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Review

Of the National Budget Office

on the implementation of 2009 state budget of Azerbaijan Republic

Summary

The implementation of 2009 state budget was realized during the global economic crisis thus reflecting the negative impacts of the crisis as a whole. Taking into account the particular importance of 2009 budget implementation against the background of the growing economic opportunities for the country within the past several years, NBO thoroughly studied the report of the government on the implementation of the budget for the mentioned year as well as the opinion of the Chamber of Accounts and came into the following conclusions:

I. On budget revenues:

The revenues of the budget of Azerbaijan Republic in 2009 made up AZN 10 325 935,1 thousand which makes 84,8% compared to the forecasted figures of that year and 95,9% compared to the performance figures of 2008. Hence for the first time in the most contemporary history of Azerbaijan the implementation of the state budget was accompanied with the sharp decrease in comparison with the approved budget figures.

The government explains the decrease of budget incomes with the weakened economic activity in the country during the crisis period. However the problems of the Azerbaijani economy with quite serious structural complications behind this generic explanation stay in the shadow both in the report of the government and in the opinion of the Chamber of Accounts.

The poor implementation of budget incomes is the logical consequence of the severe dependence of the budget and of the economy as a whole on oil factor. Also the problems of the budget incomes can be explained by the lack of strong and stable institutional basis of the state budget. The state budget in general is very vulnerable against external impacts and is extremely dependent on the conditions of the world market.

The decrease in budget revenues noticed in 2009 can be explained for the following 4 reasons:

1. The forecasted price of oil in 2009 state budget was USD 70 versus the average sale price of USD 62,1 during the year. Certainly the impact was inevitable when 69,2% of the state budget was formed through oil and gas revenues. Logically this decrease was accompanied with the sharp reduction of taxes that foreign companies were paying to the government of Azerbaijan within PSAs frame and of profit tax in the first place. It should be mentioned that the budget revenues formed by the profit tax paid by companies decreased by AZN 1 billion 553,1 million or 45,3% compared to 2008. Besides, the 2009 forecast was implemented by 60% only (AZN 884,8 million less than the forecast). The special weight of the profit tax in the total amount of state budget incomes made up 12,9% which was 13,7% less compared to 2008. As already mentioned above the main reason for the decrease is the reduction of the share of taxes paid by foreign oil companies

within PSA frame. Thus the payment of only 587 million 903 thousand AZN was realized versus the assigned 1 billion 230 million AZN which meant the implementation of the budget with 47,8% cut (decrease of AZN 642 billion. This figure demonstrated a more dramatic decrease (73,3%) compared to 2008. As usual the situation was relatively eased by the transfer of AZN 4 billion 915 million (47,6% of the budget revenues) by SOFAZ.

The oil factor was also found in the revenues from the taxes paid by individuals. Thus the total decrease on this tax was 7,2% compared to the previous year, whereas the income tax generated from the hired labor in contractor and sub-contractor companies on PSA decreased by 33,5%.

2. Large tax payers (Azerenerji, Caspian Sea Navigation Agency, State Railway Department, etc.) that constitute the core of non-oil sector noticed the indirect impact of the crisis as well as of the reduced oil price in the world market and this resulted not only in their decreased budget payments, but rather in allocations from the state budget in order to keep up some of them. The taxes of large tax payers (except for SOCAR) had always been symbolic in budget incomes in any case and this actually had nothing to do with the crisis. The real reason behind these huge problems lied in the lack of effective management reforms in the above mentioned agencies and in dubious conditions related to accountability, responsibility and transparency. Instead of restructuring and possessing strong competitiveness, thus improving their profitability and increasing their budget payments these agencies established their numerous “satellites” having maintained the status-quo and refocus their main revenues leading them in a totally different direction. Logically, the crisis period did not witness the balancing of the situation through payments from alternative sources against the background of sharp decrease of the oil price. The below figures reflect it even better. Thus during the reporting year the tax payments of ASRA JSC decreased by 20,3% compared to 2008, that of Caspian Sea Navigation Agency by 62,4% and Azerbaijan Airlines JSC by 40,8%. Taking into account the share of these tax payers in total tax payments of 2009 it turns out that this type of corporations can only be symbolically named large tax payers. The total share of 8 large tax payers in state budget incomes does not exceed even 2%.

For the sake of comparison, the budget payments from “Azercell” made up more than 3% of total taxes. The fact that a regular mobile service company paid more taxes than 8 large tax payers that constitute the core of the state economy should make the government seriously think about this and lead to the acceleration of structural reforms.

3. Due to the lack of business environment as well as strong and effective taxation mechanism in the economy of the country, small and medium enterprises not only could not demonstrate stability but rather faced with serious complications themselves. The sharp tightening of the scope of bank crediting, stagnation in service and sales fields, as well as the considerable slackening of the construction field that went through its pre-crisis renaissance period caused serious problems both in employment and in tax collections. These problems are first of all found in simplified tax payments from small and medium enterprises. It’s clear that the amount of simplified tax and its share in the budget is usually very small. However the figure for this tax decreased by 1,2% during the reporting year compared to 2008 and made up only AZN 63,6 million. It turns out that the huge number of entrepreneurs that regulate their activities in the economy of Azerbaijan only through this tax had been making budget payments of just AZN 5,3 million per month averagely.

4. The sharp decrease of aspect import-export operations and the consecutive implementation of customs duties with a deficit. The State Customer Committee payments to the state budget during the reporting year was executed by 67,9% which meant a decrease of 13,8% compared to 2008. The excise tax payments of the SCC to the state budget were implemented by 72,9% compared to the forecasts. The payments to the state budget from this source reduced by 25,6% compared to 2008. This reduction is linked to the decrease of the import of certain excise good, especially that of vehicles by 36,5%, alcoholic drinks by 43,6% as well as oil products by 24,4%. Certainly, the reduction of customs payments due to the tightened external trade turnover of the country is quite understandable. However linking this reduction to the crisis only would not sound

correct. We think the reduction of customs payments to the state budget can be explained by the fact that the entrepreneurship environment of the country is worsening and the state management system does not meet the desired standards.

II. On budget expenses:

The problems in state budget incomes in 2009 urged cutbacks in budget expenditures. The state budget expenses during the reporting year made up 10 774 234 thousand which is AZN 1 851 200 thousand or 15,05% less compared to the forecasted figures for 2009. In their turn all expenses had been cut compared to the approved forecasts.

The most characteristic trends related to the implementation of expenses last year were formed under the impact of limited income opportunities. These trends include the following:

1. The dynamics of expenses had demonstrated decrease for the first time for the past 5 years.

Thus, the total budget expenses decreased by AZN 270 300 thousand AZN or 2,5% compared to 2008. Nevertheless, the government could ensure the increase of performance figures on most functional fields compared to the similar figures of 2008. For instance, general state service expenses increased by AZN 164 627 thousand (25%), maintenance expenses for juridical body, legal-defense and prosecutor offices by AZN 105 279 thousand (21,5%), educational expenses by AZN 168 181 thousand (17,2%), health expenses by AZN 56 138 thousand (16,2%), social defense and provision expenses by AZN 208 040 thousand (24,5%) and agricultural expense by AZN 108 570 thousand (38,5 %).

2. Certain social fields were exposed to severe sequestration. Hence, the two of the three functional divisions that experienced largest cut were health and education fields. The health expenses were cut by 21,1% and educational expenses by 15,2%. In their turn social defense and social provision expenses were sequestered by 7,1% and culture and art expenses by 9,2%. Unlike the social block certain divisions could “get away” with slight cuts. For instance the defense expenses were implemented by 98,2% and maintenance expenses for juridical body, legal-defense and prosecutor offices by 95,3%.

3. Certain expense items that are stated as “protected expense items” in the budget legislation and the sequestration of which is not permitted have been cut. Hence the forecast for labor expenses has been implemented by 86,8% (the actual performance of AZN 2 2 219 000 versus the forecasted figure of AZN 2 557 654 thousand). AZN 338 654 thousand on this direction has not been spent. The forecasts on pensions and social benefits were implemented with 6,2% cut (the actual implementation of AZN 1 026 300 thousand versus the forecasted AZN 1 093 636).

4. Sharp decrease was observed in two directions that the government had considered of particular importance in expense priorities. For instance, the defense expenses had been reduced by AZN 137 300 thousand (10,5%) and industrial and construction expenses by AZN 724 688 thousand (16,9%) compared to the previous year.

5. The total share of social expenses in the budget increased compared to the previous year.

The share of four functional directions, namely, social defense and provision, education, culture and art and health expenses, that constitute the social expense block of the budget was increased by 5 points reaching 26,5% compared to 2008. The structural analysis of the expenses shows that this increase was due to the decrease of the special weight of industrial and construction expenses in the budget by 6% going down to 34%.

6. The tendency of certain large state-owned companies and enterprises to acquire budget allocations has strengthened.

Despite the huge problems in the tax payments by state enterprises named “large tax payers” to the state budget and non-disclosure of information on the expenses and revenues of those enterprises to the public large funds are allocated to them from the state budget. AZN 921 213 thousand was allocated from the reserve fund of the budget, reserve fund of the President, investments expenses and various functional divisions for those enterprises in 2009. AZN

27 440 thousand out of this amount was spent on the repayment of loans acquired through state guarantee and of budget loans (Azal JSC and Caspian Sea Navigation Agency), AZN 45 000 thousand on the payment of subsidies related to the refunds for damages that emerged during the provision of services (Baku Metro Service and Azal JSC) and AZN 848 773 thousand on various investment projects. For instance, Baku Metro Service Agency received a state budget allocation of AZN 33 100 thousand in the form of subsidy and AZN 159 700 as investment expenses (including AZN 30 900 thousand from the reserve fund of the budget and AZN 128 800 thousand within the framework of investment expenses). However, the need of maintaining control over the revenues and expenses of this agency, as well as the establishment of legal basis for the allocation of subsidies is stressed in the opinion of the Chamber of Accounts. Also, whereas “Bakielektrikshebeke” (Baku Electric Power Net) was able to function independently during the 4 years (2002-2006) when it was managed by a foreign company, the company acquired AZN 60 million from the state budget (including AZN 10 000 thousand from the reserve fund of the President and AZN 50 000 thousand within the framework of investment expenses). Neither government report, nor the opinion of the Accounts Chambers states the need for this increase. The situation is similar with Caspian Sea Navigation Agency that acquired AZN 17 700 thousand and Azal JSC that acquired AZN 88 380 thousand from the state budget. Nothing is mentioned about the necessity of issuing loans to either agency from the state budget at all. It should taken into account that the issuance of budget loans from the state budget remains still unclear in the existing budget legislation (purpose of such loans, justification of purposes, repayment periods and terms, justification of the amount of loans, rights and liabilities of debtors and creditors in cases of payment inability or force major).

III. On budget deficit:

The budget deficit of 2009 was not “real” but rather “virtual”. Both the monitoring of cash performance and the sources of coverage for the amount that is stated as a “deficit”, provide ground for this conclusion. Hence, the cash performance of the budget per months shows that the budget demonstrated surplus for all months, except for December. The amount of the surplus was AZN 1163,3 million in October and AZN 1026,9 million in November. Nevertheless, December, the last month of the year when $\frac{1}{4}$ of the budget expenses were performed, the budget demonstrated a “deficit” in the amount of 177,9 million – the exact amount considered in the legislation. It’s quite curious that the financing of this “deficit” was realized not through the borrowed funds but rather through the sources that can be considered the real revenues of the budget: this deficit was covered by AZN 58,6 million gained from the privatization of the state property and by AZN 119,3 million that remained as the residue amount for January 1, 2009.

IV. On state debt:

The amount of the internal debt of the state increased by more than 4,5 times. The internal debt of the country was AZN 367,4 million on January 1, 2009. The upper limit of the internal debt of the country is stated as AZN 750,0 million in article 14 of the Law of Azerbaijan Republic on “2009 State Budget of Azerbaijan Republic”. However, later this upper limit was accelerated to AZN 2250,0 million AZN according to Law No 905-III QD dated November 13, 2009. This change happened due to the state-guaranteed long-term loans of AZN 860,6 million issued by the Central Bank the State Oil Company and that of AZN 247,3 million issued to “Azeraluminium” JSC. Consequently, the amount of the internal debt of the country was AZN 1664,8 million on January 1, 2010 which is 4,5 times more than the amount on January 1, 2009. The loan issued to the above mentioned two companies through state guarantee made up 66,5% (AZN 1107,9 million) of the total amount of the internal state debt. Such a sharp increase in the amount of loans issued to state companies and corporations through state guarantee causes anxiety. It’s known that several state companies get into trouble paying back the loans they have received through state guarantee in

time. For instance, according to the information of the Accounts Chamber AZN 12,7 million was allocated to Caspian Sea Navigation Agency and AZN 11,5 million to “Azerbaijan Airlines” JSC from the loans with state guarantee issued by the reserve fund of the state budget of 2009 with the term of payback period of 8 years. In other words due to the trouble these agencies faced with paying back these loans the debt is loaded onto the state budget.

V. On non-compliance with budgeting procedures:

1. The submission form of annual report on 2009 state budget implementation to the Parliament: “a step forward and two back”. The annual report on 2009 state budget implementation alongside with three accompanying documents was submitted to the parliament members. The purpose of these accompanying documents prepared by the government is for the MPs to easily read and understand the report. Though the content of these documents is not fully satisfactory this step itself can be considered an improvement. However, the step backward in the submission of the report for the current year compared to the submission of the report on the implementation of 2009 state budget should be mentioned as well: last year for the first time the report on the annual budget implementation was submitted to the Parliament with the detailed information on the implementation of the state budget according to functional and economic categories. For some reason this year the government did not submit the details of budget implementation according to economic and functional categories to the Parliament. Such a step of the government when the budgeting process is expected to become more transparent and accountable cannot be left unnoticed by the civil society;

2. The government made a change to the approved forecast amount of the budget expenses without the consent of the Parliament. The report on the implementation of the state budget makes it clear that the forecasted amounts on 5 functional divisions approved by the Law of Azerbaijan Republic on “2009 State Budget of Azerbaijan Republic” were reduced (including education expenses for AZN 18,8 million, health expenses for 49,0 million, social defense and provision expenses for 35,0 million and cultural expenses for 0,5 million AZN) whereas the amount of the reserve fund of the state budget on services not included into the main divisions was increased by 103,3 million AZN, i.e., the amount of the mentioned decreases. This fact is stated as “corrected” budget in the report of the government on budget implementation. However no such change was made to the Law of Azerbaijan Republic on “2009 state budget of Azerbaijan Republic”. It should be mentioned that no changes were made to the information on the expected implementation of the budget of 2009 included into the budget portfolio submitted to the Parliament for the discussion of the state budget project for 2010. Besides all the forecasted amounts on all divisions except for the division of “other services not included into the main divisions” in the information on the implementation of 2009 budget expenses (page 56) in the Report on the work of the Cabinet of Ministers of Azerbaijan Republic in 2009. Hence, the change of the forecasted amounts happened not during the implementation of the budget, but rather during the preparation of the report on budget implementation after the budget year was over. The change does not match the requirements of Article 19.6 of the Law on “Budget System” either. The mentioned article considers the inclusion of the savings on funds with single appointment into the reserve fund of the state budget. The lack of any explanation in regards to these changes is an issue that causes anxiety;

3. The government applies different approaches towards changing (increasing or reducing) the approved forecast amounts of expenses. According to the requirements of article 18.5 of the Law on “Budgeting System” the expenses belonging to functional and economic categories (except for the defended expense articles) can be only reduced proportionately. However, as the report reveals the health expenses were performed for 21,0% less, education expenses for 15,2% less, those of industry, construction and minerals for 24,6% less and other expenses for 5-10% less in the state budget of 2009. Another example: the reduction of expenses on the subsidiary divisions of “Housing” and “Utilities” and the inclusion of this amount to the subsidiary division of “Other

services related to housing and utilities” resulted in the implementation of the latter for 46,8 times (!) more (AZN 20,4 million) than the forecasted amount (AZN 436,9 thousand). Such a sharp increase of any expense is not comprehensible from the view point of budget implementation discipline. Article 18.6 of the Law states certain limitation to the increase or decrease amounts of funds considered for the regulation of local revenues and expenses. There is need to apply limitation for the above mentioned cases as well;

4. Certain important issues are distorted in the report. According to the report “certain expense items of the budget were cut for 72,2 million AZN... in order to eliminate the possible tension during the implementation of 2009 state budget expenses and AZN 1,2 billion was not distributed and kept as a reserve fund during the distribution of state capital investment expenses”. The report also states that in total some AZN 1851,2 million was saved on 2009 state budget expenses. As is seen, the non-performance of budget forecasts and the implementation of budget incomes and expenses with a huge cut is attempted to be stated as “saving”. The report does not include the explanation of projects and expenses cut. For instance, some AZN 1,2 billion is said to be kept as a saving on state capital investments, whereas no detailed information is stated about the projects that will be stopped. The report does not state the justified explanation related to the education expenses cut for 205,1 million AZN and health expenses cut for AZN 107,2 million AZN compared to the forecast figures.

At the same time all analysis of the governmental report on budget implementation was carried out on the basis of “corrected” amounts which resulted in serious variations on certain divisions. For instance, if taken on the basis of approved forecast figures, the health expenses of the budget in 2009 turn out to have been implemented with 21,0% cut rather than 12,6% cut as claimed by the government. It’s quite interesting that neither the Accounts Chamber, nor the Parliament said anything in this regard. Even the analysis in the opinion of the Parliament on the report on budget implementation takes these “corrected” amounts of the government as basis;

5. The report reveals the existence of serious problems in budget implementation from the view point of requirements of unified budget classification. The information in the report reveals that projects with similar character and appointment got allocations from various functional and subsidiary divisions of the budget:

- i) it turns out that the practice of allocating funds from the divisions of “state capital investments”, “President’s reserve fund” and “State budget reserve fund”, as well as from other functional divisions to various infrastructure projects is quite widespread;
- ii) it’s not clear why the budget resources for ensuring the Presidential Decree dated December 29, 2009 on “the measures for removing the debts from the utilization of natural gas by the population” were allocated from the funds of state capital investment. On the top these amount is stated as an investment directed to other social fields;
- iii) the report states that certain funds were allocated to the renovation activities on “Heydar Aliyev” avenue from the subsidiary division of “other services related to housing and utilities” of 2009 state budget. Such renovation projects usually get allocations from the “Construction expenses” and the reason why the expenses for the renovation works on “Heydar Aliyev” avenue were included into “housing and utilities expenses” should be explained. The report does not state the organization that issued the order on these expenses;

6. 25% of the annual budget expenses was implemented during the last month of the year. The analysis of the quarterly reports on budget implementation shows that 29,9% of budget revenues and 38,9% of budget expenses were implemented during the last quarter of the year. The implementation of budget expenses per months causes anxiety. Hence, 25,3% (or ¼) of annual budget expenses was implemented during December which is the last month of the year. For the sake of comparison, 2,3% of budget expenses were implemented in January, 11,3% in February and about 5-8% per month for the remaining part of the year;

7. The annual report and corresponding law on 2009 state budget implementation of Azerbaijan Republic was accepted by the Parliament without being discussed. Despite the above mentioned problems related to the implementation of 2009 state budget that should have caused hot discussions at the Parliament, the acceptance of the report and of the corresponding law without any discussions once submitted cannot seem understandable. In general, the habit of the Parliament to accept the reports on the implementation of annual budget without any discussions upon the first hearing repeats every year. Such an indifferent attitude of the Parliament towards the annual reports on the implementation of the budget reduces the accountability desire of the government. The annual reports on the implementation of budget cause large and purposeful discussions at the parliament in various countries. These discussions do not only include the comparison of forecasted and implemented figures, but also the evaluation of the budget outcomes by the government and the comparison of the predicted and actual outcomes versus the resources utilized;

8. The opinion of the Chamber of Accounts on the annual report of the government on the implementation of 2009 state budget is not satisfactory. The opinion of the Accounts Chamber seems to be just an enriched form of the report of the government with additional analysis. This document too is based on the comparison of the forecasted and implemented figures, as well as the corresponding indicators of the previous year. Nevertheless, we should appreciate certain essential recommendations of the Chamber of Accounts in regards to the improvement of budget implementation. It's important that the opinion of the Chamber includes comments on the attitude of the government towards the recommendations of the Chamber on the previous years.

Recommendations for the improvement of budget accountability

The report of the government submitted to the Parliament on the implementation of 2009 state budget is quite problematic from the view point of public accessibility for most important budget information. NBO puts forward the following suggestions on the elimination of these problems, improvement of accountability and transparency:

1. It's advisable that the report is prepared on the basis of information on the implementation of economic expense items on subsidiary divisions and paragraphs of the budget;
2. The following should be added into the annual report on the implementation of state budget:
 - Information on the predicted and implemented income and expense figures – in a comparative form (stated separately for each region and city);
 - The full list of implemented investment projects with predicted and actual amounts, executor and contractor (as well as subcontractor) companies stated;
 - Information on the scope and types of budget funds (the fund for the reserve and recycling of state forests, the state reserve fund for the protection of the nature, etc.), the amounts of directions of expenses;
 - Information on the comparison of predicted and implemented figures reflecting the total amount of non-budget revenues and their amounts according to sources and organizations;
 - Information of the State Procurements Agency on the scope and prices of goods (services and activities) procured within the year by every budget client;
 - Indicators on revenues and expenses of state organizations which are large tax payers.
3. All budget clients should prepare detailed budget report on the utilization of budget funds and submit it to the parliament as a special attachment to the budget report;
4. It's essential that the report includes information on the specific directions of utilizing reserve funds and purposeful budget funds, as well as their amounts on economic items and organizations;
5. A special procedure should be developed for discussing the annual report on the implementation of the state budget at the parliament;

6. The content of the opinion of the Accounts Chamber on the annual government report on budget implementation should be enriched and adjusted for the requirements of real financial audit. The opinion of the Accounts Chamber should include the final outcomes of the annual budget functioning of the government and comments on the below mentioned issues:

- Purposeful and orderly utilization of state resources, as well as correct registration and accountability in this regard;
- Compliance of state authorities, as well as other organizations and enterprises that spend state funds with laws, regulatory instructions and rules;
- Effectiveness and efficiency of utilization of state budget funds; the effectiveness of the budgetary functioning of state bodies;
- The effectiveness of the internal control mechanism of organizations that utilize budget funds and their compliance with standards, etc.