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2021 state budget of Azerbaijan: independent view

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Center for Economic & Social Development (CESD), Baku

Reference: Gasimova, Narmina (2020). 2021 state budget of Azerbaijan: independent view. Baku, Azerbaijan : CESD Press, Center for Economic and Social Development (CESD).
https://cesd.az/new/wp-content/uploads/2020/12/CESD_Publication_State_Budget_Azerbaijan_2021.pdf.

This Version is available at:

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2021 State Budget of Azerbaijan: Independent View

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December 2020

Abstract

Restoring its territorial integrity, the Republic of Azerbaijan has entered a new era. The state authorities have to carry out restructure and infrastructure building tasks in the liberated territories to provide energy, utilities, transport infrastructure, and create conditions for life and business of citizens returning to their native lands. Therefore, one of the main features of the state budget for 2021 is the creation of financial security to implement the aforementioned honorable and responsible tasks. Along with their implementation, the budget for 2021 envisages the creation of financial guarantees for further improvement of the people's welfare, sustainable economic development, and implementation of state programs.

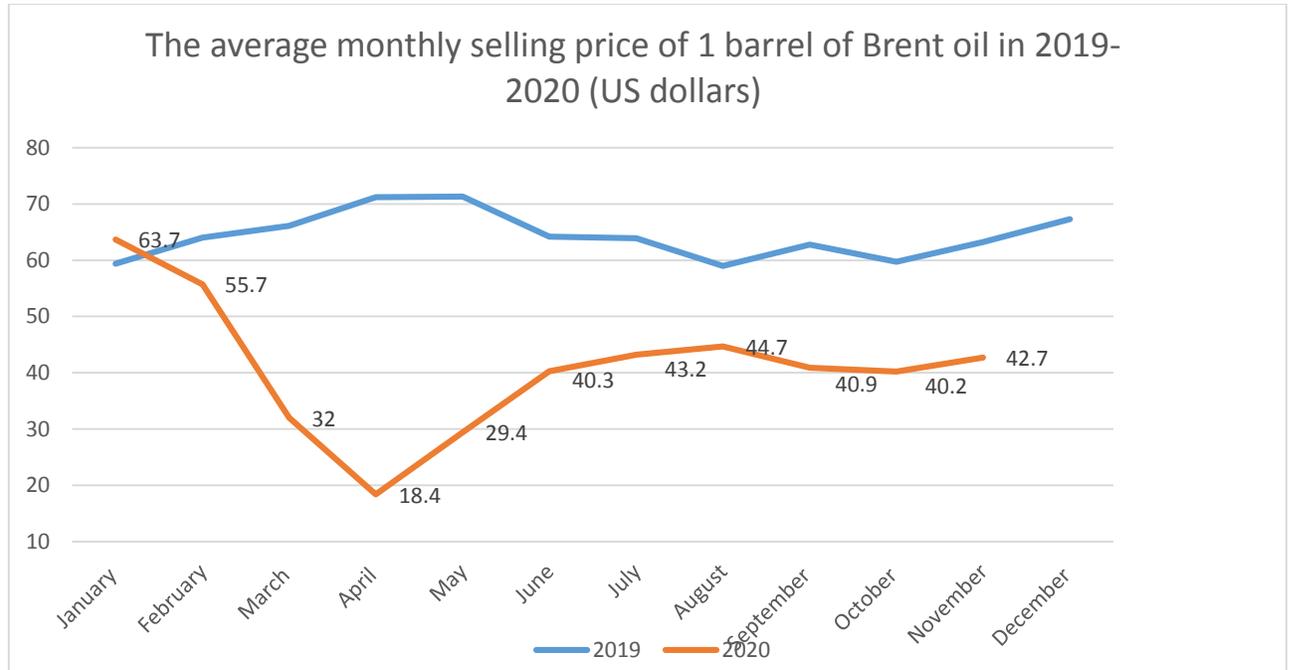
1. Introduction

The fundamental feature of the 2021 draft budget is that it has to be built on a victory basis. The novelty of the project is the introduction of the Medium-Term Expenditure Framework, which covers three sectors and, as a result, the transition to a result-based budget. Meantime, an increase in the number of funds allocated to all social areas has to be implemented, respectively. There is a necessity to mention several points in this regard. The project itself demonstrates that counter-fiscal policy will continue next year. At the same time, several international financial institutions consider this fiscal policy acceptable for the short term. Despite the wide range of financial buffers, it would be expedient to develop a strategy for the future transition from the counter-fiscal policy.

The world's leading financial institutions and oil price forecasting agencies predicted that the average price of Brent crude this year will be around \$ 40 per barrel and that there will be no sharp rise in oil prices, at least for next year. Thus, while calculating the budget revenues for 2021, the average price per barrel was designated at \$ 40. On the other hand, it might be considered risky in case if the pandemic expands. According to the calculations of the Ministry of Finance, if the price of oil falls from \$ 40 to \$ 35 per barrel, it will have an impact on the non-oil revenues along with the state budget revenues. Thus, as a result of the indirect effects of the decline in oil prices on the non-oil sector, non-oil revenue may decrease by 0.5%, while the state budget revenues may decrease by

1.3%. It leads to a question on the methodology and whether the effects on the State Oil Fund were taken into account.

Graph1. The average monthly selling price of 1 barrel of Brent oil in 2019-2020 (US dollars)



Source: *US Energy Information Administration, 2020*

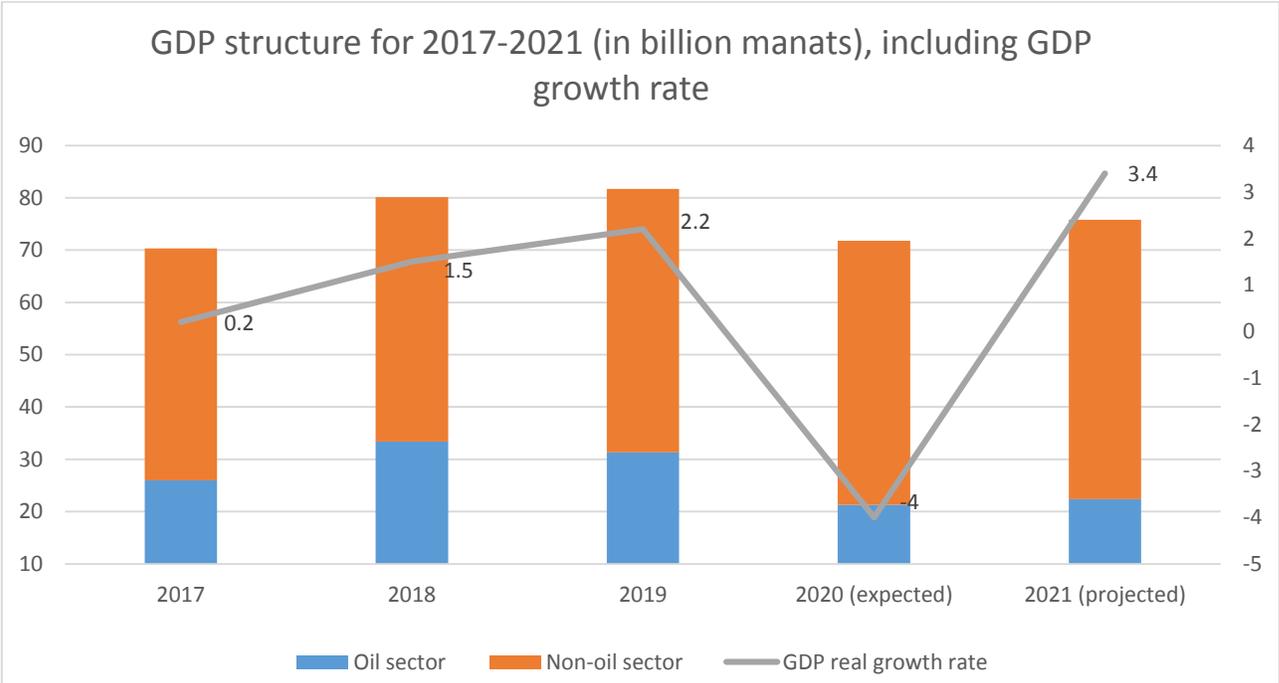
88.6% of the state budget revenues or 12.2 billion manat will be generated through transfers from the State Oil Fund of the Republic of Azerbaijan. Only 11.4 % or 1 billion 576 million manat are actual revenues from the oil sector, received through the tax authorities. 48% of total budget revenues will be generated from contributions to the fund.

It goes without a doubt that since the end of 2017, the economy of Azerbaijan has entered a significant stage of transformation following the challenges of the post-oil era. Therefore, the diversification of the economy has become one of the priorities for the government and its policies. [Bayramov and Orujova](#) have studied the consequences of the oil shock encountered in early 2014 and demonstrated how vulnerable the economy of Azerbaijan was at that time.

In this regard, it is worth mentioning that the difference between economic diversification and fiscal diversification will remain next year. Although the share of the non-oil sector in GDP will increase to 70.5 % in 2021, the share of the non-oil sector in budget revenues remain comparatively lower.

Only 45.8% of state budget revenues will come from the non-oil sector. In this regard, it is essential to expand measures to increase the share of the non-oil sector in the budget revenues in the future. The Ministry of Economy predicts that the economic growth rate will be restored in 2021, and GDP will increase by 3.4% in real terms to 75.8 billion manat.

Graph 2. GDP structure for 2017-2021 (in billion manat), including GDP growth rate



Source: *The State Statistical Committee of the Republic of Azerbaijan; Ministry of Economy of the Republic of Azerbaijan, 2020*

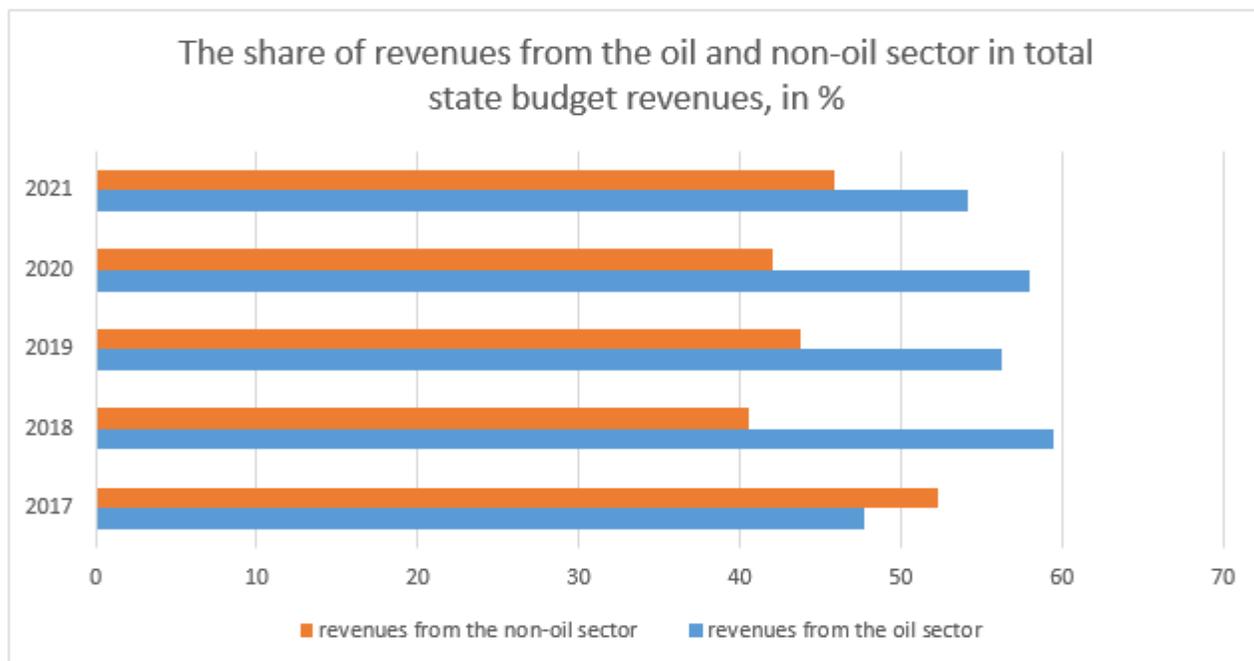
The project envisages the main priorities of a government in its fiscal policy direction, which is based on several key areas that include an established balance between budget revenues and expenditures, strengthening of a country's economic competitiveness, and stimulation of non-oil exports.

2. Revenues

On the background of a pandemic, weakened economic activity and decline in both trade turnover and aggregate demand have had a negative impact on the development of the country's economy. Therefore, the country had to apply a set of supportive mechanisms in order to main the economy and support businesses mostly affected due to an outbreak of a pandemic ([CESD Research team, 2020](#)). The main direction of revenue policy will be to increase non-oil revenues of the state budget. On this basis, minimizing the dependence of those who perform in the non-oil sector on shocks in the oil sector, expanding the geography and nomenclature of non-oil exports, increasing non-oil budget revenues will be considered important targets for medium-term revenue policy. Measures will be taken to strengthen the requirements for transparency and accountability in the activities of economic entities. Meanwhile, the tax base will be expanded, and tax administration will be improved, respectively. It is assumed that the development of relations between taxpayers and tax authorities based on mutual trust, ensuring timely and full payment of financial obligations, as well as the creation of favorable conditions for the payment of tax debts, will lead to a significant increase in fees in the medium term. The establishment of a tracking system to control the import, domestic production, turnover, wholesale and retail sales of goods will stimulate the formation of additional budget revenues. Additionally, special attention will be devoted to increasing the cost of large-scale construction and rehabilitation work in the liberated territories, which seem crucial from the perspective of potential investment opportunities.

In accordance with the data provided by the Ministry of Finance, revenues of the state budget for 2021 are projected at 25427.0 million manat, which compose 33.6% of GDP, while revenues of the consolidated budget are projected at 23828.1 million manat ([Ministry of Finance, 2020](#)). 54.2% or 13776.0 million manat of the projected state budget revenues for 2021 fall to the oil sector, while 45.8% or 11651.0 million manat relate to the non-oil sector.

Graph 3. The share of revenues from the oil and non-oil sector in total state budget revenues, in %



Source: *The Ministry of Finance of Azerbaijan Republic, 2020*

In addition, it has to be mentioned that revenues of the centralized state budget of the Republic of Azerbaijan for 2021 are formed from the following sources: customs duties, value-added tax, and excise duty when importing goods into the territory of the Republic of Azerbaijan (except for those collected by customs authorities of the Nakhchivan Autonomous Republic), proceeds from the lease of state property, proceeds from loans to foreign countries, dividends received from enterprises in which the state has a share and others.

3. Expenditures

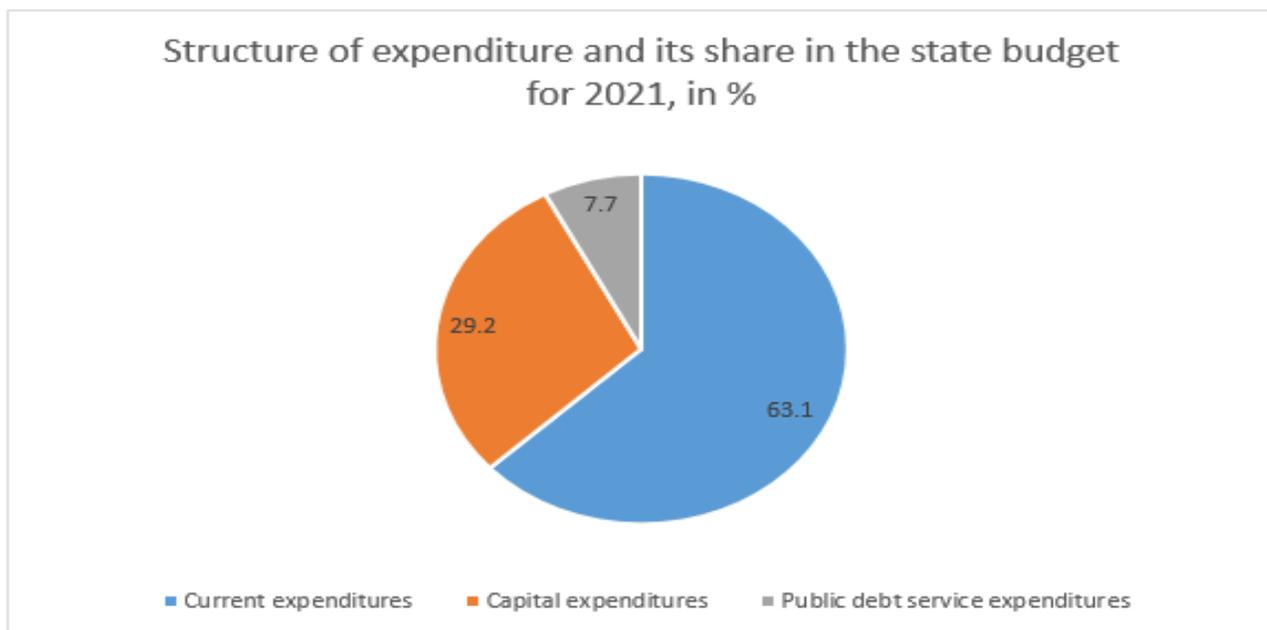
As it was mentioned above, particularly important trends were taken into consideration while preparing the draft budget plan for 2021, first and foremost of which is the large-scale reconstruction in the territories liberated from occupation. The second significant issue relates to the challenges that emerged on the background of the pandemic. Therefore, the global economic situation, along with the aforementioned trends, was taken into account. Moreover, it is worth mentioning that the main directions of expenditures are based on the strategically important documents of the country, including the recent decrees of the President of the Republic of Azerbaijan, along with strategic roadmaps for the national economy and its key sectors. Thus, along with the continuation of the main functions of the state (social security, health, education, defense and security, public debt service), state funds will be allocated in the following areas:

1. Elimination of the consequences of the war and reconstruction of the liberated territories, which include restoration of the infrastructure and support to improve the material and social situation of soldiers and the families of martyrs.
2. Measures to combat the COVID-19 pandemic, which include the strengthening of measures to control and prevent its further spread. At the same time, these measures include the acceleration of economic growth, the introduction of state support mechanisms in areas affected by COVID-19, along with the provision of state guarantees and loans to businesses.

In addition to the above-mentioned key areas, development of the non-oil sector, stimulation of the agricultural sector along with the formation of sustainable water supply for agricultural development was taken into consideration as well. Furthermore, in order to improve the population's living conditions, the state will continue to invest in the construction of social housing, as well as housing for vulnerable groups, including families of the disabled and martyrs.

Therefore, expenditures of the consolidated budget will amount to 31163.4 million manat, while the deficit will consist of 7335.3 million manat. Meantime, expenditures of the state budget for 2021 are projected at 28543.0 million manat (37.7% of GDP).

Graph 4. Structure of expenditure and its share in the state budget for 2021, in %



Source: *The Ministry of Finance of Azerbaijan Republic, 2020*

Current expenditures included in the structure of expenditures of the next year's state budget indicate 18014.0 million manat (63.1%) of total expenditures, 8330.3 million manat (29.2%) of capital expenditures, 2198.8 million manat (7.7%) of public debt service. Social expenditures of the state budget for 2021 (total expenditures on labor, pensions and benefits, medicines, food products) are projected at 11,111.9 million manat. The upper limit of the state budget deficit in 2021 is projected at 3116.0 million manat, while the ratio of the state budget deficit to GDP will be 4.1%. Taking into account the aforementioned details, a question related to the risk arises, respectively.

4. Fiscal Risks

The main parameters of the consolidated and state budget of the Republic of Azerbaijan are based on several assumptions (oil prices, the exchange rate of manat, etc.) and forecasts of socio-economic development for the medium term submitted by the Ministry of Economy of the Republic of Azerbaijan. Taking into consideration the possibility of these assumptions to be changed on the background of the impact of global economic challenges, the structure of consolidated and the state budget in terms of revenues and expenditures may change, respectively. Therefore, it seems quite

reasonable to take a deeper look at the current and possible challenges and evaluate the possible risks and strategies to combat them.

The first and foremost issue of concern relates to the pandemic and its impact on the economy. Taking into consideration the existing damage that was brought by it, the perspective for the future economic recessions reflect the necessity for the assessment. Moreover, the uncertainty of the duration of the pandemic remains one of the main challenges for the state budget in 2021. The possibility of the next wave of the pandemic and continuation of the long-term social isolation and support to entrepreneurs may create a need for additional funds. Thus, a necessity to meet expenditure needs through existing reserves or additional borrowing may arise, respectively. Meanwhile, it is hard not to notice that applied quarantine measures, closure of borders, and non-resumption of international flights have a negative impact on catering, tourism, and transport, creating a risk of further declining non-oil revenues.

On the other hand, it goes without a doubt that achieving an agreement between OPEC + countries to significantly reduce crude oil production in 2020, along with successful vaccination against COVID-19 in recent months, have had a positive impact on crude oil prices. The volume of transfers from the State Oil Fund of the Republic of Azerbaijan to the state budget, which is an important component of oil revenues of the state budget, does not depend on the price of oil and the exchange rate. However, falling oil prices could lead to a further depletion of the State Oil Fund's assets by reducing revenues.

With regards to the exchange rate risks, it has to be mentioned that despite the fluctuations in the exchange rates of major trading partners in 2020, high liquidity and stability of the manat exchange rate were maintained in the current year. At the same time, in the context of the continuing pandemic and tightening of quarantine rules, the application of soft monetary policy as an anti-crisis measure stimulates economic activity by easing credit conditions and satisfies liquidity needs in the foreign exchange market. However, the significant decline in aggregate demand of the population leads to excess liquidity in the foreign exchange market. In this case, the operations carried out by the Central Bank and the Ministry of Finance in the stocks and bonds market also prevent possible pressures in the foreign exchange market.

5. The upper limit of the state budget deficit and its financing

The upper limit of the state budget deficit in 2021 is projected at 3116.0 million manat, which indicates that the ratio of the state budget deficit to GDP will be 4.1 %, which is 0.6 percentage points less than in 2020.

It is worth mentioning that the deficit is expected to be met from the following sources:

- loans attracted on the basis of project financing in the amount of 610.0 million manat in accordance with the signed loan agreements,
- domestic and foreign borrowing in the amount of -1895.0 million manat,
- balance of the single treasury account of the state budget as of January 1, 2021, in the amount of 500.0 million manat,
- revenues from privatization in the amount of 111.0 million manat.

Conclusion

In connection with the transition to a qualitatively new stage of public finance management in our country, one of the priorities of the Azerbaijani government is to implement large-scale reforms to optimize public administration, including fiscal policy aimed at strengthening financial and debt discipline, as well as regular public disclosure of state and consolidated budgets.

The state budget for 2021 has been formed taking into account the environment of qualitatively new challenges, in order to ensure the financing of the main functions of the state.

Taking into account the COVID-19 pandemic and its negative impact on domestic economic growth, incomes and investment climate, as well as the increase in expenditures on health and welfare measures, counter-cyclical fiscal policy has been prioritized.

Therefore, as part of this policy, tax and other benefits have been provided to entrepreneurs, incentives and subsidies have been introduced to increase access to credit, direct financial assistance has been provided to vulnerable groups, and the growing health care needs of the COVID-19 disease have been met. For this purpose, the budget rule was suspended until 2022,

the state budget expenditures were revised and increased due to the amount of transfers from the State Oil Fund and the expansion of the budget deficit.

The main line of the next year's state budget will be to maintain the priority of social expenditures and support measures aimed at economic recovery while maintaining the current level of transfers to ensure public spending.

Thus, if to apply a detailed analysis of the draft budget for 2021, it becomes clear that in the following year, more oil share is expected in the budget. At the same time, there is a need to revise the policy of domestic debt and implement a switch from conservative to foreign. Nevertheless, it is hard not to notice the positive aspect, which reflects an increase in all social programs to 38.9% related to social expenditure.

Meanwhile, an analysis provided an opportunity to make a comparison and identifying the difference between 2020 and 2021, which reveals that even though a residue in the treasury remains, the Ministry of Finance has to step into domestic and foreign borrowing.

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