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Current and Proposed Non-Oil Tax System in Azerbaijan

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Abstract

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This paper analyzes developments in non-oil tax policy, administration, and revenues in Azerbaijan, and suggests measures for further improvement. The main finding is that Azerbaijan's non-oil tax revenues increased significantly as a share of non-oil GDP in the last five years, but remain below potential. The non-oil tax revenue shortfall is mainly due to widespread exemptions, but there is scope for strengthening tax and customs administration. In the short term, expanding the tax base and better tax and customs administration will yield more revenues. In the medium term, more far-reaching reforms including reducing some direct tax rates, should be considered. The overall reform package could be made broadly revenue neutral by improving taxpayers' compliance and reducing exemptions.

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I. INTRODUCTION

Azerbaijan is experiencing a large but temporary oil production boom that presents unique opportunities for economic development, but also raises important fiscal challenges. At a time of abundant oil revenue, a key challenge is to ensure that the non-oil tax system operates efficiently and generates an adequate amount of revenues, while minimizing distortions in economic incentives. Continued efforts at improving the non-oil tax system, in the absence of pressing budget financing needs, are necessary to enable the government to sustain an adequate level of government expenditures by the time oil production starts its expected decline around 2011.²

This paper provides an overview of the key issues facing Azerbaijan's non-oil tax system and proposes some policy options to address them. Section II reviews developments in tax policy and administration that explain the significant increase in the ratio of non-oil tax revenue to non-oil GDP during the last five years. Section III analyzes the main deficiencies of the current system and assesses the sustainability of a strong non-oil revenue performance over the medium term. Section IV provides estimates of potential annual tax revenues from value-added tax (VAT) and customs duties for 2005–07, it also presents a tentative assessment of the revenue shortfalls resulting from existing exemptions and tax administration shortcomings. Section V suggests measures to improve the current non-oil tax system drawing on the theoretical models of optimal taxation, empirical evidence of the economic impact of various taxes, and the experience with tax reforms in the Baltics, Russia, and other countries of the former Soviet Union (BRO), as well as some Eastern European countries. Section VI concludes with the main findings and recommendations.

The paper recommends a phased implementation of the proposed tax measures. In the short term, the expansion of the tax base and the reduction of exemptions, together with further improvements in tax administration would yield higher revenues. In the medium term, once a robust revenue base has been established, the merit of reducing some direct tax rates on efficiency and equity grounds could be considered.

II. NON-OIL TAX REVENUE DEVELOPMENTS

After acceding to independence in 1991, Azerbaijan has made significant progress in setting a functioning tax system virtually from scratch. By 1999, it ranked well among other BRO countries in an international comparison prepared by Fund staff (Table 1).³ Moreover, continued efforts in later years, together with the buoyancy of the tax bases, led to an increase in Azerbaijan's non-oil tax revenues⁴ from about 20 percent of non-oil GDP in 2003 to about 32 percent in 2007 (Figure 1 and Table 2).

² This paper presumes that the non-oil tax revenue to non-oil GDP ratio should remain broadly unchanged over the medium term. The discussion of the adequate size of public expenditures is beyond the scope of this paper.

³ See Ebrill and Havrylyshyn (1999) and Summer and Baer (2003).

⁴ In this section, non-oil tax revenues include social security contributions (SSCs).

Table 1. Former Soviet Union Countries: Progress on Tax Policy 1/

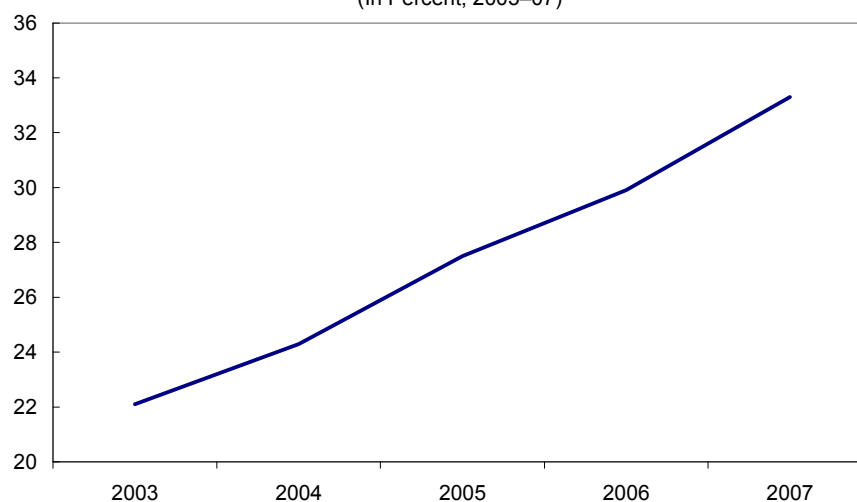
Country	Assessment of Degree of Policy Progress from 1992 through Mid-1998
Azerbaijan	3
Belarus	4
Estonia	1
Georgia	2
Kazakhstan	2
Kyrgyz Republic	3
Latvia	1
Lithuania	1
Moldova	2
Russia	4
Tajikistan 2/	3
Turkmenistan	5
Ukraine	3
Uzbekistan	4

Source: Tax Reform in the Baltics, Russia, and other countries of the Former Soviet Union; Occasional Paper 182, IMF, Washington 1999.

1/ Scale from 1 (high degree of appropriate market-oriented reform) to 5 (very little, if any, reform).

2/ Tajikistan subsequently adopted a new tax code that would move its score to 1.

Figure 1. Azerbaijan: Non-oil Revenues to Non-oil GDP
(In Percent, 2003–07)



Source: Azerbaijan authorities.

Table 2. Azerbaijan: Non-oil Tax Revenues, 2003-07 1/

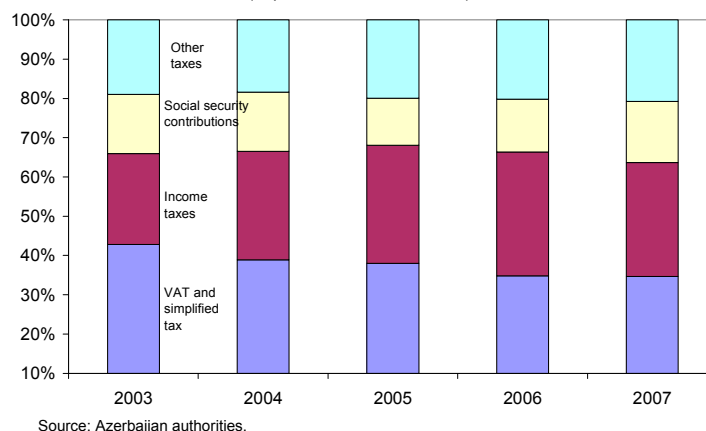
	2003	2004	2005	2006	2007	Average 2003-07
(In millions of manats)						
Non-oil tax revenues	837	1,024	1,454	1,905	2,984	1,641
Income taxes	228	333	496	693	1,024	555
Personal income tax	150	222	317	407	589	337
Corporate income tax	77	111	179	286	436	218
Value added	410	453	600	738	1,179	676
Domestic	266	281	346	386	644	385
Imports	144	171	254	351	535	291
Excises	67	72	141	187	403	174
Domestic	58	61	121	164	331	147
Imports	9	11	20	23	72	27
Land tax	11	14	15	19	27	17
Property tax	27	32	40	56	72	45
Simplified system tax	13	16	28	29	47	27
Customs revenues	59	77	101	139	159	107
State duties	22	25	31	33	51	33
Road fund	1	1	1	12	21	7
Social security contributions (SSCs)	149	182	198	294	551	275
Non-oil tax revenues and SSCs	986	1,206	1,652	2,199	3,535	1,915
(In percent of non-oil GDP)						
Non-oil tax revenues and SSCs	19.7	20.6	23.6	25.4	31.8	24.2
Non-oil taxes	16.7	17.5	20.8	22.0	26.8	20.8
SSCs	3.0	3.1	2.8	3.4	4.9	3.5
(In percent of total non-oil tax revenues and SSCs)						
Income taxes	23.1	27.6	30.0	31.5	29.0	28.3
Personal income	15.3	18.4	19.2	18.5	16.7	17.6
Corporate income	7.8	9.2	10.8	13.0	12.3	10.6
Social security contributions	15.1	15.1	12.0	13.4	15.6	14.2
VAT and simplified tax	42.8	38.9	38.0	34.9	34.7	37.9
Excises	6.8	6.0	8.5	8.5	11.4	8.3
Customs	6.0	6.3	6.1	6.3	4.5	5.8
Other	6.2	6.0	5.3	5.4	4.8	5.6
Total	100.0	100.0	100.0	100.0	100.0	100.0
Direct taxes	38.2	42.7	42.0	44.9	44.6	42.5
Personal income tax	15.3	18.4	19.2	18.5	16.7	17.6
Corporate income tax	7.8	9.2	10.8	13.0	12.3	10.6
Social security contributions	15.1	15.1	12.0	13.4	15.6	14.2
Indirect taxes	61.8	57.3	58.0	55.1	55.4	57.5
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Azerbaijan authorities; and IMF staff estimates.

1/ Excludes extrabudgetary revenues.

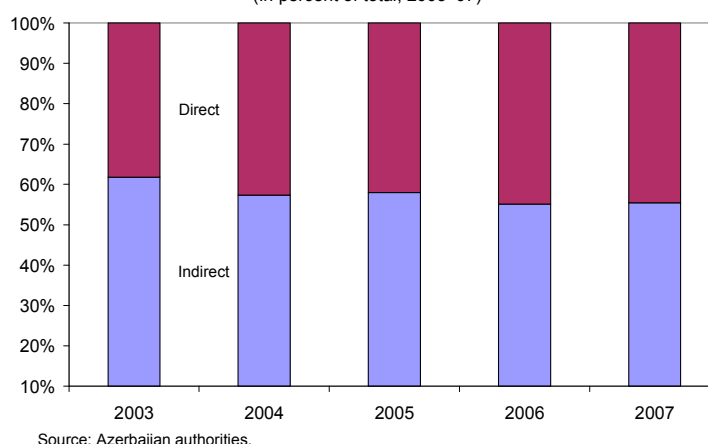
In the last five years, Azerbaijan's non-oil tax system has remained broadly unchanged. It has consisted mainly of the VAT, the simplified tax, income taxes, social security contributions (SSCs), excise taxes, and customs duties (Table 2).⁵ During this period, excise taxes were regularly increased, the corporate income tax rate was lowered from 24 percent to 22 percent in 2005, and the combined SSCs by employer and employee were reduced from 28 percent to 25 percent in 2004. During 2003–07, on average, the VAT contributed almost 38 percent of non-oil tax revenues, income taxes 28¼ percent, and SSCs 14¼ percent (Figure 2).⁶

Figure 2. Azerbaijan: Composition of Non-oil Taxes
(In percent of total, 2003–07)



The budget has become increasingly dependent on direct tax revenues (Figure 3). The decline in the share of indirect taxes in total non-oil revenues reflected mainly two factors. First, VAT frauds and evasion reportedly intensified during 2004–06 but declined afterwards (as discussed below). Second, total consumption—the base of the VAT—grew more slowly than the population's nominal incomes and corporate profits, which are the bases of the personal and corporate income taxes, respectively.

Figure 3. Azerbaijan: Direct and Indirect Non-Oil Taxes
(In percent of total, 2003–07)



Among indirect taxes, the share of VAT registered the largest decline in total non-oil revenues. It declined from 42¾ percent in 2003 to 34¾ percent in 2007. Moreover, compared with other oil-producing BRO countries, Azerbaijan's VAT collection was relatively low in 2006.

⁵ This is a turnover tax at rates of 2 to 4 percent collected from small taxpayers in lieu of the VAT.

⁶ In the rest of the paper, VAT revenues for Azerbaijan also include revenues from the simplified tax.

III. MAIN ISSUES OF THE CURRENT NON-OIL TAX SYSTEM

In the last ten years, the tax administration system has been significantly modernized.⁷ By 2004, the government implemented a number of reforms aimed at establishing a strong foundation for modern tax administration. The reforms included: (i) the enactment of a consolidated tax code; (ii) the establishment of a full service large taxpayers unit; (iii) the adoption of automated systems in several functions, and (iv) the creation of a taxpayers services program. Since 2005, the modernization process has continued with: (i) the tightening of the VAT registration controls; (ii) the implementation of an integrated computer system for all taxes; (iii) the introduction of electronic filing; (iv) the establishment of a one-stop shop business registration in early 2008; and (v) the strengthening of human resources management and performance measurement. Moreover, the building and office facilities of the Ministry of Taxes (MOT) have been improved.

The main tax administration problems related to VAT collection have been corrected in recent years. A widely used fraudulent practice consisted in the establishment of fictitious businesses with the sole purpose of requesting VAT refunds. Also, non-compliance with registration procedures was rather common. These problems have been tackled by cleaning up the VAT register, which resulted in a 50 percent reduction in the number of registered VAT taxpayers between 2005 and 2007. At the same time, registration controls were strengthened and a system of VAT bank accounts became effective on January 1, 2008.

On the other hand, customs administration shortcomings are estimated to keep collection of VAT on imports and customs duties below potential. Governance and administrative problems reportedly have contributed to significant tax evasion at customs. Against this background, the Customs Committee has implemented recently a “single window” facility for custom clearance and card payments, with a view to increase transparency in the implementation of the customs regulations and reduce the face to face interaction between importers and customs officials.

In addition, the non-oil tax system still suffers from widespread exemptions. The VAT tax base has been eroded through special regimes and exemptions. The special regimes favor firms participating in the production sharing agreements (PSAs) and joint ventures (JVs), many of which operate in the hydrocarbon sector. These firms receive inputs with a zero-rate VAT from suppliers. Each head company covered by a PSA or JV and each of its contractors and subcontractors receive a certificate that entitles them to acquire goods and services free of VAT. When a purchase is made, the enterprises merely provide a photocopy of the certificate to the supplier or to the customs agent in the case of imported goods. This framework jeopardizes the integrity of the tax system and makes it difficult to enforce compliance.

⁷ Azerbaijan’s progress and main issues in tax administration, as well as key recommendations for improvement, have been presented to the Azerbaijan authorities in two confidential Technical Assistance (TA) reports prepared by TA mission teams from the IMF Fiscal Affairs department in 2005 and 2008.

VAT exemptions extends beyond the special regimes granted to PSAs/JVs but their number has been declining. In early 2008, the exemptions list included some agricultural products, as well as imports of grains, pharmaceutical products, fertilizers, military equipment, aluminum ore, electricity, some food and paper items, and agro-leasing services.⁸

The existence of a possibly large informal economy significantly undermines non-oil tax collection. In Azerbaijan, many businesses operate in the informal economy and use mainly cash for payments. By precluding any records of their transactions, they cause a significant erosion of the tax base. Economic operators who fail to pay the VAT or the simplified tax are also likely to evade personal and corporate income taxes. The new one-stop registration facility, operated by the MOT, is expected to help reduce the size of the informal economy.

The outstanding tax policy and administration issues need to be addressed because the projected decline in oil revenues in the next decade may coincide with a slump in direct taxes. The corporate income tax collection is boosted through tax withholdings imposed on subcontractors working in oil-and gas-related construction projects, which are slowly coming to an end. The recent fast increases in personal income taxes and SSCs reflects in large part the rapid growth of public sector wages and pensions, which is not sustainable in the longer term. Even before oil production enters its expected declining path, around 2011, public expenditure increases on wages and pensions will need to be moderated in order to avoid a price wage inflation spiral and to keep the non-oil fiscal deficit on a sustainable path. The need for tighter macroeconomic policies, in turn, will limit the potential growth of the base of direct taxes.

IV. ESTIMATES OF THE VAT AND CUSTOMS REVENUE POTENTIAL

After presenting the qualitative analysis of the main sources of non-oil revenue losses, the next step is to quantify them. To this end, this section examines the revenue potential of the VAT and customs duties in order to provide reasonable estimates of the losses stemming from exemptions and shortcomings in tax and customs administration. This analysis was not extended to other taxes due to data limitations.⁹

In 2007, the VAT potential revenues are estimated at AZN 1,791 million or 16.1 percent of non-oil GDP. The difference between potential and actual VAT tax revenues represents the estimated VAT losses—about 31½ percent of potential VAT revenues. The losses have two components. The first one is attributable to the authorities' estimated losses due to exemptions, which amount to about AZN 503 million.¹⁰ The second component is attributable to the tax administration losses computed as the total losses minus losses due to exemptions. The VAT revenue losses due to shortcomings in tax administration are estimated at about 0.6 percent of non-oil GDP in 2007 compared to 2.4 percent of non-oil GDP in 2006.

⁸ See Cabinet of Ministers Ordinance No. 220 issued on December 30, 2007.

⁹ The estimates of revenue potential from VAT and customs duties were calculated on the basis of exemption rates and average statutory customs duty rate which have been assessed by the authorities.

¹⁰ The authorities' data show a decline in the share of exempt consumption from 32.0 percent of total consumption in 2004 to about 29.6 percent by 2006.

Table 3. Azerbaijan: Estimates of VAT Revenue Potential, 2005–07 1/

	2005	2006	2007
(In millions of manat, unless otherwise specified)			
VAT revenue base			
Final consumption (including VAT) 2/	6,582	8,443	11,148
Final consumption (excluding VAT) 3/	5,879	7,537	9,951
Total potential VAT revenues	1,058	1,357	1,791
Exemptions			
Exemption rate (in percent) 4/	30.0	29.6	29.6
Value of exemptions	1,974	2,499	3,300
Actual revenues			
VAT	600	738	1,179
Simplified tax (2 to 4 percent of turnover)	28	29	47
VAT plus simplified tax	628	766	1,226
Estimated revenue losses			
Revenue losses due to exemptions	301	381	503
Revenue losses due to tax administration problems	129	209	62
Total revenue losses	430	590	565
In percent of potential VAT	40.7	43.5	31.6
In percent of non-oil GDP	6.1	6.8	5.1
Memorandum item (annual growth rate):			
Final consumption (including VAT)	12.3	28.3	32.0
VAT and simplified tax revenues	33.9	22.1	59.9
Non-oil GDP	19.5	23.6	28.6

Source: Azerbaijan authorities.

1/ The VAT revenues do not include revenue collected by the Nakhichevan Autonomous Republic, which are excluded from the budget.

2/ IMF staff estimates.

3/ Final consumption excluding VAT = Final consumption * $\left[\frac{(1-\text{exemption rate}/100)}{1+0.18}\right]$ + (exemption rate/100).

4/ Provided by the Ministry of Taxes.

Revenue losses from customs duties increased in 2007 and accounted for a rising share of potential revenues (Table 4). The assessment of the customs duties' revenue potential is based on non-oil imports. Using the reported average statutory customs duty rate of 5.7 percent, potential revenues from customs duties in 2007 are estimated at about AZN 233 million or 2.1 percent of non-oil GDP.¹¹ The difference between potential and actual customs duty revenue (AZN 73 million) represents the estimated revenue losses. Based on official estimates, from customs duties, hence the corresponding revenue losses would have amounted to AZN 42 million. The difference between the total estimated losses and those due to exemptions can be ascribed to shortcomings in customs administration. The customs administration losses are estimated at about AZN 31 million (or 0.3 percent of non-oil GDP) in 2007 compared to AZN 8 million (or 0.1 percent of non-oil GDP) in 2006. These estimates do not capture the effects of possible underinvoicing of imports.

¹¹ The customs authorities noted that the average statutory customs duty rate declined after 2004. However, the new rate has not been made available to IMF staff.

Table 4. Azerbaijan: Estimates of Customs Duties Revenue Potential, 2005-07

	2005	2006	2007
(In millions of manats, unless otherwise specified)			
Customs duties base			
Non-oil imports	2,290	3,148	4,080
Total potential revenues at an average statutory rate of 5.7 percent 1/	131	179	233
Value of exempted imports 2/	417	573	743
Custom duties revenue	101	139	159
Estimated revenue losses			
Revenue losses due to exemptions	24	33	42
Revenue losses due to tax administration	6	8	31
Total revenue losses	30	41	73
In percent of potential revenues	22.9	22.8	31.5
In percent of non-oil GDP	0.4	0.5	0.7
Memorandum item:			
Average effective custom duty rate (in percent)	4.4	4.4	3.9

Source: Azerbaijan authorities; and IMF staff estimates.

1/ The statutory rate (5.7 percent) was provided by the Customs officials. They indicated that this rate declined after 2004, but the new estimated rates have not been made available to the Fund staff.

2/ The exemption rate (18.2 percent) for 2006 was provided by Customs officials and is subject to revision.

A constant exemption rate was assumed during 2005-07.

V. REFORMING THE NON-OIL TAX SYSTEM

A. Short-Term Measures

In the short term, tax revenues should be brought closer to their potential by reducing exemptions and phasing out special regimes (Box 1). Specifically, the authorities need to quantify the fiscal cost of existing exemptions and special tax regimes and specify their intended time span. Bringing more transparency to the process of granting tax privileges will help mobilize political support for reducing the number of exemptions and phasing out the special tax regimes. This could be done, for example, by making public the name of the individuals or firms enjoying the tax benefits. The VAT system, in particular, can be improved by phasing out the special tax regime for PSAs and JVs. It would be preferable to request that suppliers charge the VAT in the usual way and to provide the PSAs and JVs with a timely refund.

Box 1. Short-Term Recommendations

In the short term, Azerbaijan's non-oil tax system could yield more revenues if the tax base is expanded through a reduction of exemptions and better compliance with the VAT, customs duties, and other taxes. The following measures, most of them suggested by tax experts from the IMF that have been providing technical assistance to the authorities over the last few years, could help to achieve this objective without changes in the tax rates

- Quantifying the cost of exemptions, submitting proposal for new exemptions to Parliament for approval, and indicating their time span.
- Strengthening customs administration, by eliminating the ad-hoc implementation of regulations and reducing direct contacts between customs officials and importers.
- Strengthening the voluntary compliance and the basic conditions needed for an effective system of self-assessment.
- Introducing more targeted risk-management approaches for audits.
- Developing an effective fraud intelligence network that gives early warning of potential fraudulent and evasion activities.
- Reducing the cost of compliance by simplifying the procedures and reducing the frequency of filing.
- Strengthening governance and performance, including refinement of outcome reporting and measuring an agreed set of key performance indicators (such as measuring client satisfaction).
- Building the capacity to deal with complex compliance issues (e.g., transfer pricing and oil-related tax issues, particularly those associated with PSAs).
- Improving the quality of tax statistics for analytical purposes.

Regarding tax administration, the priorities are

- Implementing risk management approaches to improve compliance within key taxpayer segments.
- Reducing the compliance costs of doing business in meeting tax obligations.
- Shifting toward a modern system of self-assessment (Box 2).

Regarding customs administration, the priority is to continue with the on-going simplification of customs procedures and modernization of the regulatory framework.

This includes putting in place a new Customs Code, currently under preparation, as expected in the context of WTO accession.

Box 2. Conditions for an Effective Self-Assessment System¹

Several conditions need to be met to operate a self-assessment system successfully:

Simple tax laws. For the taxpayers to comply with the tax laws, it is first necessary that they understand their obligations. Complex tax laws can significantly increase the taxpayers' compliance costs. These laws often result in a low level of tax compliance. Simple tax laws should provide for their uniform application to all categories of taxpayers involved in similar activities within the territory of a given country. They should also provide for limited exemptions, a simple rate structure, appropriate registration thresholds, and simplified taxation systems to deal with small taxpayers.

Services to taxpayers. A major responsibility of the tax office is to assist taxpayers to meet their obligations. Taxpayers must receive clear information describing their obligations, the taxes applicable, and when and where taxes are payable. They need to be informed in advance of changes to the laws and they should have easy access to information and tax forms. The tax administration must ensure that the laws are interpreted consistently by its officials and that once a ruling is provided on a given set of facts, that ruling will be binding on the tax administration, unless there is a material change in the facts provided by the taxpayer.

Filing and payment procedures. Tax forms should be simple, have clear instructions, and be submitted through means convenient to taxpayers.

Collection enforcement. Prompt detection of taxpayers that fail to submit tax returns and/or pay the tax due is critical to improve tax compliance. Collection enforcement must be prompt and expeditious. The older the debt, the more difficult it is to collect. Therefore, the collection enforcement staff must be able to start administrative actions quickly, especially against large taxpayers.

Audit. Taxpayers must know that if they fail to comply with the tax laws, they face a reasonable risk of being detected. The tax office must have sufficient resources to audit a reasonable percentage of taxpayers each year to effectively increase the risk of detection of noncompliance. Taxpayers must also comply with requirements to maintain business records and issue invoices, and be liable to appropriate sanctions when they do not comply with these obligations. As needed, simplified bookkeeping obligations need to be implemented for small taxpayers.

Penalties. Noncompliers must know that if they are detected, they will be punished, and that penalties will be strictly and uniformly applied. It is important to draw a distinction between interest and penalties: while penalties are imposed as sanctions for violations of the law, interest is intended to compensate for the time the taxpayer has used the government's money. Non-financial penalties (such as temporary closure of businesses) should also apply where taxpayers do not comply with requirements to maintain business records and issue invoices. Moreover, tax fraud should be prosecuted through the criminal justice system.

Access to independent review of decisions. While a tax administration must have effective powers to detect and sanction noncompliance, it is also important that taxpayers have access to an appeal process to protect their rights. When a taxpayer disagrees with the results of an assessment, he must have access to administrative and judicial processes for the resolution of any dispute with the tax office.

¹ This Box was presented to the tax authorities of Azerbaijan as part of a technical assistance report by the IMF Fiscal Affairs Department.

As part of this short-term agenda, the availability and quality of the tax data must be further improved. The financial and accounting reporting practices of many individuals and firms in Azerbaijan make it difficult for the authorities to generate reliable and detailed tax statistics. In the current environment, it is challenging to quantify the impact of tax measures. The mandatory implementation of the International Financial Reporting Standards starting in 2008, would provide a good basis to assess the economic impact of tax policy if the new reporting standards are effectively enforced.

B. Medium-Term Measures

Once the tax base has been expanded and the effectiveness of tax and customs administration has strengthened further, more far-reaching tax reforms could be considered.¹² In particular, tax reforms should aim at maintaining revenues close to their full potential; minimizing economic distortions associated with taxation; and improving the equity and simplicity of the tax system. To this end, the composition of non-oil revenues, currently skewed in favor of direct taxes, should be reviewed by weighing the relative advantages and disadvantages of indirect and direct taxes in Azerbaijan.

Theoretical considerations

Theoretical models consider consumption taxes (e.g., VAT) more efficient (or less distortionary) but less equitable than direct taxes.¹³ This is because, unlike direct taxes, the VAT induces fewer distortions in decisions on investment and saving and choices between work and leisure that could negatively affect growth. However, the VAT is often considered inherently regressive, because it is normally collected at a single rate, as it is impractical to implement graduated tax rates on consumption.

In theory, direct taxes (e.g., personal and capital income taxes) are more equitable but less efficient than indirect taxes. Regarding distributional considerations, in principle, these taxes can make the tax system more equitable by imposing higher tax rates on the higher-income taxpayers. In practice, however, this progressivity is seldom achieved in developing countries due to widespread tax exemptions and deductions provided to the higher-income groups.¹⁴ These exemptions and deductions erode the tax base, increase the cost of tax assessments, foster tax avoidance, and reduce compliance. With respect to efficiency considerations, an increase in direct taxes, under reasonable assumptions, negatively impacts economic growth by reducing the incentives to work, save, and invest.¹⁵

In many theoretical settings, corporate income taxes reduce the return on capital and negatively affect investment. Moreover, they are normally accompanied by the use of exemptions, special regimes, or sector-specific incentives. These tax benefits tend to favor the

¹² For a discussion of the main features of a good tax system see Tanzi and Zee (2000).

¹³ See Ebrill, Keen, Bodin, and Perry (2001).

¹⁴ See Tanzi and Zee (2000).

¹⁵ See Auerback (2003).

largest firms, which have more resources to lobby for them, and greater incentives for tax avoidance and evasion.

Empirical findings

The empirical evidence on the impact of several taxes on growth is mixed.¹⁶

- **Consumption taxes.** The results are inconclusive regarding the impact of consumption taxes on growth. Consistent with the theoretical models, several studies found no negative impact of such taxes on employment and growth.¹⁷ However, others found some instances in which consumption taxes could have a negative impact on growth by reducing savings.¹⁸
- **Direct taxes.** For the advanced countries, several studies suggested that high personal income taxes have a negative impact on growth.¹⁹ It is also found that taxation of capital income is generally negatively correlated with savings and investment rates.²⁰ This, in turn, could also have a negative impact on growth. Cross-country studies found that corporate income taxes have a negative impact on growth in advanced countries. However, the results did not hold for middle-income countries, possibly reflecting measurement problems.²¹

Proposed measures

There is merit in changing the structure of non-oil taxation in Azerbaijan. In light of the theoretical considerations and empirical evidence broadly in favor of indirect taxes, the Azerbaijan authorities may need to consider boosting the share of indirect taxes in total revenues by reducing exemptions and further improving compliance with these taxes. Given the significant scope for improving the collection of indirect taxes (up to 6 percent of non-oil GDP) and direct taxes as well, lowering direct tax rates could be revenue neutral. Lower rates of direct taxes would also help counter tax competition from neighboring countries. In fact, by regional standards, tax rates on personal and corporate incomes are relatively high in Azerbaijan (Tables 5, 6 and 7).

¹⁶ The summary discussed here was published in Poirson (2006).

¹⁷ See Daveri and Tabellini (2000) and Kneller, Bleaney, and Gemmel (1999).

¹⁸ See Tanzi and Zee (2000).

¹⁹ See Daveri and Tabellini (2000).

²⁰ See Mendoza, Razin and Tesar (1994).

²¹ See Blankenau and Tomljanovich (2004).

Table 5. Azerbaijan: Non-oil Tax System, 2006
(Rates in percent)

General Income Tax Rates	Personal allowances 2/	Corporate Tax Rates	Treatment Interest and Capital Gains of Dividends 1/	Social security contributions		VAT
				Employer	Employee	
14-35	AZN 100-750	22	10 Interest is not taxed; Capital gains taxed as ordinary income	22	3	18

Source: Azerbaijan authorities.

1/ A 10 percent withholding is imposed on the dividend paid by a resident enterprise.

2/ By Presidential order, personal allowances are granted mainly to families of war victims.

Table 6. Current Flat Taxes^{1/}
(Rates in percent)

Country	Year Adopted	Personal Income Tax Rates		Corporate Income Tax Rate, after the Reform	Change in Basic Deduction
		After the Reform	Before the Reform		
Estonia	1994	26	16-33	26	Modest increase
Lithuania	1994	33	18-33	29	Substantial increase
Latvia	1997	25	25 and 10	25	Slight reduction
Russia	2001	13	12-30	37	Modest increase
Ukraine	2004	13	10-40	25	Increase
Slovak Republic	2004	19	10-38	19	Substantial increase
Georgia	2005	12	12-20	20	Eliminated
Romania	2005	16	18-40	16	Increase
Average		20		25	

Source: The "Flat Tax (es)": Principles and Evidence by Michael Keen, Yi Tae Kim, and Recard Varsano, IMF WP/06/218.

1/ Rates relate to year before and after adoption of the flat tax.

Table 7. Summary of the Flat Tax Systems
(Rates in percent)

Estonia	General Income Tax 1/		Corporate Tax and Dividends 2/		Interest and Capital Gains		Social security contributions		VAT
	Rates	Personal allowances	Rates	Treatment of dividends			Employer	Employee	
1994	26	EEK 3,600 3/	26	Exempt	Interest: 10 percent final withholdings, 4/ Capital gains usually taxed as ordinary income		33	zero	18
1993	16, 24, 33	EEK, 2400	33	NIA	Capital gains usually untaxed		33	zero	18
1/ Retained profits untaxed from 2000, and distributions taxed at the general rate. 2/ General rate of tax on labor and corporate income 24 percent in 2006; to be reduced by one point each year to 20 percent in 2009. 3/ Inter-company dividends carried a tax credit at 26/74 percent. (From 2005, inter-company dividends are exempt.) 4/ Interest income from credit institutions untaxed in 1994; non-exempt interest taxed at 24 percent in 2006.									
Lithuania	General Income Tax		Corporate Tax and Dividends 1/		Interest and Capital Gains		Social security contributions		VAT
	Rates	Personal allowances	Rates	Treatment of dividends			Employer	Employee	
1994	33	LTD 115	29 2/	No withholding system	Capital gains taxed as ordinary income		30	1	18
1993	10, 18, 24, 28, 33	LTD 35	29	NIA	NIA		30	1	18
1/ Corporate tax rate 15 percent in 2002; personal tax rate remains at 33 percent. 2/ 10 percent reduced rate was introduced for retained earnings in 1994 and it was reduced to zero in 1997.									
Latvia	General Income Tax		Corporate Tax and Dividends		Interest and Capital Gains		Social security contributions		VAT
	Rates	Personal allowances	Rates	Treatment of dividends			Employer	Employee	
1997	25	LVL 252, plus 126 for spouse and per child	25 1/	No change	No change		33	5	18, 9
1996	25, 10	LVL 270, plus 138 for spouse and per child	25	Dividends paid by Latvian company exempt	Dividends paid by Latvian bank exempt		37	1	18, 9
1/ Corporate tax rate 15 percent in 2006; personal tax rate remains at 25 percent.									
Russia	General Income Tax		Corporate Tax and Dividends		Interest and Capital Gains		Social security contributions		VAT
	Rates	Personal allowances	Rates	Treatment of dividends			Employer	Employee	
2001	13	RU 4,800	31 1/	30 percent withholding with credit for underlying CIT 2/	Interest: 13 percent, except 35 percent on "excessive" bank interest; Capital gains: taxed as ordinary income		Marginal rates decreasing from 35.6 to 5 percent	Zero	20, 10
2000	12, 20, 30	Ru 3,168	30 15 percent final withholding	Interest: 15 percent final withholding; Capital gains: taxed as ordinary income			38.5	1	20, 10

Source: The "Flat Tax (es)": Principles and Evidence by Michael Keen, Yi Tae Kim, and Recard Varsano, IMF WP/06/218.

1/ Combined federal and provisional rate remained at 30 percent, but municipalities were allowed to charge an additional 5 percent.

2/ A withholding agent may apply the 13 percent rate if the recipient is a Russian resident.

The tax reforms undertaken by some BRO and Eastern European countries provide good examples for revamping the non-oil tax structure in Azerbaijan.^{22,23} The reforming countries in the region put emphasis on simplifying their tax systems. Specifically, Russia, Ukraine and Georgia scaled down exemptions to broaden the tax base, and all of the reforming countries listed in Table 7 implemented flat income taxes. There is evidence that after these reforms compliance has improved, particularly in Russia, and better compliance has brought positive distributional effects.²⁴ This is because a flat and lower income tax rate provides high-income taxpayers with less opportunities and incentives for tax evasion and avoidance.

Suggested tax reforms for Azerbaijan

- **Simplification of the tax system**
 - In many BRO and Eastern European countries, the tax system was simplified by curtailing exemptions and establishing a single rate income tax. In some of these countries, the single personal income tax rate is different from the single corporate income tax rate. In Estonia, however, consistent with best practice,²⁵ the tax system has a single and unified personal and corporate income, and dividend tax rate. In the Slovak Republic, the tax system has a single and unified personal and corporate income tax rate and VAT rate.
 - In Azerbaijan, there is a single corporate income tax rate and multiple personal and capital income tax rates. All of these rates could be unified into a single rate.
- **Reduction of the direct tax rates**
 - In most BRO and Eastern European countries, the personal and corporate income tax rates and the SSCs were lowered.
 - In Azerbaijan, the personal and capital income tax rates range from 14 to 35 percent. These could be unified with the existing single corporate income tax rate, at a level equal to or below the current 22 percent. The SSCs rate, at 25 percent, is broadly in line with those in other BRO countries and could remain unchanged.²⁶

²² See Keen, Kim, and Varsano (2006).

²³ This group includes countries with very different per-capita income levels, progress with market-oriented policies, and institutional development (Table 6).

²⁴ See Keen, Kim, and Varsano (2006).

²⁵ See Tanzi and Zee (2000) p. 16.

²⁶ Changes in social security contribution rates should only be considered in the context of a wider reform of the social security system.

- **Indirect taxes**

- In other BRO countries, the VAT was kept at the rate in effect before the tax reform (18 percent in most countries).
- In Azerbaijan, the VAT rate is 18 percent and no changes are suggested.

VI. MAIN FINDINGS AND RECOMMENDATIONS

The main finding of this paper is that Azerbaijan's non-oil tax revenues increased significantly as a share of non-oil GDP in the last five years, but remain below potential. The non-oil revenue shortfall is mainly due to widespread tax exemptions, but there is still scope for strengthening tax and customs administration. Looking forward, the recent buoyancy of the direct taxes does not seem to be sustainable over the medium term, and both oil and non-oil revenues may start to decline relative to non-oil GDP in the next decade.

Given large revenue shortfalls and uncertain medium-term prospects for non-oil revenue mobilization under the current tax regime, tax policy and administration need to be reassessed. In the short term, expanding the tax base by reducing exemptions, phasing out special tax regimes, and strengthening tax and customs administration will yield more revenues. In the medium term, once the tax base has been expanded and revenues stabilized close to potential, the authorities may wish to implement more far-reaching reforms, following the example of other BRO and Eastern European countries. In particular, the merit of reducing some direct tax rates on efficiency grounds should be considered. The overall reform package could be made broadly revenue neutral by improving taxpayers' compliance and reducing exemptions.

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