local expenditures of the state budget amounted to 1.49 billion AZN, which is 24.1 million AZN less than 2015. Local spendings included 61.3% on education, 13.6% on health, 12.1% on housing and public utilities, 7.2% on local executive bodies, and 4.7% on culture-art, media, and sports. Within the year, for the regulation of local revenues and expenditures of the of the cities and regions, from the budget's centralized expenditures 755.9 million AZN of financial assistance was made, which is 9.6 million AZN more than in 2015.

In 2016, central elements of the government's expenditure policy stated to be comprised of the coordination of the state's programs and measures with the medium-term budget expenditures, improvement of the budget expenditures' structure, increase the transparency of budget expenditures. However, in the process of implementation, there were two major adjustments, which can be distinguished, when analyzing expenditure policy related to the events, which were not considered in the Law on the State Budget, yet, financed in the fulfillment process:

- Compensation of the internal and external debts of the state-owned enterprises and companies is through the budget. Under the «Public service» functional section 1.77 billion AZN was spent on debt service costs. In addition to that, 498.1 million AZN, generated by annual savings on the other functional areas, was spent on the state debt through the state's Guarantee Fund. In addition to that, 1.17 billion AZN from the approximate 1.48 billion AZN funds (675.9 million AZN and \$497.6 million, at the beginning of 2016) of the Guarantee Fund, accumulated within the previous years, had been spent on returning the state debt. Overall, in 2016, through the state budget's separate sections and the Guarantee Fund, 3.44 billion AZN was allocated for the payment of the state debts. This amounts to 18% of the Guarantee Fund's assets for the early 2016 and 2016 state budget expenditures' value

together. About a half of the returned debts accounted for the foreign debts and the other half for the domestic debts.

- Financial support to the state-owned enterprises and companies, under the financial improvement, was through the budget. During the year, the large-scale support provided by the state budget was provided for the state-owned enterprises and companies, which operate on the principle of self-financing. Thus, in 2016, based on «expansion of the capitalization and financial recovery of the state enterprises» purpose, a 564 million AZN fund was allocated from the budget's reserve fund, through the International Bank of Azerbaijan, 91.5% of shares of which are owned by the state. Also, from the savings generated through the budget's various sections, 360 million AZN was allocated to «Azerenergy» OJSC, and 416 million AZN to «Azerishig» OJSC. As can be seen, in 2016, overall, expenditures related to the capitalization of the state-owned companies amounted to 1.34 billion AZN or 7.5% of the total budget expenditures.

Following trends on the fulfilment of the state budget expenditures are based on the analysis of the 2016 budget reports:

**x)** Both, the share in the budget and the amount of the investment expenditures fell sharply. In 2015, 5 billion AZN or 28.1% of the state budget expenditures were spent on the financing of investment expenditures. In 2016, the ratio of these expenditures to the general budget expenditures decreased by 15.2%, and the amount decreased to 2.7 billion AZN. Between 2006-2015, the share of investment expenditures in the state budget has remained in the range of 24-40%.

**xi)** Due to the government's particular attention to international sports events, a share of the e-sport expenses in the budget had significantly increased. Thus, in 2016, a share of the «Physical education and youth policy» subsection's funds in the state budget expenditures came to 2.5%. While in previous year this figure was 0.2%. In the reported year, the number of expenditures on sports, in comparison with the previous year, increased by 12.4 times and reached 447.3 million AZN. Such a rapid growth in sports expenditures was connected with the Formula 1 European Grand Prix race, which was hosted by Azerbaijan in June 2016.

**xii)** The share of social spendings in the budget is still quite low. In the budget law of 2016 expenditures for the functional section of «social protection and social provision» was approved at the level of 2.7 billion AZN. However, from the analysis provided by the Chamber of Accounts, in the 2016 state budget, it is clear that, during the year, based on the different decrees of the Cabinet of Ministers, 567.7 million

AZN, from the funds allocated for the «social protection and social provision» section, were channeled to directions not connected with the social protection system (return of the state debts, improvement of the level of capitalization of the state-owned companies). As a result, 78% of total expenditures on the «social protection and social provision» section or 2.1 billion AZN was assigned for this principal purpose. Taking this information, in 2016, a share of the actual expenditures on social protection and provision in the budget was 11.8%. In turn, the share of other social spendings in the budget in the reporting year was as follows: education expenditures - 9.9%, health spendings - 3.9%, culture, sports and media expenses - 3.6%. Taking this into account, you can see that the investment expenditures on social infrastructure and social expenses constitute 32% of the budget. While for the developed countries, as well as for the number of developing countries in transition, this figure is not less than 50%.

**xiii)** Significant sequester orders were executed on many spendings which were approved by the law. Thus, the following functional sections and subsections have been implemented with a deficit:

- «Activities not related to other categories» subsection of the «Culture, Art, and Sport» functional section - 62.4%;
- «Other expenses not related to the main sections» subsection of the «Services not included in the main sections» functional section - 56.7%;
- «Other enterprises and events in the field of education» section of the «Education» functional section - 49%;
- «Initial vocational education» subsection of «Education» functional section - 17.3%;
- «Transport and communications» functional section - 31.4%;
- «Health» functional section - 15.4%;
- «Agriculture» functional section - 14.5%;
- «Economic activities» functional sector - 11.2%;
- «Industry and construction» (Public investment) functional section - 10.5%;
- «Culture, art and sport» functional section - 7%;
- «Housing and public utilities» functional section - 7%.

**xiv)** Service costs for the public debt and defense spendings became the main priorities for the budget's expenditures. In 2016, 2.27 billion AZN from the state budget was on

debt services, which made 12.8% of the total expenses. Defense spendings constituted 2.19 billion AZN or 12.4% of the total spending. As it can be seen, in 2016, a quarter of the state budget expenditures was assigned for these two directions.

**xv)** Keeping the budget deficit at a low level had been one of the top priorities of the government. Although budget deficit projected in the 2016 budget law was 1.67 billion AZN or 2.8% of the expected annual GDP, the actual amount had been 245.6 million AZN or 0.4% of GDP.

**xvi)** The share of recurrent expenditures in the state budget had significantly increased. In 2016, the share of the expenditures in the budget had been 66%, whereas in 2015 the figure was 55%. In turn, in 2016, the number of current expenditures was 11.7 billion AZN in 2016, while in the previous year it was around 9.5 billion AZN.

**xvii)** The government had significantly increased spendings through the reserve funds. In 2016, through reserve funds of the budget 1.11 billion AZN was spent, which amounted to 6.3% of the year's total budget expenditures. In 2015, the total amount of the reserve funds was 449.8 million AZN, with a 2.5% share in the budget. In turn, although, based on 2016 budget law, the government approved the reserve fund of the state budget at the level of 128 million AZN, in the implementation process, by making adjustments in the budget expenditures, it had increased the fund by 6.5 times.

## 4. Budget deficit and its financing sources

Although the upper limit of the 2016 state budget deficit was stated to be at the level of 1.67 billion AZN, according to the summary report, the actual budget deficit had been at the level of 245.6 million AZN or 0.4% of the GDP. There are two reasons for the deficit to have come to about seven times less than projected: (a) actual budget revenues were 683.6 million AZN more than the forecasted figure; (b) actual budget expenditures were 743.7 million AZN less than the forecasted figure;

The budget deficit was financed through the following four sources :

- Income from privatization - 31.2 million AZN;
- Foreign grants - 12.3 million AZN;
- External and domestic debts - 186.8 million AZN;
- Treasury balance of the budget for the previous year - 15.3 million AZN.

In fact, state budget's deficit constituted significantly less than in the forecasts, and due to the closing of the existing deficit through the national debt, income from privatization and grants, allowed the government to protect balance in the treasury account. By December 31, 2016, from the savings generated in the previous years, 2.3 billion AZN funds collected in the state budget treasury account.

## 5. Service for the public debt through the budget

Expenditures on the service for the public debt in the 2016 state budget was set to be 1.78 billion AZN or 9.6% of budget expenditures approved by the law. In turn, all of these expenditures were planned under the section of «Public services.» During the year, under the department of «Public services» 1.77 billion AZN or 99.7% of the approved forecast was fulfilled. From the savings generated through the other areas within the year 498.1 million AZN of the debt was additionally returned through the «Guarantee Fund of publicly guaranteed debts».

In addition to that, 1.17 billion AZN of the accumulated funds, 1.48 billion AZN (675.9 million AZN or \$497.6 million, at the beginning of 2016) Guarantee Fund's fund, was paid for returning of the public debts. Overall, during 2016, 3.44 billion AZN were allocated for debt return through the various budgetary sections and the Guarantee Fund. This amount is equal to 18% of the Guarantee Fund's early 2016 total assets of the 2016 state budget expenditures added together. About a half of the returned debts were foreign debts. In 2016, for the public debt returned, 2.27 billion AZN was from the state budget or 12.8% of the actual state budget expenditures were allocated, excluding the debt returned from the funds raised by the Guarantee Fund in previous years. The debt returned from the Guarantee Fund was 492 million AZN or 27.7% more than the amount forecasted in beginning of this year.

In 2015, 704.5 million AZN from the state budget expenditures was spent for service of the public debt. As it can be seen, in 2016, service expenditures for the public debt were 1.56 billion AZN or by 3.2 times more than in the previous year.

In the reporting year, directly from the state budget, as well as through the Guarantee Fund 3.44 billion AZN was directed for the public debt return. 1.6 billion AZN (46.7%) of it for external, and 1.83 billion AZN (53.3% ) for the domestic public debt. Neither the Chamber of Accounts nor the government did not specify in their reports through which projects and specific guarantees given to bodies, the payment of the debts, under the state budget's «Public services» section, had been implemented. Whereas, information on the structure of returned debts and allocation of these debts'

payments based on organizations, provided by the Guarantee Fund. 17.9 million AZN of the foreign debt and 216.3 million AZN on domestic debt on behalf of Azersu OJSC, 47 million AZN of the foreign debt on behalf of «Azercosmos» OJSC, 69.8 million AZN of foreign debt and 297.2 million AZN of the domestic debt on behalf of the «Azerenergy» OJSC.

In addition to that, in 2016, 1.73 billion AZN of domestic debt of the state-owned enterprises and organizations was paid through the Guarantee Fund. This includes: 272.3 million AZN for «Azeraluminum» OJSC, 624.2 million AZN for AZAL, 36.1 million AZN for «Shahdag Tourism Center», 45.1 million AZN for «Azerishig» OJSC, «Azeravtoyol» OJSC 274.3 million AZN, 216.5 million AZN for «Baku Metro» CJSC, Construction and Supply department of the Ministry of Education - 31.9 million AZN, 49.8 million AZN of «Water and Melioration» OJSC, 90.2 million AZN for Yasamal District Executive Power, 20.5 million AZN for Executive Power of Baku City. All of these debts were loans taken from the Central Bank of Azerbaijan under the targeted funding measures.

## 6. Evaluation of legal and procedural issues on implementation of the state budget

Analysis of the of legal and procedural issues related the 2016 state budget implementation, and in connection with that government's report, Parliament's discussion and approval, revealed the following findings:

**xviii)** Amendments, dated December 16, 2016, to the Law on the Budget System, to ensure the transparency of the budget, was a positive step. According to the amendments, a lot of information on the budget will be enclosed in the government's annual report to the National Assembly, which previously had not been disclosed. For example, information on performance of targeted funds, performance of the local incomes by the tax and other payment types, as well as information about the amount of performed expenditures on the level of main and complementary sections, by the functional and administrative classification must be reflected in the reports;

**xix)** In the current budget legislation, approved by the National Assembly and signed by the president, there is a lack of the exact limits and restrictions for amendments made by the government, in the implementation process of the budget, based on its own decisions, which raises some questions. In the Law on the Budget System there is stated that amendments in the level of the approved budget allocations under the sections of functional classification, as well as within the sections, complementary sections, paragraphs, items, and «semi-items» of the economic ranking, may be done by relevant executive authority, if necessary (article 18.4)<sup>9</sup>. However, it is still not clear, exactly what kind of situations the expression «if necessary» encloses, although this is required<sup>10</sup> By the Law on Normative Legal Acts. So the government «benefits»

---

<sup>9</sup> <http://www.e-qanun.az/framework/1126>

<sup>10</sup> Article 64.4 on normative legal acts of the Constitution of the Republic of Azerbaijan stipulates that, of determination of the state bodies' authorities in too generalized form is not acceptable, and vague expressions such as, "as a rule", "is allowed in exceptional cases", "authorities within their powers", "if necessary", is not allowed.



from this opportunity to determine the cases under this «if necessary» expression, based on its views. «Frequent» amendments, made by the government in the number of budget parameters approved in the in the 2016 budget law, also associated with this. For example, the paragraph of «The reserve fund of the state budget» of the «Services not included in the main sections» had increased by 6.5 times, compared to the forecast, while subsection of «Communication» and «Transport and communication» section increased, overall it was reduced by a factor of 12. Similar adjustments were also made in the expenditures based on economic classification. These amendments had been made by the Cabinet of Ministers' directions of April 11, August 1, December 26 and December 30, 2016, without discussion in the National Assembly. Concern related to such cases expressed<sup>11</sup> also in the Chamber of Accounts' opinion on the state budget for 2016.

Another example: The classification of the «one-time spendings» concept stated in the article 19.6 of the Law on the Budget System had not been provided as well. Although the composition of this «one-time spendings» was disclosed in the opinion of the Chamber of Accounts, it was not specified what normative document it is based on.

**xx)** The legislation, which would prevent the government from making adjustments to the state budget implementation based on its own views, is not strictly adhered to. For example, in the Law on the Budget System there is said that, in the reporting year, savings generated from the one-time spending funds, under the paragraphs, sections, units and semiunits of the economic classification, in the process of implementation of the state budget, can be directed to the state budget's reserve fund and be used in financing of other events, by consulting with the Cabinet of Ministers (article. 19.6.). Thus, it is clearly indicated that, during the process of the state budget implementation, direction of savings to the budget's reserve fund must proceed under the economic classification of expenditures. The government was able to increase the reserve fund due to the amendments made in indicators (approved by the law) of the state budget's functional, complementary sections, and paragraphs. In addition to that, although, according to the law, savings can be directed only to the state budget's reserve fund, part of these funds were used to pay debts of state-owned companies through the Guarantee Fund.

**xxi)** If we look into the government's report on the state budget implementation, we can see that the information, related to fulfillment of the requirements, stated in the presidential decree related to the relevant year's law on the state budget, is not reflected. Improvement of the rules related to the financial assistance from the

---

<sup>11</sup> [http://sai.gov.az/upload/files/ICRA-2016-SON\\_FINAL.pdf](http://sai.gov.az/upload/files/ICRA-2016-SON_FINAL.pdf)

state budget to agricultural producers<sup>12</sup> It is included in the presidential decree on implementation of the Law on the State Budget for 2016. Also related to the matter, there it is indicated that within two months they must prepare and submit to the president of Azerbaijan proposals on improving the transparency and efficiency of the use of funds. It is also important to include in the report the information on the implementation of this kind of tasks.

---

<sup>12</sup> For the fuel and engine oil used in farmed lands and cultivation of perennial plants, for the cultivation of wheat and rice, selling of mineral fertilizers and herbicides at bargain prices.

## 7. Recommendations

For resolving the shortcomings, revealed from study and analysis of the data and the government's report on the 2016 state budget implementation, it is important to consider the following issues:

- The current state of the budget expenditures should be brought into line with the value of the budget revenue (excluding SOFAZ transfer);
- Information about important indicators such as the share of small, medium and large businesses, the private and public sector in the formation of the state budget would allow tracking changes in these areas. As well as, information about structure of the budget revenues and properties of the each payment types should be made public;
- Disclosure of the structure of local expenses and revenues, according to each region (city), as well as, based on all payments types and expenditure trends, would be appropriate. Also, in the next years, detailed disclosure of local revenues of all the regions, based on the payment types, in the government's budget implementation reports would be more appropriate. In particular, since the investment rating of all regions in the country had started to be prepared, this could be a significant source of information about the investment potential of regions.
- Amount of dividends from the companies, with the state share in their authorized funds and shares, to the state budget should be increased. Also, the responsibility of large state enterprises for payment of the taxes and other payments in time and in the appropriate amounts should be increased;
- It is necessary to strengthen the control of the National Assembly over the repayment of the state enterprises' debts by the state budget;
- The use of legal limits and restrictions on the government' authority to make amendments (on the level of sections, complimentary sections, paragraphs,

items, and semi-items of the economic classification) in the budget would be appropriate. In particular, legal explanation and disclosure of unclear concepts stated in the Law on the Budget System, such as, «if necessary» or «one-time spending,» should be provided. Also, it is necessary that detailed and clear explanation of all amendments (made by the government based on its own views and decisions) on the state budget parameters, approved by the National Assembly as a law, to be included in the budget's implementation report.

- The report on the budget implementation, presented to the National Assembly, must be prepared by the requirements of the Law on the Budget System and the draft law on the budget submitted to the parliament in an envelope;
- Information on implementation of the requirements of the decree, signed by the president of the country in connection with the law on state budget implementation, should be reflected in the government's reports on the state budget implementation, from respective years;
- To increase the budget's transparency and accountability, reports on the state budget implementation should include the following items: detailed and clear information on budgetary investment projects, consolidated budget surplus, the performance of targeted budget funds.



[www.opengovernment.az](http://www.opengovernment.az)  
[opengovaz@gmail.com](mailto:opengovaz@gmail.com)

Copyright © Open Government