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**Review
of the National Budget Group on
Amendments to 2010 State Budget**

Law on “Amendments to 2010 State Budget” was adopted by the Parliament on June 18, 2010 and came into force on July 3, 2010. Following the amendments income part of the budget was increased for AZN 1 490 million (14.9%) reaching AZN 11 505 million, whereas expenses were increased for AZN 1 011.3 million (9.0%) reaching AZN 12 275.3 million. Accordingly the budget deficit was decreased for 478.7 million and determined as AZN 770.3 million. Thus, the ratio of expected budget deficit to GDP decreased from 3.9% to 2.3%.

As for the reasons for amendments, the Government states the increase of incomes of State Oil Fund for AZN 1.9 billion more than the forecasted and the increase of flows to State budget from Taxation agencies for AZN 151.8 million.

National Budget Group, having investigated legal and economic aspects of necessity of making amendments to the State Budget, as well as the structure of amendments, has come to the following conclusions:

1. Legal, macroeconomic reasons and procedure for amendments

There are no legal grounds for budget amendments

Paragraph 7 of Article 96 of the Constitution of the Republic of Azerbaijan indicates that the laws and decrees should be justified and grounds for their adoption should be stated. Nevertheless, both Government Explanation on Law on “Amendments to Law on 2010 State Budget” and the Reference of the Chamber of Accounts on amendments lacked legal grounds for reviewing the budget and no reference was made to the law on “Budget System”.

According to Article 23.3 of the Law, if the actual flows on incomes and deficit financing during the state budget implementation falls behind the quarterly indicators, when there is a risk of disbalance between budget incomes and expenses and the harmony of budget execution, when appropriate executive power representatives are not capable of dealing with the mentioned situations, they can apply to the Parliament for reviewing the State Budget of the current year according to Paragraph 2, Article 109 of the Constitution of the Republic of Azerbaijan, not before May 15 and not later than October 15 of the current year.

It should be mentioned that the amendments to the budget can be made only in case the implementation of state budget incomes is less than the planned and the increase of the budget deficit. The amendments are made according to the quarterly figures. Despite this, information on state budget execution was submitted to the Parliament for only 4 months of the year, instead of separate quarters.

Thus, National Budget Group considers none of the above mentioned cases took place during the latest amendments to the State Budget; budget incomes were slightly different from the forecasted ones, the expenses were executed with deficit, no risk of disbalance between incomes and expenses and harmony of budget execution was observed.

Macroeconomic indicators did not serve as ground for budget amendments.

The main reason for the amendments to 2010 State Budget was indicated to be the macroeconomic changes that took place in January-April 2010 and the increase of budget incomes. However, in reality, increase of GDP in indicated period did not differ from forecasted much. Besides, budget incomes were executed only with 0,5% increase. Hence the forecasts of the Ministry of Taxes were executed with 11.7% surplus, whereas the transfers of the State Oil Fund with 8.6% deficit. Additionally, incomes of the budget for January-April of 2010 were less for 1.6% compared to the similar period of the previous year.

The budget expenses were executed with 15.1% deficit in January-April. The deficit covered all sections, including state investment expenses that were intended to be increased, economic activities, health and expenses on other services. Given such a situation it would be correct to ask the following question: how logical is it to increase the expenses on state investments and economic activities while they were executed with 20% deficit during the first 4 months of the year. On the other hand, the "necessary additional activities" can be realized through savings.

In regards to procedural tasks, the Parliament adopted budget amendments during a single session. Documents on amendments on 2010 State Budget were introduced to the Parliament on June 15, 2010. The documents were delivered to MPs, just 40 minutes before 16 June, 2010 sitting of Economic Policy and Agrarian Policy committees. The amendments were adopted just in a single reading of the Parliament on June 18, 2010. According to article 16 of the Internal Regulations of the Parliament, law projects should be discussed in 3 readings. If there's decision of the Parliament's Chairman or decision of the Parliament in protocol order, law projects can be considered at one reading. NBG investigation indicated to absence of such decision. Besides, article 8 of the Internal Regulations indicates law projects should be delivered to MPs at least 3 days before the session. In this case, the documents were submitted a day later than the due date. Thus NBG considers there were procedural breaches during the adoption of the law on "Amendments to Law on State Budget of 2010".

2. Budget incomes

Increase of budget incomes was fully provided by the oil sector. Only AZN 490 million of AZN 1490 million increase of budget incomes is planned to be provided through the budget, while AZN 1 billion through the State Oil Fund. AZN 320 million will be provided by profit tax payments of AIOC, AZN 120 million by export tax of the State Oil Company and AZN 50 million by increase of VAT due to SOFAZ transfers to budget expenses.

State oil Fund will deliver more than half of the budget incomes. Following the increase of State Oil Fund transfers of AZN 1 billion, their share in budget incomes will reach 51.4%. This will strengthen the negative tendency of 2009 (SOFAZ transfers left behind the tax incomes). Additionally, AZN 6482,4 million of AZN 8663.1 million of total SOFAZ incomes are intended to be spent in 2010. This indicator was decreased relatively, however the increase was absolute.

Dependence of the budget upon the oil factor will be more than 71%. The Government declared that AZN 3620 million of budget incomes will be provided by non-oil sector, and AZN 7885 million by the oil sector. Another task was the additional AZN 50 million VAT tax caused due to the SOFAZ transfers of AZN 1 billion to budget expenses. This means inclusion of AZN 5915 million of SOFAZ transfers into budget expenses will create AZN 295.75 million VAT tax. This indicates that the dependence of budget upon oil factor is not 68.5% as declared by the Government, but more than 70%.

The share of local incomes in State Budget remains minor. Another important change is the decrease of local incomes for AZN 30.8 million, and the increase of centralized expenses for regulating local incomes and expenses of AZN 30.7 million. This change is explained by the exclusion of several tax payers from the urban and regional tax agency registration and payment of taxes in a centralized way and its technical character.

However, in reality this is part of the policy on centralization of budget resources and increased dependence of local budgets upon donations. In adopted budget of 2010 the share of local incomes was decreased by 4.6%. This problem was already raised in the review of NBG on 2010 adopted budget.

After amendments the correlation between the centralized and local incomes became deeper. The share of local incomes will make 3.7% only, which is the lowest indicator for the past couple of years.

Increase of forecasts on oil prices will not affect the tax payments of SOCAR excluding the export tax. The per-barrel price oil in the state budget calculation was increased to USD 60 from USD 45. However, this change will influence increase of export tax of SOCAR only. However the excess of oil prices compared to forecasts, will definitely affect the amount of the profit tax and VAT tax. This indicates that SOCAR

payments to the Government are made through agreed obligations with the Government, rather than the accounting reports.

3. Budget expenses

The resources allocated for eliminating the damage of the flood are not based on precise calculations and corresponding execution programs. 300 million AZN out of 1011,3 million of the considered budget expenses will be spent for eliminating the damage in certain regions resulting from the flooding of rivers Kur, Araz and others, 608,5 million AZN on state investments, 99,3 million AZN on certain health programs and improvement of the material and technical base of science, on utility measures, on acquisition of buildings for the embassies and diplomatic representative offices abroad and other measures. It was expected that resources will be allocated for eliminating the consequences of the disaster in Sabirabad and adjacent regions resulting from the flooding of Kur and Araz rivers. Government representatives were stating the allocation of AZN 400 million and sometimes 500 million for this purpose. The government was expected to allocate additional resources from 2011 budget for this purpose. Despite the allocated amount of AZN 300 million for eliminating the consequences of the disaster, the government has no document or project in place on the scale of the damage or its elimination. Due to the fact that the resource allocated is not based on precise calculations and corresponding program, its utilization in an ineffective and non-transparent way can be observed.

Investments on defense field will be increased. The amount of state investments in 2010 state budget following the increase reaches AZN 4157,5 million which makes up 33,9% of the total budget expenses. 400 million AZN of the amount increased will be directed to defense and security field. The justification for this is "the improvement of the defense ability of the country and ensure its security in accordance with the geopolitical situation of the region where the country is situated". Though the explanation is not quite clear, the resources are known to be directed primarily to the investments in defense field. It should be mentioned that for the past 2 years the government has been including these expenses either into defense functional division or state investment expenses. For instance, in 2009 the defense expenses were reduced and the construction expenses of this field were included into the state investment expenses. Upon budget approval in 2010 the investments considered for the defense field were reduced for 3 times compared to 2009. The latest amendments consider the restoration of this cut. Thus, though the corresponding changes carry the purpose of capital investments into the defense field, their inclusion into investment expenses rather than defense expenses reduces the previous share of 10,7% of defense expenses in budget expenses down to 9,8%.

Allocations for infrastructure projects will be increased. The amount left from the above mentioned expenses will be spent on the resolution of urgent problems in the fields of science, health, education and social-defense, to the provision of Baku city with secure electric power and to the completion of certain transportation infrastructure

projects. One of the clear trends of the budget policy of the government is the increase of allocations for infrastructure projects as much as possible. At the same time, information on the directions of state investment projects and the values of the projects are not revealed to the Parliament and to the public. The list of state investment projects approved by the Cabinet of Ministers has been zealously hidden from the mass media and civil society representatives since 2009 with no legal basis. It should be mentioned that the civil society is remaining with its numerous questions on the effectiveness, transparency and corruption risks of state investment expenses.

The reform expenses in utilities sector have reached 109,5 million AZN. The "Economic activity" section of the approved budget of 2010 considered AZN 50,0 million as "Expenses related to the reforms in utilities and communication services". Upon the changes to the budget another 59,5 million AZN was added to these expenses (in other words twice as much) and the total amount reached AZN 109,5 million. The government's explanation includes no information about the directions for this allocation and about the reforms that are going to be carried out in this sector.

4. Budget deficit

One of the changes is the decrease of the expected budget deficit of 2010 state budget for AZN 478,7 million and its reduction down to 770,3 million AZN. The fact that the budget deficit was determined as 4% of GDP upon the acceptance of 2010 state budget was catching attention. The fact that the budget for 2010 included a deficit of 1249 million AZN whereas in 2007-2009 it was performed with a surplus was causing anxiety. However in its review on the approved budget of 2010 NBG stated that the fact that 701,4 million of the approved budget deficit will be covered by the credits issued by the international financial institutes for infrastructure projects meant that the actual deficit was AZN 547,6 million AZN. Following the amendments, the actual budget deficit will make up AZN 68,9 million with no problems expected in regards to its coverage.

5. Oil price and forecasts

The oil price used for the state budget and review budget calculations has been increased to USD 60 from USD 45. The update of the forecasts of state budget and review budget revenues is related to this change. This figure was stated as unreal upon the acceptance of 2010 state budget and the oil price was stated to be at least USD 60-65 in 2010. Also when 2010 state budget was undergoing approval the per barrel oil price was around USD 70. It should be mentioned that a year ago when 2009 state budget was approved by the Parliament, the oil price was taken as USD 70 whereas the international market price was only USD 50.

The sharp difference between the actual and forecasted performance of both oil price and separate expense and income directions of the budget, as well as the income and expense directions of the state budget and review budget for average term indicates

that the government is having problems with this field. One of the reasons for the yearly amendments to the budget during May-June is related to these problems, or to be more precise with the inaccuracy of forecasting.

5. Recommendations

Taking into account the mentioned issues, the National Budget Group recommends the following:

- It's important to improve the normative-legal base on budget review. The current legislation considers changes to the budget only in case the incomes are performed with deficit. Hence, the improvement should also include the cases of surplus revenues and this process should be regulated.
- The legal justification and purposes, as well as the references to the legislation should be stated in the corresponding reports of the government and in the review of the Chamber of Accounts.
- Accurate budget forecasting is very essential. The sharp difference between the actual and forecasted performance of both oil price and separate expense and income directions of the budget, as well as the income and expense directions of the state budget and review budget for average term indicates that the government is having problems with this field. One of the reasons for the yearly amendments to the budget during May-June is related to these problems, or to be more precise with the inaccuracy of forecasting.
- The government should formulate a long-term balanced and stable budget strategy. Once such a strategy is in place, the budget policy for the next year and for average term too can be built on the basis of this strategy and in this case it would be based on the reality.
- It's important to improve the efforts of the Chamber of Accounts and civic society in order to ensure the financial control and civic control over the resources allocated for the elimination of the damage in the regions resulting from the flood.

Baku city

July 16, 2010