

AZERBAIJAN HAS STARTED IMPLEMENTATION OF FISCAL RULES

Summary

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Pro-cyclical budget policy is an essential threat for macroeconomic stability and its effects can be stabilized mostly with application of limiting fiscal rules. Implementation of pro-cyclical policies means that the government makes spending without any limitations and in the case of crisis it continues spending by lending money and by withdrawals from a savings account. Fiscal rules impose the following qualitative restrictions on the size of the public debt, budget deficit, level of spending (as percentage share of GDP, or as the share of rate of growth), volume of income (particularly the amount of transfers between different budget lines).

The necessity of applying fiscal rules in Azerbaijan was mentioned for the first time in the "Strategic Roadmap for the National Economic Outlook of the Republic of Azerbaijan", approved by the decree of December 6, 2016. According to the roadmap stabilization the transfer amounts from the State Oil Fund to the state budget based on the "golden rule" could protect the government spending from volatility of oil prices. The amendment to the "Law on Budget System" made by the parliament on June 29, 2018 formed the legal basis for the implementation of new fiscal rules.

Framework of fiscal rules for Azerbaijan:

- The upper limit of the budget spending for the next financial year should not exceed 103 percent of the approved consolidated budget spending for the current year;
- To determine the amount of oil revenues that could be spent, 20 percent of the difference will be defined between the total amount of oil revenues generated by the 30 percent of net financial assets at the beginning of the predicted budget year and the amount will be determined by summing the least of these two indicators;
- To determine the net financial assets, SOFAZ's assets, the single treasury account, and the sum of the foreign debt of the foreign countries to Azerbaijan will be summed up and the sum of the domestic and foreign public debt will be deducted from the result;
- The target of the consolidated budget for the next fiscal year is to reduce the non-oil deficit as a share of GDP in comparison to the current year;
- To calculate the upper limit of the consolidated budget spending, public debt, debt of the state enterprises (including loans backed up and not backed up by the state) are taken into account and based on this the medium-term debt and growth targets of state and public enterprises are determined.
- The implementation of the budgeting procedure in the execution process can be halted - for this the state budget revenues and current quarterly actual cash inflows for deficit should be at least 10 per cent of the quarterly approved indicators, or 5 per cent less than the quarterly approved indicators, excluding transfers of the SOFAZ to the state budget.

A number of following challenges in the global market and domestically over the past 10 years have prompted implementation of fiscal rules in Azerbaijan;

- **Sharp fluctuations in budget spending have occurred due to the volatility of oil prices.** Thus, depending on the dynamics of the oil prices in 2003-2018 the budget spending has increased to 75-80% and the level of budget spending decreased only between 5-6% annually.
- **There was a sharp disbalance between the growth rate of the economy and the acceleration of the budget spending.** While the growth rate in 2005-2013 has changed from 0.1% to 34.5%, budget spending accelerated between 9.9-77%. Only in the period of low oil prices between 2014-2017, the government has made significant budget cuts, which reduced disbalance between financial and real sector.
- **In the recent years, the ratio of savings by the Oil Fund has significantly declined.** The income flow of the State Oil Fund in 2005-2017 has been 121.6 AZN, of which 90.1 bil. or 74.1% of the total amount was spent and of 30.5 bil. or 25.9% of the funds were placed in the savings fund. In 2005, 64.7% and in 2007-2011 35-64% of the funds were directed towards savings. Starting from 2012, the ratio of the savings started to sharply decline and was 22.7% in 2012, 9.5% in 2013, 20.5% in 2014, 4.1% in 2016, and 9.2% in 2017.
- **The level of dependency on resource revenues was extremely high.** In 2005, the state budget's dependency on oil revenues was only 33.7%, and in 2012-2014 it increased to 74%. In 2015-2017, the share of oil revenues in the budget has declined in comparison to the previous years, as a result of plunge in oil prices and decline of income flows from oil sector. Over the past 3 years the share of the oil sector in the budget has been around 50%.

A thorough analysis of both risks and opportunities deriving from new fiscal rules should be conducted. Such preventive analysis is essential for the efficient application of these rules.

The opportunities of the fiscal rules for the economy:

- Restricting spending might create an opportunity for achieving expected results in transition to counter cyclical policies
- Limitation of state debt is an essential condition for decreasing macroeconomic risks

Possible risks of the fiscal rules for the economy:

- Savings for future generations might be possible only if the oil prices are at least 55 USD per barrel
- Economic justification for the impact of limited spending of oil revenues through the budget on the exchange rate's stability should be provided
- The pro-cyclical character of suggested formula for limiting income flow should be kept in mind
- The proposed budget rules may not necessarily lead to a lower dependency of the budget on oil revenues
- The formula for determining the share of oil revenues is directly dependent on the exchange rate of the national currency
- The legal requirements for stopping the budgetary rule in the financial year are fairly soft, and regular disruptions in the application of rules (as seen in practice of Russia) significantly reduce the impact of fiscal frameworks.

- Classification of public debt in determining the actual volume of oil revenues that can be spent suggested within the framework of the current legislation is not reliable.

Experience of various countries shows that creating a favorable institutional environment is a prerequisite for the effective implementation of fiscal rules. In this regard, the required institutional environment in Azerbaijan is the following:

- Inventory of government spending commitments should be conducted and most of the spending through the budget should be reconsidered, especially investments should be partially redirected to the private sector.
- There should be an enabling environment for the activities of civil society and think tanks to keep the budget under constant public oversight and the government should be open to cooperation with them.
- Implementation of the result-based budgeting mechanism should be initiated immediately and the transition to the use of quantitative and qualitative indicators in budget planning should be ensured by measuring the results of the activities of all enterprises that use the budget funds.
- It is necessary to increase competency of the parliament members over budget control; particularly making any changes to the budget without the parliament's consent should be limited to the minimum, budgetary priorities and mid-term spending frameworks should be defined by the parliament together with the representatives of the civil society and strict legal restrictions on derogations from priorities should apply.
- Strong legal restrictions should be set for reimbursement of debts of state owned entities from the state budget.
- The law should limit the maximum annual net debt (estimated budget expenditures, as a share of GDP), and the levels of maximum budget deficit (as a share of GDP).
- Changes to the budget rules and suspension of its implementation during a year should be restricted to a maximum.