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# **The 2018 State Budget Project of Azerbaijan: From Consolidation to High Spending?**

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## Introduction

The legislative project on the state budget of the Republic of Azerbaijan for 2018 and the state and consolidated budget projects of 2018 were publicized on 19<sup>th</sup> of October, 2017 according to the legislation on the Budget system.

As the oil prices started rising slowly after the sharp decline in the previous years, it created a potential opportunity for Azerbaijan to diversify its economy and achieve a more stable budget. Modest increases in revenue generated by the oil and gas sector has resulted in a higher inflow of foreign currencies to the local market, leading to a less volatile manat. Yet, according to the Central Bank, the inflation rate, as of September 2017, is still as high as 13.9%. As it stands, budget revenues for 2018 are estimated at 20.13 billion AZN (\$11.84 billion US) while expenditures for 2018 are forecasted to be 20.9 billion AZN (\$12.29 billion US). Compared to the budget revenues and expenditures of 2017 the expected revenues and expenditures of 2018 will be 24% and 23.7% more than the previous year. This, in turn, will create a budget deficit of 0.77 billion AZN (\$0.45 billion US).

We would like to underline that while analyzing the projections, we have used the average exchange rate of 1 USD = 1.7383 AZN for the conversions of 2017, whereas for the conversions of 2018, we have used the latest official exchange rate as of November 20th: 1 USD = 1.7002 AZN.

Given all these circumstances, it is of great importance to carefully consider the internal and external economic situation in order to effectively use fiscal and monetary policies. As in previous years, the Center for Economic and Social Development has prepared an analysis of the budget project publicized by the government.

### **1. Current Economic Challenges, Global Economic Trends**

The main challenges facing the economy of Azerbaijan is its huge reliance on the oil sector for state revenue that, in turn, depends on the price of oil and trends on global oil markets. Taking 2014 as an example, which saw a sharp drop in the price of oil, the economy of Azerbaijan contracted. It is worth nothing that following the slumps in oil price, GDP growth of Azerbaijan steadily declined, eventually reaching -3,1% in 2016, the first negative growth rate Azerbaijan has seen since 1995. This fall in GDP led to a decline in purchasing power, inflation and multiple devaluations of the local currency in the following years. On the other hand, the modest reform undergone within the non-oil sector has failed to materialize the sector as a balance to the oil-sector's influence of the economy. This is evident if one looks at exports of 2017 October, where 86,24% of exports originated from the oil and gas sector and only 13,76% came from the non-oil sector, of which the largest share belongs to vegetables and fruits (4,15%). However, the decline in oil prices has had some positive impact on the composition of sector revenue, namely: a steady decrease of the share of oil-sector to budget revenues since

2014. This trend is likely to end as forecasts predict a rise in oil prices in the near future relating to the production cut agreement among oil-producing countries.

The current price of a barrel of BRENT is \$62.29 US, accounting for a 9,6% increase since the beginning of 2017. In 2016 this price was dropped to \$43.76 US (EIA, Nov 2017). It is expected that the average price for BRENT crude oil in 2017 will hover around \$53.01 US and rise slightly to \$55.61 US in 2018 (EIA, Nov 2017).

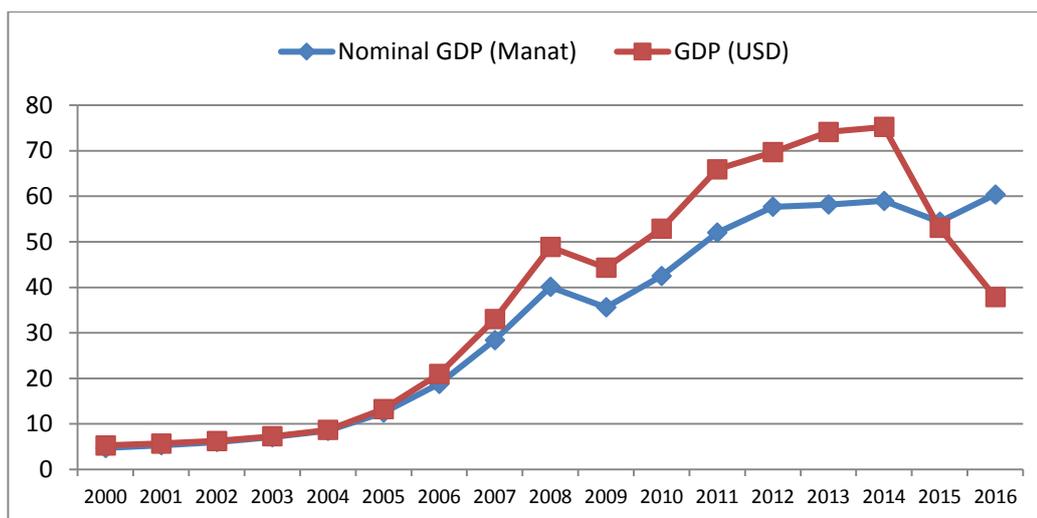
Oil output, on the other hand, will decrease to 0.83 million barrels per day (bpd) in 2017 while a further decrease is expected to 0.82 million bpd in 2018 (Abbasova, N. 11 Jan 2017). This cut in output is in line with the deal reached among OPEC and non-OPEC countries to cut output and thus reduce the current global oil output (Abbasova, N. 11 Jan 2017). The EIA expects that current global oil output will continue on to 2018 but at a slower pace (Abbasova, N. 11 Jan 2017). The degree of effectiveness and duration of both OPEC and non-OPEC cuts after 2018 remains uncertain according to the agency (Abbasova, N. 11 Jan 2017).

In sum, modest increase in the price of oil coupled with a gradual lowering of production will led to a slight increase of 1.5% in GDP, according to estimations by the Ministry of Economy. As can be seen above, the correlation between the slight increase in GDP and the events on global oil markets underline the degree of volatility of Azerbaijan's economy on its oil sector and the global oil market and the relative insignificant influence the non-oil sector has as a revenue stabilizer in the economy of Azerbaijan.

## **2. Macroeconomic Overview of the Economy of Azerbaijan**

The decline in oil prices since 2014 coupled with lower oil production in Azerbaijan has translated into a steady decline in Gross Domestic Product of Azerbaijan, reaching -3.1% in 2016. On the other hand, the impact of the construction sector, which saw a 30,7% decline in 2016 also exacerbated the GDP growth. As a result, nominal GDP of 2016 has become 60.4 billion manats (\$37.8 billion dollars US). The share of non-oil production in GDP has increased by 2.5% and reached 62.6%<sup>1</sup> in the first 9 months of 2017.

**Diagram 1: GDP of Azerbaijan (billion manats&dollars)**



**Source: State Statistical Committee of the Republic of Azerbaijan; World Bank, 2017**

As seen from the graph above, GDP of Azerbaijan in terms of dollars had a steep drop beginning from 2014. The main reason behind this trend is the devaluations of national currency which occurred in February and December 2014. As a result, inflation set in 2014 which has led to, as can be observed in the graph, to a sharp divergence between GDP in terms of manats and dollars. The central bank has increased interest rates, which make taking loans costly, in order to decrease the aggregate demand and stem high levels of inflation.

During these months, exports were 4.4 billion dollars while imports were 6.2 billion dollars, which has led to a foreign trade surplus of 1.8 billion. For the same period of 2016, exports were 5.8 billion dollars and imports were 5.5 billion dollars, amounting to a 0.3 billion dollars trade surplus. This larger trade surplus in 2017 has led to an inflow of foreign currencies which the economy desperately needs. It is worth noting that compared to 2016, exports have decreased by 25%, meanwhile imports saw a 12% increase. The main reason behind the decrease of total exports is due to oil exports, which saw a decrease of 43.17%. On the other hand recent devaluations have made local products more competitive on foreign markets and the decrease in exports was partially offset by the increase in exports of agricultural products, especially cotton, which was exported 6.68 times more during the first 9 months of 2017 compared to the same period in 2016<sup>2</sup>. Imports of meat, milk and pharmaceutical products have had the largest increase during the abovementioned period.

As of August 2017, foreign reserves of the central bank stand at 5.1 billion dollars, a 21.6% increase from 4.19 billion dollars in August 2016. It is important to point out that the main reason behind this increase is the 7.5 billion dollars transferred from the State Oil Fund to the Central Bank. This was the first transfer from SOFAZ to the Central Bank.

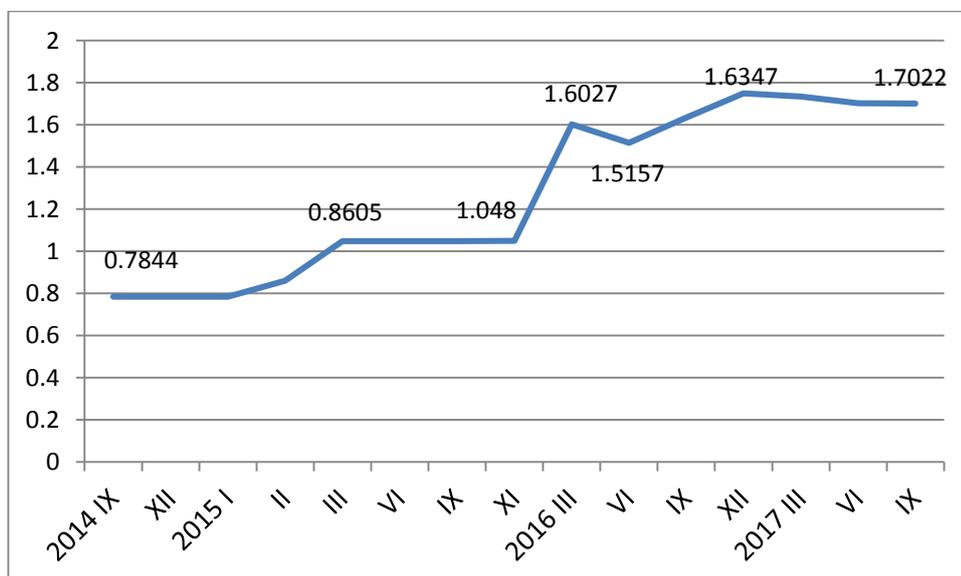
Budget revenues and expenditures for the period of January – September 2017 have been 12.04 billion manats (6.92 billion dollars) and 12.78 billion manats (7.35 billion dollars), respectively, which produced a budget deficit of 738.6 million manats, 42% more than the budget deficit of the same period of last year.

Increased oil prices led to an increase of foreign reserves of the State Oil Fund of Azerbaijan by 8.67% since the beginning of 2017 and currently stand at 36.02 billion dollars as of 1 October, 2017<sup>3</sup>. This means that 87.6% of all foreign currency reserves are concentrated in SOFAZ, 2,4% less than in September of 2016.

The foreign debt of Azerbaijan on 1 July, 2016 was 7.63 billion dollars, or 20% of the total GDP. As of 1 July 2017 it is 7.17 billion dollars, which is 18.9% of total GDP, 1,1% less than last year.

The official exchange rate of AZN as of 1 September 2017 was 1\$ to 1.7002 AZN, according to the Central Bank. Except for a sharp increase in January – February, the exchange rate of dollar to manat has been more or less stable during the first 10 months of 2017. Despite this stability, the population continues to have low confidence in the currency because of the large devaluations of last year.

**Diagram 2: Official Exchange Rate of AZN to USD**



Source: Central Bank of Azerbaijan, 2017

### 3. Forecast for 2018

According to the forecasts of the Ministry of Economy, GDP growth in 2018 will be 1.5%, producing a GDP of 69.4 billion manats (40.82 billion dollars). However, according to the Asian Development Bank, the figure is more likely to be 1.0%, while IMF predicts same indicator to be 2.0%. It is expected that the share of the non-oil sector in total GDP will increase by 2.9% while the share of the private sector will reach 83%. Out of 15.9 billion manats (9.35 billion dollars) worth of investments, 9.5 billion manats (5.59 billion dollars) is expected to be directed at the non-oil sector in 2018, as stated by the ministry. Majority of these investments to the non-oil

sector are provided mainly from the state budget because of the unattractiveness of this sector to foreign investors.

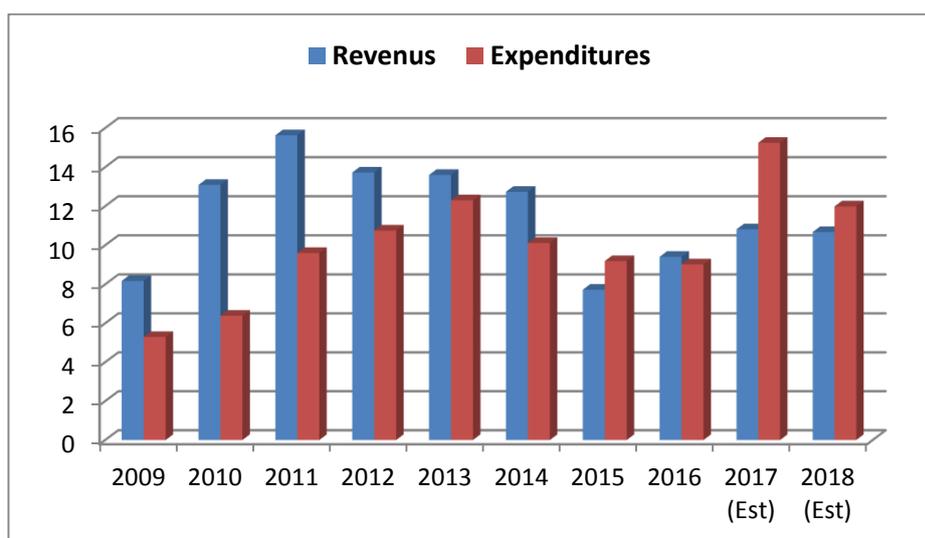
#### 4. Consolidate budget forecast for 2018

*The consolidated budget of the Republic Azerbaijan is constituted of the state budget, the budget of the Autonomous Republic of Nakhichevan, the State Oil Fund and the budget of State Social Protection Fund under the Ministry of Labor and Social Protection of the Population of RA.*

##### 4.1 SOFAZ budget

Revenues of SOFAZ in 2018 are estimated to be 10.67 billion manats (6.28 billion dollars) while expenditures are estimated at 11.99 billion manats (7.05 billion dollars). This will translate to a budget deficit of 1.31 billion manats (770 million dollars). Compared with the budget deficit of 2017, it is expected that the budget deficit of 2018 will be 4.7 times less. In other words, we will expect to see a fiscal consolidation. Running a deficit on SOFAZ budget undermines the main role of the fund, which is to safeguard the wealth accumulated from natural resources for the use of future generations. In this respect, the government is attempting to establish a “golden rule” as part of its Strategic Road Map for effective transfer of revenues and efficient preservation of oil funds for future generation. However, we have yet to see any results as SOFAZ budget is still and will most likely be running a budget deficit.

**Diagram 3: Revenues and Expenditures of the State Oil Fund (billion manats)**



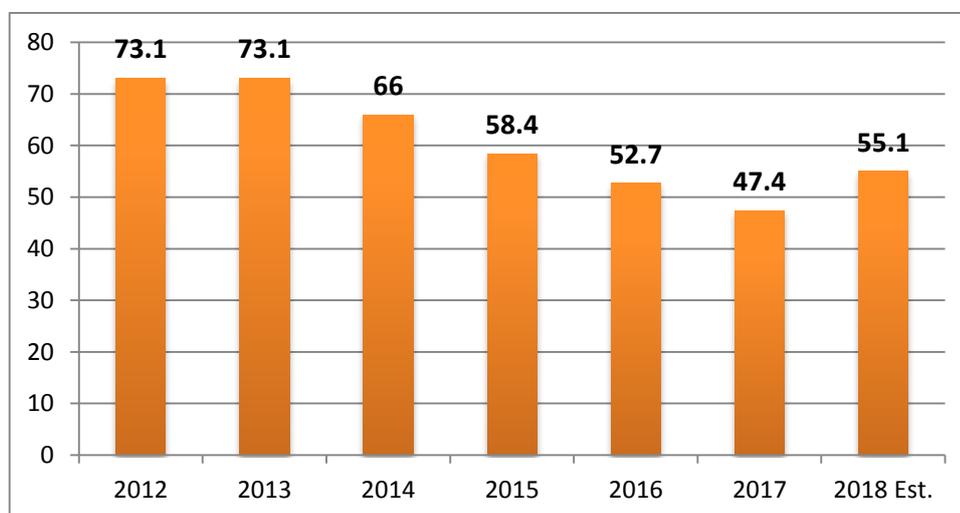
Source: Ministry of Finance of the Republic of Azerbaijan, 2017

## 4.2 State Budget Indicators

Revenues of the 2018 budget are estimated to be 20.13 billion manats (\$11.84 billion dollars US). For 2018 budget revenues are estimated to be more than 24% compared to the revenues of 2017. Oil sector alone will contribute to 89.3% out of this increase. The shrinking share of the oil sector in budget revenues since 2013 is going to be reversed next year, with an increase of 7,7%, and will once again become the largest source of revenue for the state budget, estimations say.

It must be noted that while forecasting the budget revenues for 2018, the price of 1 barrel of oil has been accepted as \$45 US. This is to be used as a benchmark price by the government, particularly for revenue accumulation. By having a lower benchmark the government envisions a worst case scenario of oil at \$45 US, while estimates by other organizations such as the World Bank or the IMF put that estimation higher. Everything above the benchmark will entail an increase in extra revenue; this brings the question of revenue allocation. Following the drop in oil in 2014, the government reduced both spending and allocated major revenues to achieve fiscal consolidation. However, as will be shown below, the government intends to increase expenditure with the increasing revenue. In other words, we can expect to see a return to the policy of high spending characteristically of the pre-oil slump, effectively abandoning the process of fiscal consolidation since 2014. The growth of GDP at 1.5% for next year is expected to be fueled by this return to high spending, particularly for capital expenditure, a sector the government hopes will energize the economy.

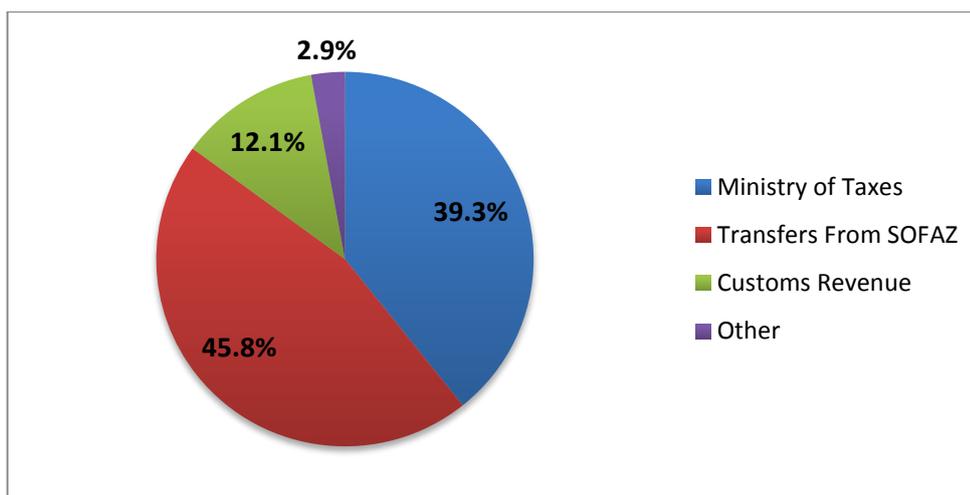
**Diagram 4: Share of oil sector in state budget**



**Source: Ministry of Finance of the Republic of Azerbaijan, 2017**

55.1% of the budget revenues will be generated from the oil sector. Of that amount, direct transfers from SOFAZ constitute 83.1% while the remaining 16.9% comes in the form of taxation of oil companies.

**Diagram 5: State Budget Revenue Shares**



**Source: Ministry of finance of The Republic of Azerbaijan, 2017**

According to estimations, 66.7% of non-oil sector revenues will be generated as tax revenues, while 26.9% will come from the State Customs Committee and the remaining 6.4% from other sources. This highlights the importance of the share of overall budget revenues that SOFAZ transfers will provide to the state budget, with calculations putting this figure at around 45.78% of the estimated budget for 2018.

#### **4.2.1 Budget Transfers from the State Oil Fund**

The ongoing decline of transfers from SOFAZ to the state budget is expected to end in 2018 as it is estimated to reach 9.2 billion manats (\$5.41 billion dollars) in 2018. This amount is 51% and 21% larger than the upper limit of transfers for 2016 and 2017, which were 6.1 and 7.62 billion manats. A return to higher levels of transfers from SOFAZ will most likely fuel higher spending of the state budget in future years.

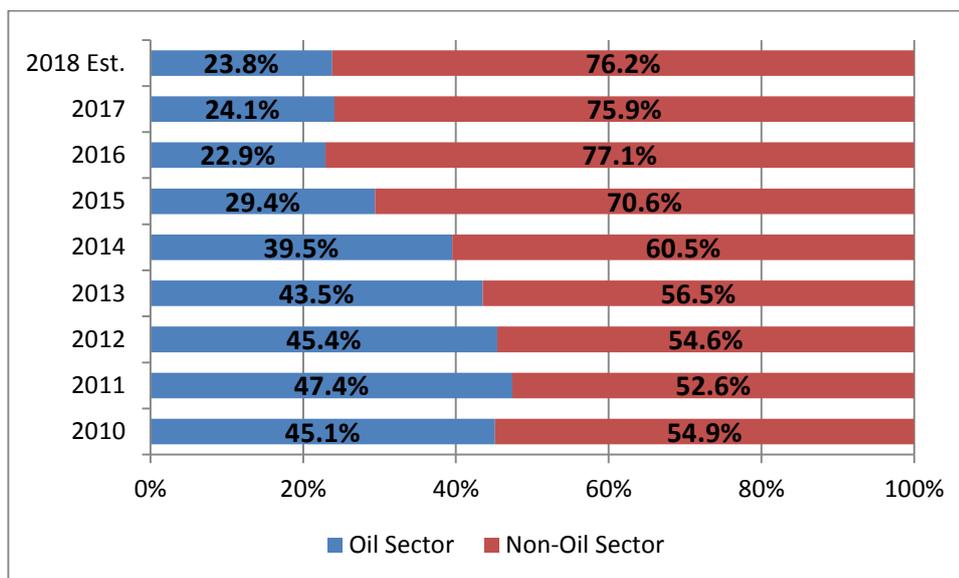
In 2018, 45.7% of the total budget revenues will be from transfers from the State Oil Fund. This number was 37.5% in the approved budget of 2017. The main reason behind this increase in share is the increase of the revenues of SOFAZ as a result of projected increases in crude oil prices.

#### **4.2.2 Non-oil revenues of the State Budget**

44.9% of state budget revenues will be generated from the non-oil sector. Tax revenues (excluding taxation of oil companies) are expected to be 6.03 billion manats (\$3.55 billion US) while taxation of the oil sector will bring 1.88 billion manats (\$1.10 billion US). Compared with the non-oil tax revenues of 2017 and 2016, next year's amount is 3.8% and 11.5% larger. These increases are the result of government policies aimed at fostering the non-oil sector to achieve a certain degree of diversification of the economy, as the oil sector has proven to be too unreliable.

In spite of this, the effects these policies will have on the economy will only be marginal. The small increase in non-oil tax revenue further backs up this argument.

**Diagram 6: Share of Oil and Non-oil Sector in Tax Revenues**



Source: Ministry of finance of The Republic of Azerbaijan, 2017

### 4.2.3 Tax Revenues

It must be noted that the forecasted amount of tax revenues, which is 7.91 billion manats (\$4.65 billion dollars US), constitutes 11,4% of GDP. This number is 3,4% and 12,7% more than the estimations of 2017 and the actual tax revenues of 2016. The main force behind this are increases in corporate, simplified and excise taxes. As the price of natural gas and oil increased, it resulted in higher revenues for SOCAR which translated into more corporate revenues for the state. Simplified taxes increased as a result of amendments to the tax code, thus more people will be paying simplified taxes. A 6.9% increase in excise taxes is also anticipated as a result of higher consumption of AI-92. The introduction of a new legislation on the payments of employees through bank transfers will facilitate the process of transparency. This in turn will lead to increase tax revenues, which the government necessarily needs if it wants to decrease the budget's reliance on the oil sector.

### 4.2.4 Budget Revenues from the State Customs Committee

Revenues from the State Customs Committee is expected to be 2.43 billion manats (\$1.43 billion dollars US) or 3,5% of Gross Domestic Product, which is 6,2% more than the estimated amount of 2017. It must be noted that the estimation of excise taxes for 2018 is 91,1% more than the same indicator of 2017. The main reason behind this significant increase is down to the government's decision to increase excise tax rates on imported alcohol and tobacco products because of the devaluations, which has made the excise tax lose its share in the overall price of goods. The government took this action in order to protect local producers and supply the local

market internally. Customs tolls have also seen a 14,1% increase in terms of manats, mainly due to 3 factors. Firstly, the trend of decreasing imports since 2015 will be reversed in 2018 as a result of the increase of purchasing power which will then lead to an increase in toll revenue by customs. Secondly, government policies that aims to promote better transparency of the customs service. Lastly, the difference in exchange rate has led to a larger amount of imports, in terms of manat after it was devaluated several times.

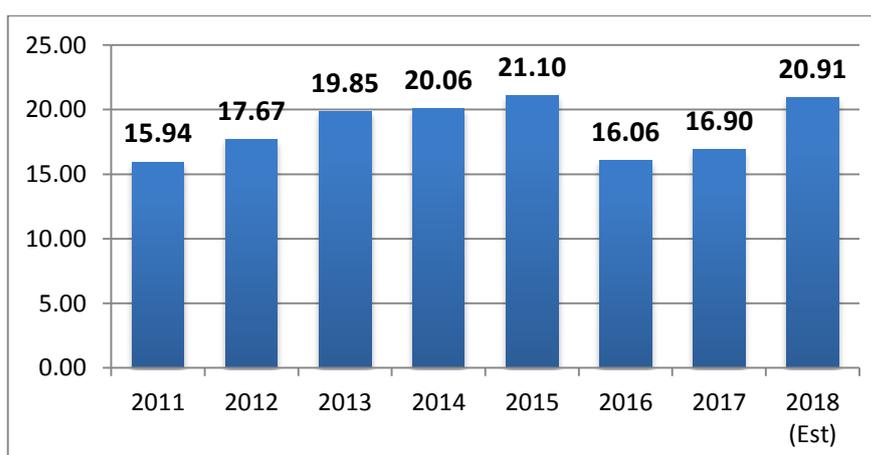
### 4.3 2018 State Budget Expenditures

Estimated budget expenditures are 20.9 billion manats (\$12.29 billion dollars US), which is 23.7% and 17,8% more than the actual expenditures of 2017 and 2016. Government expenditures will constitute 30,1% of the total Gross Domestic Product.

Current expenditures are estimated to be 10.76 billion manats (\$6.33 billion dollars US) which is 51,5% of total expenditures and 1.3% less than last year's. While current expenditures have seen a small decrease, capital expenditures are expected to rise by 46,0% and reach 7.84 billion manats (\$4.61 billion dollars US). It must be noted that high level of non-transparency in this sector results in a large amount of money becoming unaccounted for. Meanwhile, expenditures of public debt is also estimated to be 37,8% more and reach 621,0 million manats (\$365.3 million dollars US). In 2018, 4,7% of expenditures or 978,8 million manats (\$575.7 million dollars US) were allocated to subsidies

Majority of the public expenditures are derived from the oil sector, rather than from the non-oil sector, which as mentioned above, will increase next year. Unlike Azerbaijan and most other oil producing countries, public expenditures in developed countries are covered by general taxation. If the abovementioned trends continue, it is highly unlikely that budget expenditures will be generated from taxation of non-oil sector in the near future.

**Diagram 7: State Budget Expenditures (billion manats)**



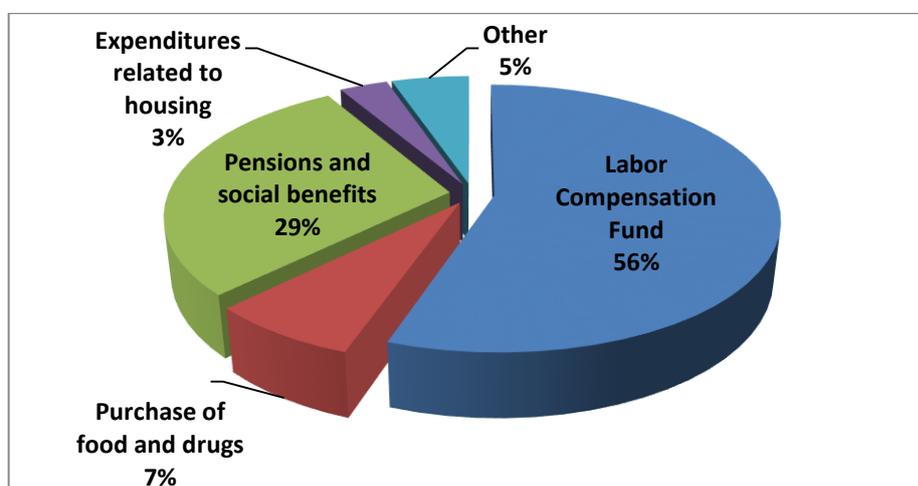
**Source: Ministry of finance of The Republic of Azerbaijan, 2017**

### 4.3.1 Social Expenditures of the State budget

Social-oriented expenditures (labor compensation, pensions and benefits, total expenditure on the purchase of merchandise, bandaging supplies and materials as well as food products) are going to be 7.0 billion manats (\$4.11 billion dollars US) which translates to 33,5% of total budget expenditures. This number is 2,2% more than last year. If we include financial help to citizens in need of housing, and subsidies to corporations such as Baku Metro and Azerbaijan Airlines, then these costs will amount to 36,6% of total expenditures.

As we can see from the figures above, a larger share of budget expenditures will be allocated for the capital expenditures rather than social expenditures. In other words, 7.84 billion manats (\$4.61 billion dollars US) will go to capital expenditures while only 7 billion manats (\$4.12 billion dollars US) will be dedicated for social expenditures, which serve the interests of the general population.

**Diagram 8: Volume of social-oriented expenditures in 2018,**



**Source: Ministry of Finance of the Republic of Azerbaijan, 2017**

For pensions, targeted social help, matters of internally displaced people and etc., state expenditures have been projected at 2.19 billion manats(\$1.29 billion dollars US), which is 6,6% less than last year.

The main reason behind this decline is that the elimination of natural gas subsidies to the population has been phased out to decrease government expenditures. Following the cancellation of subsidies the price of natural gas has rebounded.

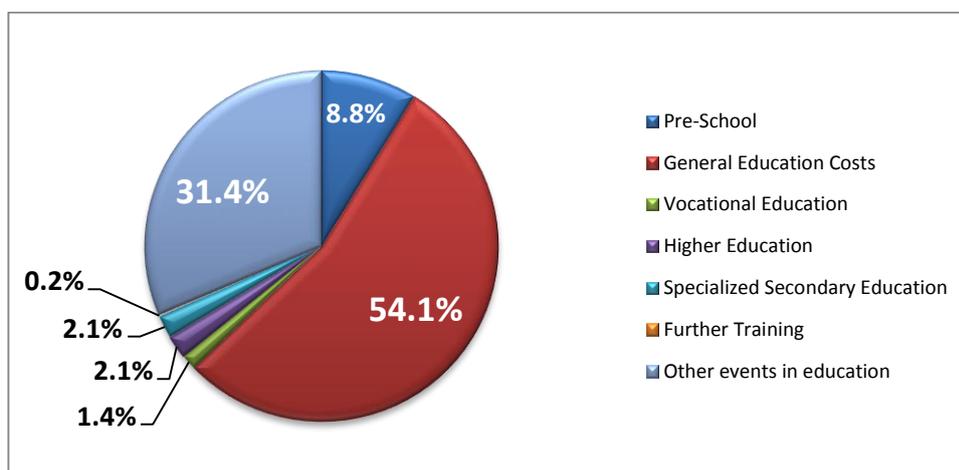
Social defense and social assistance expenditures are going to be 10,5% of total expenditures in 2018. Of that amount, 1.3 billion manats (\$764.6 million dollars US) or 59,2 will be accorded to the budget of the State Social Protection Fund, while 627,2 million manats (\$368.9 million dollars US) or 28,5% will be granted to the Ministry of Labor and Social Protection of the Population, and 245,0 (\$144.1 million dollars US) or 11,2% will be transferred to the State Committee on Refugees and IDPs.

### 4.3.2 Education expenditures

Projected education expenditures for 2018 will be 2.0 billion manats (\$1.18 billion dollars US), which is 210,3 million manats (\$123.5 million dollars US) or 15,2% more than the actual spending of 2017. The ongoing trend of increasing education expenditures will continue throughout 2018. However, this increase is mainly due to inflation and it must be noted that the actual share of education expenditures in 2018 will decrease by 1.21%, as a result of the increase in total expenditures of 2018.

Investment in education is vital for the development of human capital in the long term. These lower education expenditures will have repercussions in producing a well-educated and high skilled labor force.

**Diagram 9: Main directions of education expenditure**



**Source: Ministry of Finance of the Republic of Azerbaijan, 2017**

Compared to the shares of each category in the projections of 2017, the highest increase has been Pre School Education, which saw a 0,8% increase in the total share of education, followed by General Education Costs, which had a 0,2% increase. Among the categories with a decrease, the main ones have been Specialized Secondary Education and Higher Education which lost 0,4% and 0,3% of the total share, respectively. One of the reasons for the decreasing expenditures for universities is the recent transformation of large universities such as Baku State University, State University of Economics and others into public legal entities. As public legal entities these universities will be self-funded and come under the jurisdiction of the ministry of education, which in turn will translate to decreased budget expenditures towards these institutions.

Salary of teachers, especially in middle schools continues to be a major problem in education system of Azerbaijan. In 2016, average salary of an education worker was just 307 manats (\$192.4 dollars US). Since 2012, the increase in the average salary for a education worker has been only 19,7 manats (\$11.59 dollars US). As a result, most of the teachers are working in

second jobs in order to get a livable salary, which decreases their motivation, focus and efforts on classes and leads to a lower standards of education.

### **4.3.3 Healthcare expenditures**

Healthcare expenditures for 2018 are expected to be 740,7 million manats or \$435,6 million dollars US, which constitutes 3.5% of total projected budget expenditures. This number is 0.7% less from last year's budget in terms of manat and 8,9% less in terms of dollars. The main reason for this gap in decrease in terms of manat and dollar is the difference in the average exchange rate of 2016 (1 USD = 1.59 AZN) and the latest official exchange rate (1 USD = 1.7003 AZN).

Of that amount, 348,7 million manats (\$205 million dollars US) or 47,1% of total healthcare expenditures is to be spent on hospitals, which is 2.2% more than the same expenditures in the budget of 2017. 109,7 million manats (\$64.5 million dollars US) or 14,8% are designated for polyclinics, 11,7 million manats (\$6.88 million dollars US) or 1,6% for research and development and 285,5 million manats (\$367.9 million dollars US) or 36,5% for other expenditures related to healthcare. It is worth noting that expenditures for polyclinics are going to be 3.7% less than the budget of 2017. At the same time, expenditures for research and development are going to rise to 11,7 million manats from 5,1 million manats, accounting for a 130% increase. This on the other hand will have a positive impact on human capital development and potentially improve the healthcare sector.

It must be noted that the healthcare services are considered to be free for all the citizens of Azerbaijan but it remains highly underfunded compared to developed nations of the world. Average nominal salary of a healthcare worker was 214.8 manats (\$134.6 dollars US) in 2016. Since 2012, this number has increased only by 39.7 manats (\$23.4 dollars US), despite the high levels of inflation, which further decreased purchasing power of healthcare workers. As a result, people are frequently forced to make payments to the doctors, nurses and others or they get denied the service. Additionally, the quality of public healthcare centers is also highly doubtful, as they still tend to use equipment from the Soviet era.

The Government has maintained the implementation of a pilot programme for a country wide mandatory insurance system in Mingachevir and Yevlakh. This insurance includes a "base package" which covers 1829 healthcare services, while citizens can also pay to get an additional package which would include an extra 1186 services<sup>4</sup>. Yet, the effectiveness of such a national mandatory insurance program is doubtful, as individual payments continue to be the largest health related expenditures.

#### **4.3.4 Government debt management expenditures**

Projected expenditures for government debt spending in 2018 are 2.26 billion manats or \$1.33 billion dollars US. Compared with the same figures of 2017, these numbers are 37.8% and 40.9% more, respectively.

71,2% of this increase is because of payments of the external debts of the International Bank of Azerbaijan (IBA) from the budget. The bank defaulted on May 2017 as a result of years long inefficient, nontransparent and costly administration. Following the default, the government stepped in and took responsibility for IBA's external debts. Now the burden of these debts is on the shoulders of taxpayers.

On September 1<sup>st</sup> 2017, the Government of Azerbaijan issued bonds worth 2.26 billion manat (\$1.30 billion dollars US) for the above mentioned purpose. Of that amount, 441,9 million manats' (\$259.9 million dollars US) worth of bonds are due next year.

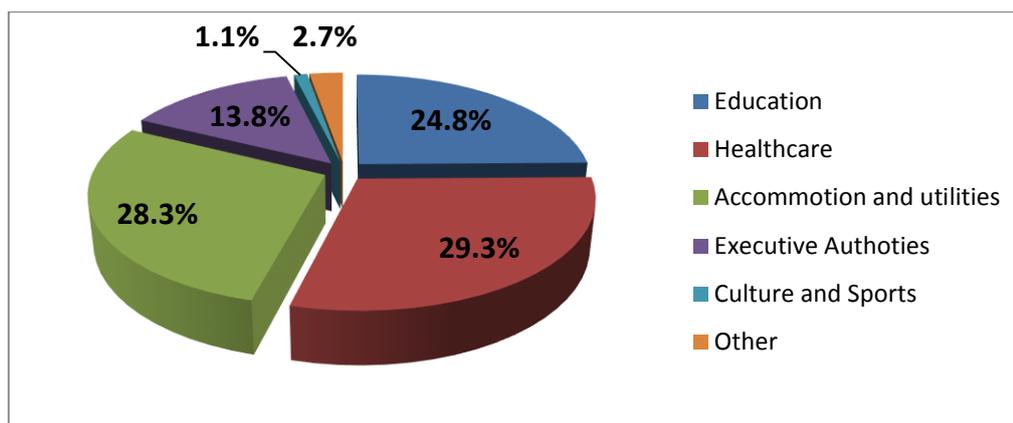
#### **4.3.5 Government capital expenditure**

7.87 billion manats (\$4.62 billion dollars US) have been dedicated for capital expenditures during 2018. This amount is 46,0% more than the same indicator for 2017. Decreasing government capital expenditures, which were observed as the price of oil started to decrease, is going to be turned back as the oil prices recently hit their highest in 2 years. With that increase, the actual share of capital expenditures in total budget expenditures have increased 7,6% point and reached 37,7%. The main reason for this increase comes from the state capital investments which is expected to rise by 82,9% during 2018. Most of that additional investment is going to be used for repair and reconstruction of buildings, roads and installations and purchasing non-financial assets. This huge amount and increase dedicated to these sectors presents an economically illogical choice, narrow down to two reasons. Firstly, overspending in these highly non-transparent sectors will only promote further rent seeking. Secondly, vital sectors such as education and healthcare will receive little to no increase compared to the abovementioned sectors. Finally, it is important that the construction and transport sector both have limited export potential thus further underlining the illogic of high expenditure in these sectors (V. Bayramov, & G. Abbas, 2017, 155).

#### **4.3.6 Local revenues and expenditures of State Budget**

Local expenditures in 2018 are projected to be 650,7 million manats (\$382.7 million dollars US), down by 38 million manats or 5,5% from the approved budget of 2017. It must be noted that out of all local revenues, the capital Baku alone constitutes 92,1% and its local expenditures are 34,7 times less than the local revenues, mainly due to the oil sector, while the regions with the highest local revenues are: Absheron, Imishli and Khachmaz who account for only 0,49%, 0,28% and 0,27% of total local revenue. This indicates that economic power in Azerbaijan is highly concentrated in one city, namely Baku. As a result, the process of brain drain occurs from the regions to the capital.

## 5. Diagram 10: Distribution of local expenditures.



Source: Ministry of Finance of the Republic of Azerbaijan, 2017

It is worth noting that in the budget projection of 2018, 9 cities and 20 regions had larger local revenues than local expenditures. On the other hand, in 31 regions the expenditures are expected to exceed revenues. These numbers have not changed from the approved budget of 2017 but the number of cities and regions which could match revenues and expenditures are significantly higher than in 2016, which was only 7 (2 regions and 5 towns). However, this increase is due to a new method of calculating local expenditures that turned pre-school costs (which were a significant part of the local expenditures) into centralized costs. With this new method, local expenditures fall by 849.57 million manats (\$499.69 million dollars US) or 55,2% in 2017. As a result, it became much easier for cities and regions to meet smaller local expenditures.

## Conclusion

In sum, the forecasts for 2018 point to an overall increase in revenue both for the state budget and SOFAZ's budget. However, only SOFAZ budget will experience a fiscal consolidation in 2018. The state budget will have a more positive growth, estimated to be 24% more than in 2017. On the other hand, SOFAZ's expenditures will outbalance its revenue accumulation in 2018, thus, maintaining a budget deficit, albeit 4.7% less than in 2017. In terms of revenue for the state budget, the share of the oil sector, following several years of decline, will again become the largest source of revenue for the state budget. However, we will also see a slight increase in the share of non-oil revenue, estimated at 3.8%. Revenues from the State Customs Committee will likewise be expected to reach an increase of 6.2% compared to 2017.

With regards to expenditures for the state budget in 2018, the government forecast predicts an equal increase in expenditures from the state budget. Total expenditures from the state budget in 2018 are estimated to be 23.7% more than in 2017. It is expected that social expenditures will reach a modest increase of 2.2% compared to 2017, expenditure on education will also see an increase of 15.2% , government debt and capital expenditures are estimated to increase to 37.8% and 46% ,respectively, more than in 2017. The main reason for increase in debt expenditures is due to the government stepping in and acquiring debts of the International Bank of Azerbaijan this year. The great increase of total capital expenditures lies in the increase in state capital expenditures in the infrastructure and construction sectors, which are notoriously

non-transparent. Nonetheless, certain sectors will see their share of expenditure from the state budget drop. In particular: social defence and social assistance expenditures (a 6.6% decrease), healthcare (at 0.7%) and local expenditures which drop with 5.5%.

What this means for the state budget and the overall economy is a return to high spending levels almost equal to levels of 2015. However, one needs also to consider that the purchasing power of the manat has decreased since 2015, making the levels of spending for 2018 lower than those of 2015. Thus, the expected GDP growth for 2018 will be driven by higher levels of expenditures, with the majority of those expenditures coming in the form of larger transfers from SOFAZ and taxation of the oil sector, due to the oil price increase for next year. Likewise, the share of the oil sector and SOFAZ's transfers to overall composition of state budget revenue will also a result rise. This marks the end of the period of fiscal consolidation of the state budget that commenced in 2014, following the price slump.

The main factor here will be the price of oil. A rebounding price of oil, driven by events abroad; such as local politics in Saudi Arabia, the extension of the agreed production cut by oil producing countries, as well as global economic growth in the major importers will affect the amount of foreign currency accumulated by the state. This will inevitably lead to an increase in oil revenue within the economy of Azerbaijan. As a consequence, higher oil prices will result in majority share of the state budget being based on the oil and gas sector. This in return, might lead to the process of diversifying the economy losing steam among policymakers. Additionally, any effort to increase the efficiency and transparency of tax and customs revenues could be disincentivized.

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