

**IMMEDIATE
ATTENTION**

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To: Members of the Executive Board

From: The Secretary

Subject: **Azerbaijan Republic—Report on Observance of Standards and Codes—
Fiscal Transparency Module**

The attached report on the observance by Azerbaijan Republic of the standards and codes fiscal transparency module by Azerbaijan Republic was prepared in the context of the last Article IV consultation discussions with Azerbaijan Republic (EBS/99/102, 6/16/99). A summary of this report was included in EBS/99/102.

It is expected that this report will be published on the Fund's external website at the beginning of January 2001.

Questions may be referred to Mr. Potter (ext. 35669) and Mr. Allan (ext. 38542).

Att: (1)

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INTERNATIONAL MONETARY FUND

AZERBAIJAN REPUBLIC

**Report on the Observance of Standards and Codes (ROSC)
Fiscal Transparency Module**

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November 13, 2000

EXECUTIVE SUMMARY

This report provides an assessment of fiscal transparency practices in the Azerbaijan Republic in relation to the requirements of the IMF *Code of Good Practices on Fiscal Transparency—Declaration on Principles* based on the authorities' response to the IMF fiscal transparency questionnaire and other documents provided by the authorities.

Some important steps have been taken to improve fiscal transparency in the Azerbaijan Republic in recent years, but many key weaknesses remain. Recent improvements include expanded coverage of the budget and the creation of the central treasury, which has enhanced expenditure control and the quality and timeliness of fiscal reporting. The new tax code and improvements in tax administration should raise the level of transparency in the tax system. A major weakness is the absence of an external audit function, though efforts are underway in this area. The intertwining of public and private sector responsibilities in government institutions creates conflicts of interest, and quasi-fiscal activities through state-owned enterprises are widespread. In addition, regulations of the private sector in many cases are either not clear or their enforcement is not transparent.

While noting that improvements have been made, the staff emphasized that sustained top-level commitment is required for the benefits of these initiatives to be fully realized. To build on recent and planned initiatives, the staff recommended various strategies to improve the realism of the budget, expand the information in the budget document, improve fiscal reporting, and strengthen internal auditing. The staff recommended reforms to clarify the delineation of the public and private sector activities, reveal the relations between the government and state-owned enterprises, and minimize interference in the private sector. The staff also stressed the need to strengthen the credibility and capacity of the external audit institution. Finally, the staff highlighted the need to develop a medium-term fiscal policy perspective particularly with respect to the use of the wealth derived from the development of the oil sector.

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ABBREVIATIONS AND ACRONYMS

ANB	National Bank of Azerbaijan
CoA	Chamber of Accounts
EBFs	Extrabudgetary funds
GDDS	General Data Dissemination System
MOF	Ministry of Finance
SOEs	State-owned enterprises
SSC	State Statistics Committee

I. INTRODUCTION¹

1. This draft report provides an assessment of fiscal transparency practices in the Azerbaijan Republic. The assessment has two parts. The first part is a description of practices in relation to the requirements of the IMF *Code of Good Practices on Fiscal Transparency—Declaration on Principles*, prepared by the IMF staff on the basis of the authorities' responses to the IMF fiscal transparency questionnaire. The second part is an IMF staff commentary on fiscal transparency in Azerbaijan.

II. DESCRIPTION OF PRACTICE

A. Clarity of Roles and Responsibilities

2. **Azerbaijan adopts internationally accepted definitions of general government as a basis for defining fiscal activity.** However, its public sector is relatively large and there are continuing difficulties in distinguishing private and public activities in practice.² For example, many government agencies continue to engage in commercial activities. There are approximately 200 "self-supporting" organizations that engage in commercial activities, but many are partially supported by the budget and more than 50 are completely dependent on the budget. In addition, many state-owned enterprises perform both commercial and regulatory functions that give rise to a clear conflict of interest, particularly in the areas of mining, transport, and energy. A major restructuring of government is being planned with the intention of eliminating or privatizing those activities deemed to be commercial in nature, and consolidating the regulatory functions that remain within the government. A ministry of transportation is planned and a ministry of energy may be created, and they will be assigned the regulatory functions that lie with SOEs at the moment.

3. **Government intervention in the private sector is considered extensive, and in many cases regulations either are not clear or their enforcement is not transparent.** There are also cases of unequal treatment of public and private sector enterprises, and foreign and domestic enterprises. Furthermore, regulations and licensing are a source of rent seeking by public sector employees. Despite a Presidential decree in 1999 against intrusive inspections by police and prosecutors, this behavior persists. A Law on Police and a Law on Prosecutors were passed in 1999, but they are not sufficient to protect businesses from

¹ Fiscal transparency discussions with the authorities were held in Baku during February 17–25, 2000. Discussions were led by Ms. Taryn Parry, (Economist, FAD) based on a draft prepared by Ms. Parry and Mr. B.K. Chaturvedi (member of FAD panel of experts). The team met with officials in the Ministry of Finance, the Tax Ministry, the Azerbaijan National Bank, the Ministry of Economy, and the State Statistics Committee. The final report was completed with input from the staff of EU2, FAD, and PDR Departments.

² It is estimated that the activity of all enterprises with full or partial government ownership accounts for over one quarter of total economic activity in Azerbaijan. Progress has been made in privatizing small and medium sized enterprises, but no large state owned enterprises (SOEs) have been privatized or prepared for privatization.

unwarranted investigations. The government does not report on its equity participation in the private sector.

4. **A clear division of responsibilities between different levels of government is still emerging.** Azerbaijan is in the process of establishing municipal governments. However, the new and proposed laws do not define their responsibilities or sources of revenue clearly. The Draft Law on Municipal Property defines what property (e.g., primary and secondary schools) will become municipal property, and the municipalities will have the responsibility for maintaining and managing these properties. The Law on Financial Principles of Municipalities (1999) states that budgeted expenditures may include other items such as local social protection, socioeconomic development, or environmental protection. This law also defines local budget revenues which will include subventions from the state budget, but the specific criteria for determining the size of the transfers are not provided. Although the law says certain criteria will be taken into account, it also states, in effect, that a deficit shall be covered by subsidies received from the State budget. Finally, municipalities are given the right to short- or long-term credit from domestic financial institutions, but the law also states that the State government will bear no responsibility for covering the obligations of municipalities to credit institutions.

5. **No legislative framework comprehensively defines the fiscal management roles of the three branches of government,** nor is there any overarching legislation that defines the fiscal management roles of government agencies. However, a budget code is under preparation that will comprehensively define the fiscal management roles of all concerned agencies. At present, the future role of the newly created Tax Ministry (formerly the State Tax Inspectorate) in the area of tax policy is uncertain.

6. **Azerbaijan has a strong executive branch with decision making power concentrated in the Cabinet of Ministers and the President.** The parliament can reject the entire budget, but it cannot pass a budget that differs from that proposed by the executive. Supplemental budgets are not commonly used. There is no separate development budget, but clear mechanisms for the coordination and management of budgetary (and extrabudgetary) activities are needed. The law provides contingency plans in the case of a revenue shortfall. A reserve fund for contingencies (around 1 percent of the budget) is controlled by the Cabinet of Ministers, and the treasury records how these funds are spent. Three extrabudgetary funds (EBFs) have their own budgets that are approved by parliament around the same time as the annual budget. Other funds have been brought on budget, though they continue to function through earmarked revenues.

7. **The National Bank Act (as revised in 1996) establishes the basis for the independence of the National Bank of Azerbaijan (ANB),** but the ANB continues to play a significant fiscal role. Coordination of fiscal and monetary policy has been improving, and the ANB no longer provides deficit financing. However, within the year the central bank does provide temporary financing to the government at below market (treasury bill) rates. The financial relationship between the central bank and the Ministry of Finance (MOF) is not fully transparent: the MOF does not pay interest on its debt to the central bank and the

central bank does not pay interest on the government's accounts, including on the account that collects oil-related revenues. The profit transferred by the central bank to the budget is negotiated at the time of budget preparation.

8. **Taxes, duties, and charges have an explicit legal basis, but the existence of many amendments and discretionary provisions reduces transparency.** In the past case-by-case negotiation of tax liabilities was common for the state oil concern, SOCAR, but recently this practice was changed by moving the object of taxation from the headquarters to the production companies. However, a new tax code, which simplifies and clarifies the tax system and provides fewer opportunities for discretion, is currently under debate in parliament.

9. **Transparency of the tax system is compromised by noncompliance of businesses on one hand and corruption by some tax and customs officials on the other.** However, efforts are underway to reduce the scope of illegal activity and improve the transparency of tax administration. Recently some staff have been replaced by new highly qualified staff. A very important move to reduce corruption was the introduction of new procedures (effective October 1, 1999) that require taxpayers to deliver declarations to a single window at the local tax inspectorate, and prohibit contact between the taxpayer and tax inspectors when making tax payments. The tax code provides for taxpayer rights and these rights will be publicized.

10. **The draft Law on Public Servants contains a code of conduct.** The authorities may also issue separate regulations covering the ethical behavior of public servants.

B. Public Availability of Information

11. **Although information is not secret, there does not seem to be a strong commitment to regularly publish fiscal data of a comprehensive nature.** According to the MOF, they do not have the right to publish data because this is the responsibility of the State Statistics Committee (SSC). The SSC produces monthly reports that do not contain much detail on government finances, and more detailed annual reports. Even though the treasury produces monthly detailed reports on actual revenues and expenditures and maintains information on expenditure commitments, debt, and loans including government guaranteed loans, none of this information is published. There are no advance release date calendars for public information.

12. **The actual budget document that is submitted to parliament and published with its approval is missing key information:** it does not show amounts with their classification of expenditure, it does not cover extrabudgetary funds or extrabudgetary activity (financed from fees and charges), and it does not include the budget outturn for the previous two years. The annual budget contains some indication of expenditure priorities for the budget year, but no statement of objectives proposed to be achieved through government programs. The budget documents also do not distinguish existing program costs from new ones.

13. **The budget does not include any statements on contingent liabilities, tax expenditures, quasi-fiscal activities, payment or revenue arrears, or financial assets and**

liabilities. Box 1 describes activities concerning SOEs that may be considered quasi-fiscal activities. The number of government guaranteed loans is not large, but the issuance of guarantees has been increasing recently. Defaults of guaranteed loans have also increased.

Box 1. Quasi-fiscal Activities in Azerbaijan

- Rather than provide direct subsidies to SOEs, **the government has tolerated tax arrears of many large SOEs.** The total stock of tax arrears doubled in 1998, and it is estimated to have increased one and half times in 1999. SOCAR, the state oil concern, accounts for about half the stock of arrears and eight other large SOEs account for an additional 25 percent of the total stock of arrears. SOCAR's stock of tax arrears was 23 percent of GDP at the end of 1999. Tax arrears accumulated by SOCAR in 1999 were 6 percent of GDP.
- Particularly in the energy sector, not only does the state tolerate substantial tax arrears, but nonpayment by the state-owned gas and electricity companies for the fuel they receive from SOCAR amounts to 7 percent and 19 percent of GDP, respectively. Furthermore, **these companies sell at prices considerably lower than world market prices** and they also have **extremely poor collection rates (e.g. 26 percent) from their customers, which amount to an indirect subsidy for heat and power** that is borne by the SOEs in the energy sector.
- The State Property Ministry cannot liquidate or sell parts of enterprises. When unprofitable enterprises are not closed, the budget does not make explicit transfers to cover their losses, and inter-enterprise arrears are generated. When their suppliers do not receive cash, they too are reluctant to make cash payments. This starts a long chain of nonpayments, offsets, or barter transactions in the economy. In this way the losses of unprofitable SOEs are borne by many in the economy, and where offsets are reported on a net basis, tax liabilities will be inappropriately reduced.
- In the past the state-owned banks have lent at below market rates and have been directed to extend loans to current or former state enterprises. All state banks have a large portfolio of nonperforming loans. The general problem of directing lending to unprofitable investments has halted due mainly to the independence granted to the ANB in the revised National Bank Act of 1996. **However, there has been at least one recent incident of directed lending to prevent a default by an SOE on a government guaranteed loan.**

14. Although there is an annual limit, there is no explicit overall limit on the number of guarantees or the amount guaranteed. The MOF has had some success in requiring the agencies defaulting to repay the MOF, but it is highly unlikely that recent defaults will be repaid. The debt department of the MOF has recently begun to analyze the probability that government guaranteed loans will need to be covered by the budget, but this process is not yet institutionalized. Similarly, the tax ministry is making efforts to determine revenue foregone due to tax expenditures, but again, this is not yet done in a systematic way.

C. Open Budget Preparation, Execution, and Reporting

15. The budget preparation process does not reveal the basis for revenue or expenditure estimates and does not result in a realistic budget. Estimates are unreliable due to unclear or unrealistic assumptions. Revenue projections are particularly problematic because of the difficulty in estimating effective tax rates. Some areas like utilities are severely underbudgeted partly because the expenditure provisions are based on unrealistic norms. Yet subsequent budgets have not entirely corrected for these errors. Risks to the budget are not examined nor are there any analyses of the fiscal sustainability of current policies. Although the economy and budget are particularly susceptible to changes in the price of oil, the budget does not contain any discussion on oil price assumptions.

16. **The overall balance is the only indicator of the fiscal position that the annual budget provides for the budget year.** There is a ceiling on the annual deficit and on the gross debt required for balancing the budget, but not on the stock of debt. No other fiscal rules are applied. No statement on medium-term fiscal policy objectives or priorities is made as part of the budget presentation. The acquisition of a number of project loans, some very large, has recently increased. However, the capacity to undertake project appraisal is very limited in the MOF and spending ministries, and hence there is a concern that these loans may not be in the best interest of the state.

17. **Fiscal rules to avoid wasting resources derived from oil production are under consideration.** A decree was recently issued (end-December 1999) instructing the Prime Minister to establish an oil fund and devise rules for its operation. The oil fund should enable the authorities to save on a net basis a portion of revenue windfall from oil development. However, funds have not yet been deposited in the account for the oil fund despite the receipt of profit oil revenues. The operating rules for this fund have not yet been specified nor has any management structure been established.

18. **Some improvements in budget preparation are underway.** The creation of the macroeconomic unit in the MOF in September 1999 has given the MOF the capacity to develop a macroeconomic framework and to systematically incorporate macroeconomic data in the budget process. This unit is also helping to develop medium- and long-term macroeconomic and fiscal forecasts, which are very important given the projected large increase in revenue from the oil sector in coming years.

19. **The recent creation of the treasury (1998) enables the MOF to produce more reliable and timely information on the government's fiscal operations using a GFS-based classification.** The treasury produces monthly, quarterly, and annual reports on a cash basis covering the budgetary and extrabudgetary fiscal activity of the central government and local governments. In 1999 it introduced reporting requirements for three extrabudgetary funds and for externally financed development projects so that reports on the fiscal activity of the general government can be produced. Reconciliation with budget appropriation and bank accounts is effective and timely. However, the manual processing and recording of

fiscal transactions is cumbersome and limits the effectiveness of the treasury. A treasury computerization project scheduled to begin this year will improve controls and reporting.

20. **Some problems with treasury reporting and expenditure control remain.** In recognition of the problem of accumulating payment arrears, commitment controls were introduced in 1999, and an inventory of the stock of payment arrears accumulated before 1999 was compiled. However, in cases of underbudgeting for utilities, services are not shut off once the budget appropriation has been used and spending agencies accrue arrears without registering commitments. Another concern is that many budget organizations, especially those providing health and education services, charge fees or otherwise collect and spend revenues that are outside the budget process. In principle, these transactions are now processed through the treasury and included in treasury reports. In practice, however, it is not known whether all of these transactions are processed by the treasury. Finally, in 1998 and 1999 problems were encountered with large unplanned expenditures from privatization and other revenues outside the budget process. In order to meet the deficit target, other planned spending had to be reduced and budget arrears increased.

21. **Basic mechanisms of control exist but their combined effect is weak.** A law on public procurement prescribes open tendering for public supply contracts, but gaps and inconsistencies weaken its observance. In January 1999 the internal audit offices of the ministries were eliminated giving the MOF sole responsibility for internal audit of all government agencies at the republican and local government level. However, the methods and procedures for internal auditing have not been sufficiently updated. New procedures, training and more highly qualified staff will be required to adequately perform the function of internal audit. Auditing of service delivery, outputs, efficiency, and effectiveness of operations has not yet been developed.

D. Independent Assurances of Integrity

22. **Currently there is no external audit of the government financial accounts.** A new law (August 1999) establishes an accounting chamber to perform the function of external audit, but the provisions of the law are very weak. Although the accounting chamber will be accountable only to parliament, and not to executive organs, the functions assigned to it hardly qualify it to be a supreme audit institution. In addition to auditing the annual accounts on state budget implementation, its duties will include monitoring and analyzing state budget execution. The accounting chamber will be very small (a staff of only nine people) relative to the number of tasks it must perform. Therefore, satisfactory performance will depend on a sufficiently large budget for contracting the services of additional auditors.

23. **The assumptions and economic policies underlying the macroeconomic forecasts of the Ministry of Economy are clearly stated,** but at present there is no law or regulation guaranteeing access to information on forecasts. Assumptions are subject to political factors as well as objective analysis, and the debate on this is not public.

24. **The technical independence of the SSC is not guaranteed by law**, but in practice it operates independently. While the SSC aims to produce objective and reliable data that is internationally comparable, it does not subscribe to the General Data Dissemination System (GDDS).

III. IMF STAFF COMMENTARY

25. **Some important steps have been taken to improve fiscal transparency in Azerbaijan in recent years, but many key weaknesses remain.** Recent improvements in the coverage of the budget and in the treasury have enhanced expenditure control and the quality of fiscal reporting. The development of a comprehensive budget code is another welcome step, which should further strengthen control and improve transparency of budget management. The proposed new tax code and continued strengthening of tax administration should improve transparency of the tax system. Further effort and sustained top-level commitment is required, however, for the benefits from these initiatives to be fully realized.

26. **A two-track strategy is needed for continued improvement in fiscal transparency in Azerbaijan.** First, it is necessary to widen and deepen the process of analysis and reporting on fiscal activity, building on the foundations of recent treasury and budget reforms. Second, it is necessary to address the fundamental questions of the appropriate role of the government sector vis-à-vis the rest of the economy as well as the most appropriate roles for each element of the public sector.

27. With regard to the first arm of the strategy, the following activities should be seen as highest priority.

- **Improve the realism of budget estimates.** When expenditure estimates are unrealistically low, or revenues estimates unrealistically high, budget arrears cannot be eliminated through commitment controls alone. Providing a detailed explanation of the budget estimates and opening the macroeconomic assumptions to independent scrutiny is one means of achieving this goal. If a realistic assessment of revenues and available financing are not adequate to cover the costs of existing policies, then specific instructions (e.g., reducing hours of operation, reducing staff, or introducing measures to economize on the use of energy) or policy adjustments are required to bring expenditures in line before the start of the fiscal year. Without these adjustments the budget will be unrealistic and arrears are almost guaranteed.
- **Identify and measure quasi-fiscal activities** and provide this information in a statement in the annual budget. Since it is more transparent for enterprise losses to be covered by explicit budget transfers rather than permitting them to incur inter-enterprise arrears, a gradual move in this direction should be taken. This needs to be done in combination with strong structural measures to reduce the losses of SOEs and a restructuring of public expenditures. In the long run, the most effective measure may be the elimination of such activities through restructuring and privatization.

- **Publish comprehensive fiscal data on a regular basis.** These reports should be based on treasury data and include information on budgetary arrears, extrabudgetary transactions, and project loans. Fiscal data dissemination should be brought in line with internationally accepted standards such as the GDDS. The SSC should be granted legal independence.
- **Analyze the sustainability of fiscal policy and make this information publicly available.** The rate of increase in contracting project loans is alarming. The government's capacity to service debt in the future should be analyzed by considering the ratio of debt to GDP. Since long run fiscal sustainability depends on the rate of depletion of a nonrenewable resource, the nonoil fiscal balance and if possible, total net worth of the government, should also be published routinely.
- **Develop a medium-term budget framework** to take into account future income from oil resources and to set development priorities. Project proposals need to be examined in the context of a medium-term budget framework. In addition, the capacity to evaluate project loans needs to be developed in the spending ministries and the Ministry of Finance to ensure these projects have a positive social rate of return.
- **Ensure that the operations of the Oil Fund will be transparent.** There should be clear rules guiding the inflows, outflows, and investment of the funds. The operations of the Oil Fund should be integrated into the state budget in a coherent manner. Rigorous mechanisms should be created to ensure adequate management, control and accountability of these resources. The Oil Fund should be audited annually and its financial statements should be available to the public. Finally, to enhance planning for the use and/or saving of oil-related revenue, more attention should be devoted to medium- and long-term forecasts.
- **Complete the budget code.** It should be comprehensive and clearly define the fiscal management roles of all concerned agencies in all stages of the budget process. The organic budget law should be revised with assistance from the World Bank and the IMF.
- **Modernize internal audit procedures.** New procedures should be developed and training provided to ensure their effective implementation.
- **Improve the information in the budget document.** The budget that is approved by parliament and published should provide more detailed information including:
 - the budget classification for revenues and expenditures;
 - the outturn for two years prior to the budget year and projections for the budget year and the succeeding two years;

- a statement on fiscal risks including an assessment of contingent liabilities and quasi-fiscal activities, and an analysis of variations in the main assumptions supporting macroeconomic forecasts in the budget including GDP growth, the price of oil, inflation, and the exchange rate;
- a statement of major programs and their objectives; and
- more emphasis on efficiency and effectiveness in the delivery of government services by developing a program classification and measures to evaluate performance.

28. **It is also necessary to address more deep-seated structural issues and to redesign much of the basic machinery of government.** In this context, we strongly urge the authorities to move ahead with the World Bank-supported project for public sector reform.

29. **Reforms should aim to clarify the delineation of public and private sector activities and minimize interference in the private sector.** Priority should be given to revising the law on prosecutors and the law on police, and restructuring the government to remove conflicts of interest in the enforcement of regulations. More generally, regulation of the private sector needs to be rationalized, simplified, and clarified. These efforts should be supported by reforming the legal and judicial system and by approving and implementing the Law on Public Servants. This law should provide clear directives on the ethical behavior of public servants.

30. **Relations between the government and state-owned enterprises should be made more open and transparent.** Stronger efforts are needed to eliminate tax and expenditure arrears to remove the opportunity to engage in nontransparent transactions. The financial arrangements between the MOF and the ANB should be clarified and remunerated based on market-related rates. Extrabudgetary funds and state-owned enterprises should have annual external audits and the findings should be public information.

31. **Finally, it is important to build up the credibility and capacity of the external audit institution.** External audit of the annual accounts is a fundamental requirement for assurance of integrity of fiscal data. While the creation of a Chamber of Accounts (CoA) is a step in the right direction, it is strongly recommend that this institution be strengthened and significantly enlarged so that it can perform its assigned functions effectively. The Law on the Chamber of Accounts should be modified in line with the recommendations of the World Bank including:

- making the CoA's primary mandate the audit of the government's accounts and all other duties must be clearly secondary to this objective;
- guaranteeing the independence of the CoA and the Auditor General;

- explicitly providing complete audit jurisdiction over all public assets, liabilities, expenditures, revenues, commitments, contingent liabilities, and financial transactions of all types of public organizations;
- requiring the CoA to make an annual report, which examines the final accounts of the government and identifies any irregularities, to the parliament no later than October 15 of the following fiscal year; and
- adopting Generally Accepted Audit Standards and Codes of Conduct for Auditors.