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### Amendments to state budget of Azerbaijan for 2020: reasons and expectations

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## **Amendments to state budget of Azerbaijan for 2020: Reasons and Expectations**

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## **Abstract**

Nowadays, global economic growth has been severely affected beyond anything passed in nearly a century. The outbreak of the coronavirus disease has brought its negative impact and destructive outcome on the economies alongside with the sharp fluctuations in global energy and stock markets. There might be observed a subsequent sharp decline in the number of transactions and practical shutdown of many markets due to the large-scale quarantine and self-isolation measures. Taking into consideration the abovementioned factors, it becomes clear that there emerged a need to revise all economic forecasts for 2020-2021. The International Monetary Fund (IMF) predicted a decline of the global economic growth rate in April (-3%), but in accordance with the current circumstances, the figures were revised in June, representing a 4.9% decrease.

In spite of a fact that Azerbaijan became one of the first countries among the post-soviet countries, that allocated the largest share of GDP, in order to eliminate the economic problems caused due to the pandemic, the impact of the emerged difficulties made a necessity to revise the budget.

### **1. Main reasons for the budgetary amendments**

It goes without a doubt that the economy of Azerbaijan was severely affected by the pandemic and fluctuations of oil prices. Over the first half of 2020, oil GDP decreased by 2.9% in real terms compared to the same period last year (see Table 1). However, the agreement reached between the OPEC + countries on April 9, 2020, and the latest amendments to the "Declaration of Cooperation" partially prevented the fall in oil prices by reducing crude oil production. Thus, on the basis of the international agreement, daily production in Azerbaijan should not exceed 554, 000 barrels in May and June 2020, 587,000 barrels in July and December 2020 and 620,000 barrels between January 2021 and April 2022.

Crude oil prices on the world market are significantly cheaper in comparison with the last year's indicators. The average price per barrel of Brent crude oil over the first six months of 2020 was \$ 42.1, which is \$ 23.8 less than in January last year. The price of a barrel of Azeri Light crude oil on

world markets in June 2020 averaged \$ 38.0, which is 40.3% less than at the beginning of the year. At the same time, in comparison with the forecast of the state budget, it was also 24.0% less.

**Table 1. Value-added in oil fields**

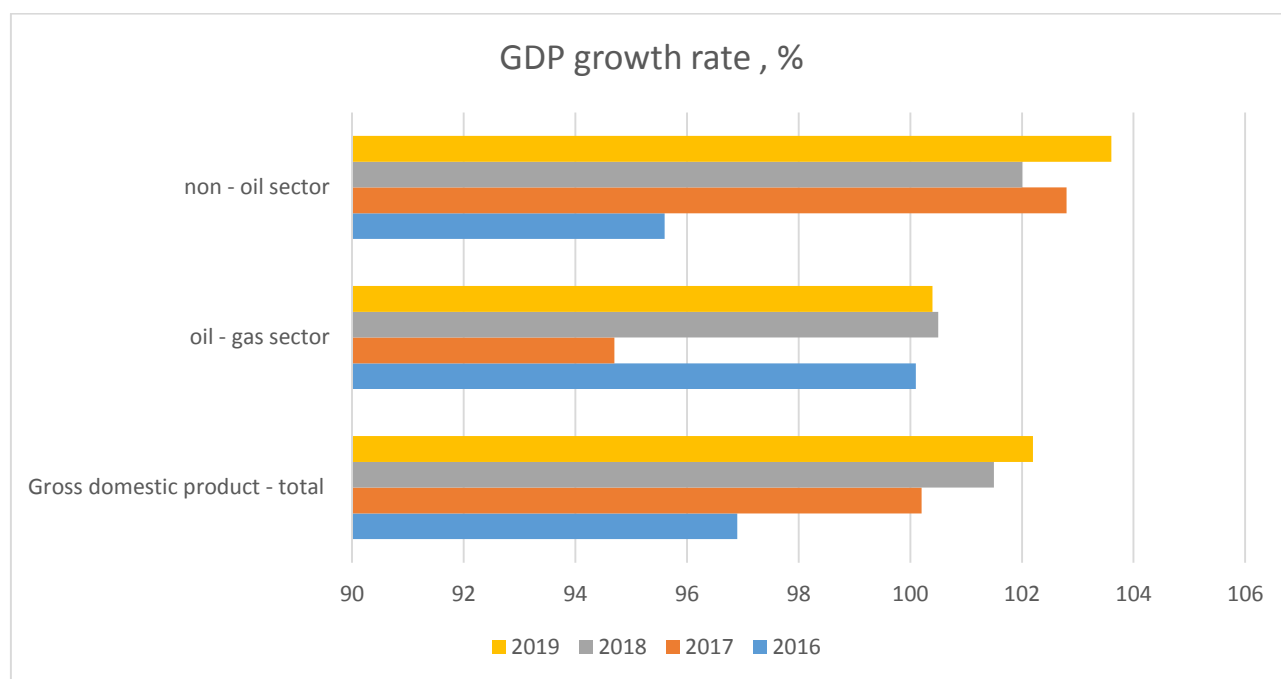
Indicators	Unit of measurement	January-June	
		2019	2020
Oil GDP	mln. manat	15603,6	10760,4
	%	1,3	-2,9
Oil production	%	-3,0	-4,9
Gas production	%	35,0	14,9

Source: *The Chamber of Accounts of the Republic of Azerbaijan, 2020*

As can be seen from the table, a decrease is observed in both: nominal terms and oil GDP. Between January-June, the non-oil sector performed as the main contributor to the decline in GDP. By 2020, 58 % or 13 billion 90.0 million manat of the adjusted state budget revenues related to the oil sector, whereas 42 % percent or 10 billion 134.0 million manat to the non-oil sector. In comparison with the approved forecast for 2020, revenues of the oil sector increased by 460.0 million manat (3.4 %), while revenues of the non-oil sector decreased by 470.5 million manat (4.4 %). The main reason for the decline emerged from the tourism and construction sectors. In spite of a real growth rate of 9,2% over the first two months of 2020, the accommodation of tourists and catering have been declining sharply since March, and this tempo has accelerated over the following months. Energy GDP decreased by 12 % year-on-year (yoy) in May, due to a hydrocarbons output cut in accordance with the negotiated OPEC+ quota. At the same time, non-energy GDP plummeted 6 % yoy in May, on top of a 13 % yoy decrease in April. As a result, overall GDP fell by 8 % yoy over the considered period.

From the Graph 1 we might see the growth rate of GDP over the four-year period and the main indicators by sectors.

**Graph 1. Growth rate of GDP, as percentage of the previous year**



Source: *State Statistical Committee of Azerbaijan, 2020*

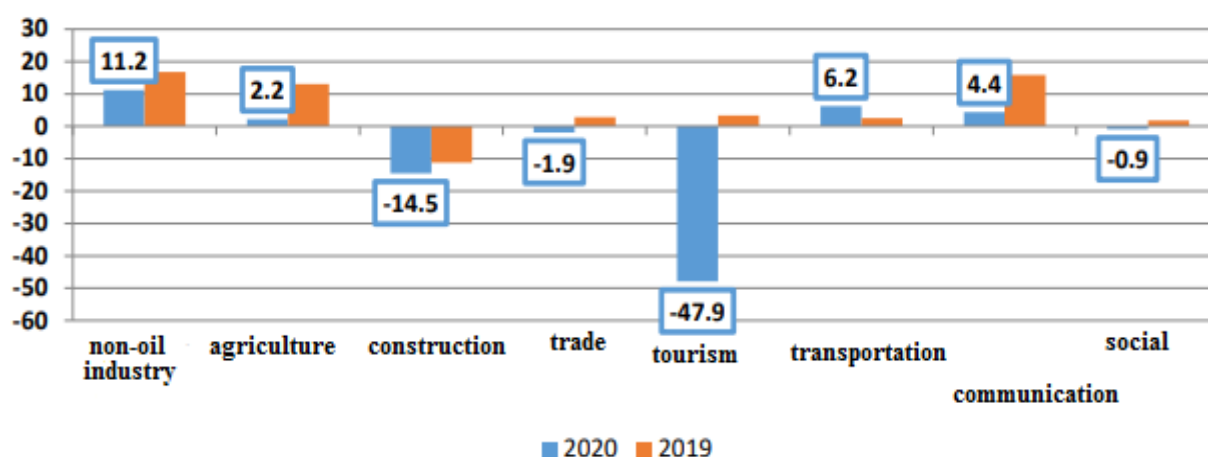
Due to the current situation in the country and measures implemented with the aim of preventing the spread of the disease, both domestic and foreign tourism were negatively affected. In particular, the largest rate of decline (47.9% decrease) and the most reducing effect on the formation of non-oil GDP (2.0 percentage points) were observed in this area. Moreover, it is worth mentioning that according to the official statistics provided by the Central Bank of the Republic of Azerbaijan, over the first quarter of 2020, the tourism services turnover decreased by 18%. Meanwhile, the amount of those who traveled abroad decreased by 23%, whereas the number of tourists visiting the country declined by 18%. As a result, it had a negative influence on the tourism industry development as well as on the dynamics of foreign exchange proceeds entering the country.

As it was mentioned above, the second important area that had a negative impact on the formation of non-oil GDP is the construction sector. Value-added production in this area (1896.7 million

manat) is 14,5% less than in the first half of 2019. The continuation of the negative dynamics might be explained by a steady decline in fixed capital investment.

As may be seen from the graph, although the indicators related to the non-oil industry are showing some positive dynamics, the real growth rate compared to the previous year decreased by 5.6 percentage points and accounted to 11,2%.

**Graph 2. Real growth rate in non-oil sector, January-June, %**



Source: *The Chamber of Accounts of the Republic of Azerbaijan, 2020*

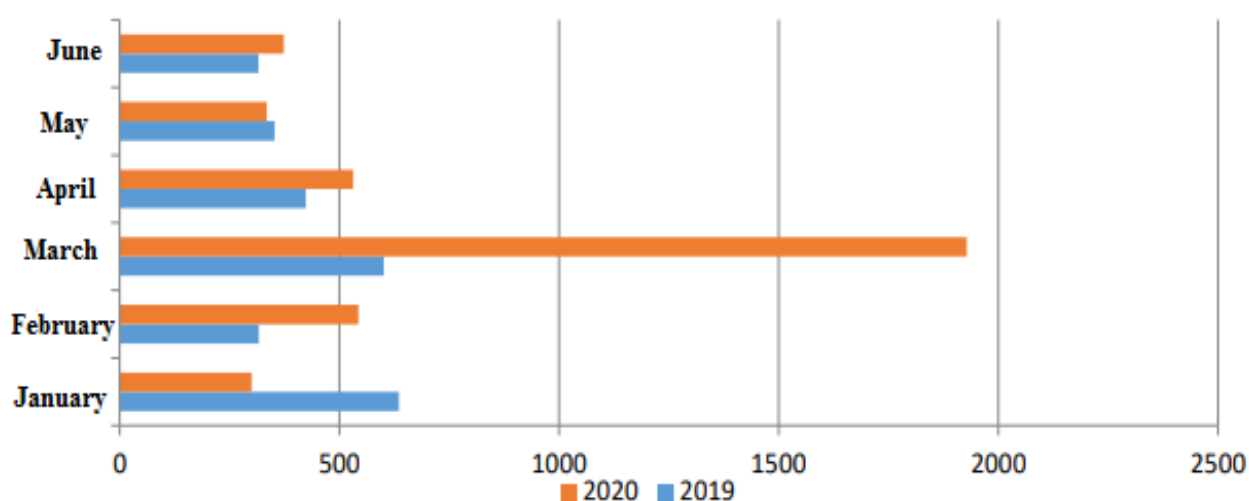
Furthermore, over the first half of 2020, the annual income of the population was composed of 27377.8 million manat. Although it increased by 0.6% in nominal terms, it decreased by 2.3% in real terms in annual comparison. Meanwhile, it is worth mentioning that the real growth rate (5,9%) of this social indicator was observed over the first two months of 2020. However, based on the applied quarantine regime, declining dynamics that was noted since April followed by, over the next months. The government has significantly increased spending on public health and announced support to the affected businesses and individuals. It is worth mentioning that the economic support program of the government also includes tax benefits, some privileges and holidays for business entities.

According to the data provided by the State Customs Committee of Azerbaijan Republic over the first half of 2020, the foreign trade turnover accounted to \$ 12675.8 million, which means a decrease of 25.4% in comparison with the previous year. Additionally, there was a decrease in the volumes of exports and imports, respectively, taking into account recorded positive saldo (\$ 2696.7 million)

over the first half of 2020. The volume of exports decreased by 23%. This recession might be explained through a decline in oil production and cheapening of the oil prices on the world market.

The pressure on the national currency (AZN) has increased in March on the background of a sharp drop in oil prices, oil revenues and foreign exchange expectations of declining incomes. As it might be observed from the Graph 3, an oversupply might be noted during the first two months of the reviewed period, while in March the demand was fully met in the amount of \$ 1928.3 million.

**Graph 3. Monthly foreign exchange sales by SOFAZ at currency auctions, mln. USD**



Source: *The Chamber of Accounts of the Republic of Azerbaijan*

According to the official data published by the State Oil Fund of the Republic of Azerbaijan (SOFAZ), the volume of transfers in the budget was composed of 5675.0 million manat, which is considered as 100% of the projected amount for the period under review. Another part of the total exchange sales of SOFAZ- 997.3 million manat was placed in the Central Bank and intended for execution in manat. Additionally, according to the provided data on the reconsideration of the parameters of the state budget, it is planned to increase SOFAZs transfers from 850 million manat to 12200 million manat. This, in turn, may maintain the economic development alongside with the growing demand for foreign currency on the background of consumer concerns.

Analysis of the revenues and expenditures based on reports on the implementation of the state budget over the first six months of 2020 illustrates that there was a surplus in January and March, while in February, April, May, and June there was observed a deficit. Thus, the largest surplus

composed of 2275.8 million. manat was noted in March, whereas the largest deficit consisted of 1140.0 million. manat was observed in May. If to compare the current indicators of the state budget with the last year's indicators, we may see that the amount of revenues is 15790.8 million manat (15,1%) more, while the amount of expenses is 779.8 million manat (7.1%) less. Meanwhile, the analysis of the monthly distribution of expenditures based on the reports on the execution of the state budget over the first six months of 2020, illustrates that the indicators were almost the same in accordance with the forecast in January and June, while in February, March, April, and May the expenditures exceeded the forecast.

It is an undeniable fact that on the background of the new challenges arisen due to the pandemic, there is a need in reconsideration of the state budget.

## **2. Necessity for the revision of the budget**

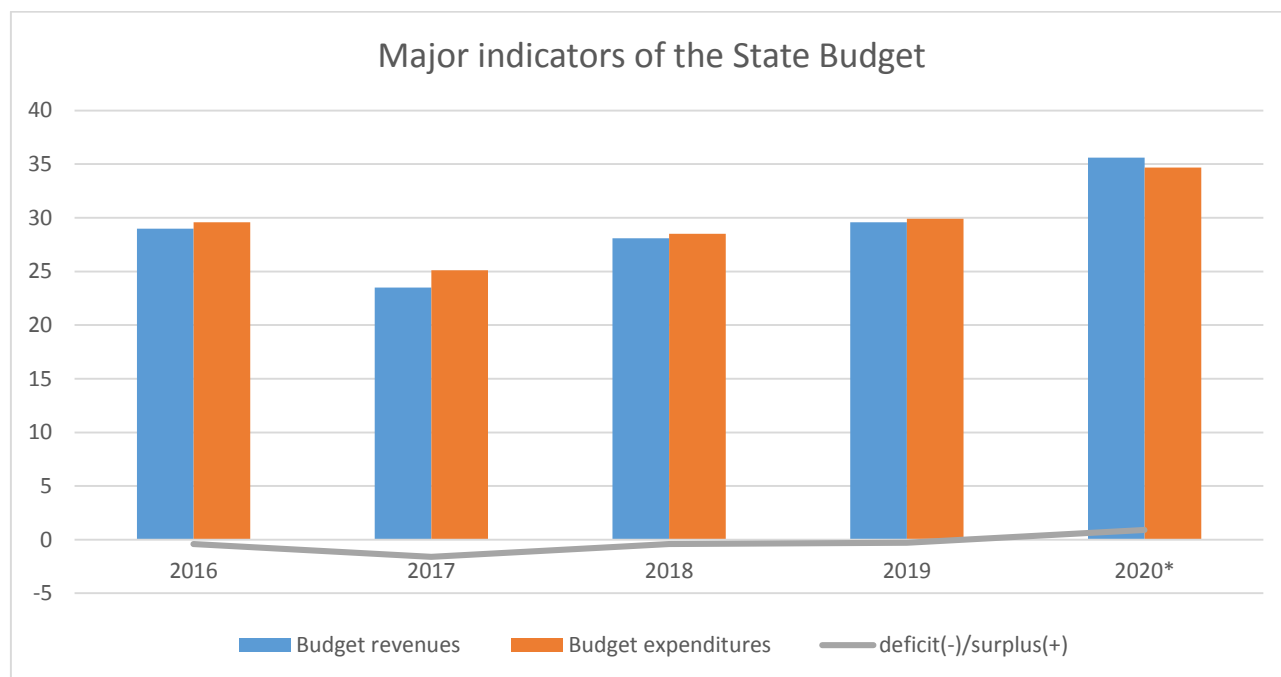
It goes without a doubt that there is a need for the qualitatively new approaches and policies in the frameworks of social and economic environments. The growing needs of the health sector, a continuation of state support for vulnerable groups, small and medium businesses (SMEs), and other public needs undoubtedly require implementation of new measures. This, in turn, creates new challenges for the increasing state budget expenditures. The creation of additional financial resources to cover the necessary expenditures is reflected in the revised draft state budget for 2020. According to the rapid spread of a new type of coronavirus infection (COVID-19), declared by the World Health Organization (WHO) as a pandemic, following Article 23 of the Law of the Republic of Azerbaijan, negative trends in the world economy and sharp fluctuations in the world energy and stock markets, reconsideration of the budget was implied in relation with to a soft countercyclical fiscal policy in the current year, with the suspension of the application of the budgetary rule to solve problems and balance budget revenues and expenditures.

Taking into account the excess of revenues over the six months, by the end of this year, the total of the state budget revenues and deficit financing amounts to 927.5 million manat (390.0 million manat on oil revenues, 500.5 million manat on non-oil revenues), while the deficit is expected to decrease by 37.0 million manat (including revenues from privatization). At the same time, taking into account new challenges, the additional demand for state budget expenditures is estimated at 1371.5 million manat. As a result, there emerges a need to form a financial provision of 2299.0 million manat to



balance the declining revenues and increasing expenditures of the state budget. The graph below illustrates the data related to the budget revenues and expenditures. The deficit might be clearly observed as well.

**Graph 4. Major indicators of the State Budget of the Republic of Azerbaijan**



\*The indicator of 2020 covers the period of six months.

Source: *Central Bank of the Republic of Azerbaijan, 2020*

In general, the additional expenditures composed of 1371.5 million manat will be used in the following main areas:

- reserves for further development of the country's defense capability and national security, coverage of unpredictable additional costs related to the fight against the pandemic, and financing of other necessary expenses- 465.0 mln. manat;
- 369.0 mln. manat for additional needs in the field of health (finance the periodic supplement to medical workers working in the conditions of coronavirus infection, the supply of necessary medical supplies, equipment and other needs);
- 238.0 mln. manat for social protection and social security in the framework of the pandemic;
- 136.6 mln. manat as financial support to state companies in the framework of the pandemic;
- 100.0 mln. manat as financial support to entrepreneurs;

- 37.3 mln. manat as financial provision for increasing salaries and filling vacant positions in a number of organizations (State Customs Committee of Azerbaijan Republic and etc.);
- 9.1 mln. manat for strengthening the material and technical support of some organizations, rent payment to the military and other necessary expenses;
- 7.0 mln. manat for financial support of e-government application on “ASAN service”;
- 2.8 mln. manat for the citizens of the Republic of Azerbaijan arriving in the country during the pandemic (mobile camps established at the border);
- an additional cost of 6.7 mln. manat is expected to be allocated for the printing of biometric passport blanks and new generation ID cards.

It has to be noted that when calculating the average annual price of a barrel of oil in the amount of \$ 35.0, the expenses of the consolidated budget and the expected amount of transfers from the State Oil Fund of the Republic of Azerbaijan to the state budget requires a reduction of about 2.5 billion manat. At the same time, taking into account the realities of new oil prices and declining oil production, the application of the budget rule in the preparation of the fiscal framework for 2021 and the next three years necessitates a sharp reduction in budget expenditures in the medium term. However, the experience demonstrates that a sharply narrowing fiscal policy applied during the crisis periods of the economy leads to a sharp decline in economic activity and employment rate within the country which leads to the deepening and continuation of the recession. In this regard, a sharp reduction in budget expenditures and transfers from the State Oil Fund of the Republic of Azerbaijan to the state budget following the budget rules in the current and following year may further complicate the situation, given the need to stimulate aggregate demand to some extent through public spending.

**Table 2. Comparative table for calculation of a budget rule**

№	Main parameters of the consolidated budget	The price of a barrel of oil for 2020 (USD)		Comparison between the expected figures in the \$ 35 scenario and the approved figures for 2020	
		55 approved	35 scenario	Difference +; -	%
1.	The upper limit of the transfer from the State Oil Fund to the state budget,	11350.0	8890.5	- 2459.5	- 21.7

	calculated in accordance with the budget rules				
2.	The projected amount of transfer from the State Oil Fund to the state budget	11350.0	12200.0*	+850.0	+ 7.5

\* Indicator that do not comply with the budget rule (target)

Source: *The Chamber of Accounts of the Republic of Azerbaijan, 2020*

All the budgetary funds that were allocated to support economic development, businesses, and social protection of citizens reached 3 billion manat, which is 12% of the state budget revenues and 3,5% of GDP. It goes without a doubt that creating favorable economic conditions in the post-pandemic period is as important as maintaining the economy in the period of the pandemic. Therefore, all programs under implementation and the huge amount of government funding have to support the stability of economic development in the long-term period.

### 3. Budget coverage

According to the Law of Budget System of the Republic of Azerbaijan, the balance between revenues and expenditures, their arranging and execution, and changing amounts are among the essential conditions for the revision of the budget.

The budget of the Azerbaijan Republic covers the following revenues and expenditures. The elements of revenues are below:

1. State Tax Service
2. Custom duties
3. State Oil Fund of Azerbaijan
4. Income from commercial activities of non-profit organizations
5. Receipts from paid services of budget organizations
6. Other sources of income.

As it may be seen from the Table 3, in relation to project law and the information attached to it, it is proposed to make changes at the level of administrative bodies and types of payments in all the context elements of the budget incomes.

**Table 3. Forecast and performance indicators of state budget revenues for 2020, including proposed adjustment parameters, thousand manat**

Numbers	Sources of state budget revenues	2020					The proposed adjustment for 2020	Comparison	
		Current annual forecast	6-month forecast in force	6-month execution	6-month execution, % (5/4 * 100)	Annual execution rate (5/3 * 100)		In the amount of (8-3)	%-with (8/3 * 100)
1	2	3	4	5	6	7	8	9	10
	State budget revenues	24 134 500,0	11 684 549,0	12 075 887,0	103,3	50,0	24 124 000,0	-10 500,0	100,0
1	State Tax Service	7 875 000,0	3 678 805,0	4 005 400,0	108,9	50,9	7 190 000,0	-685 000,0	91,3
2	Custom duties	4 000 000,0	1 921 201,0	2 019 812,0	105,1	50,5	3 830 000,0	-170 000,0	95,8
3	State Oil Fund of Azerbaijan	11 350 000,0	5 674 998,0	5 675 000,0	100,0	50,0	12 200 000,0	850 000,0	107,5
4	Income from commercial activities of non-profit organizations	29 220,0	17 638,0	74 202,0	420,7	253,9	6 287,0	-22 933,0	21,5
5	Receipts from paid services of budget organizations	839 500,0	368 121,0	266 279,0	72,3	31,7	804 000,0	-35 500,0	95,8
6	Other sources of revenues	40 780,0	23 786,0	35 194,0	148,0	86,3	93 713,0	52 933,0	22,3 times

Source: *The Chamber of Accounts of the Republic of Azerbaijan, 2020*

24,124.0 million manat (35% of GDP) is expected as the adjusted income of the state budget for 2020, which is 10.5 million manat less than ratified forecast for 2020. It should be noted that the percentage of confirmed state budget incomes to GDP for the current year is planned at 29.6%.

In comparison with the previous year, the volume of the revenues has increased during January-June and reached 1579766.0 thousand manat (15,1%), 372600.0 thousand manat (10,3%) of which came through the State Tax Service, while 24200,0 thousand manat (7,7%) through non-commercial and budgetary organizations, respectively. However, a decrease was observed in the contribution of the

State Customs Committee, 45347.0 thousand manat (2.2%) including the index of other sources which is composed of 33687.0 thousand manat (48.9%). With regard to the decreased income from the State Customs Committee, it has to be noted that the volume of imports along with value-added tax decreased per 6,2% (\$ 246337.2 thousand), the amount of imports along with custom duties decreased per 3,8% (\$ 80228.2 thousand), whereas the amount of imports along with excises reduced per 1,5% (\$ 4983.6 thousand).

The State Oil Fund and the State Tax Service performed as the main actors for increasing income in the state budget during the first half of 2020. Corporate income tax, income tax from physical persons, and value-added tax are the bases of the increase in the budget.

Main elements of expenditures:

1. General public services
2. Defense and national security
3. Judiciary, law and enforcement system
4. Education
5. Health
6. Social protection and social security
7. Culture, art, information, physical education, youth policy and other activities
8. Housing and utilities
9. Agriculture
10. Environmental Protection
11. Economic activity
12. Not related to the main sections' expenses.

From the table below, we may observe a downward trend in particular sections such as “General public services” (-169.9 million manat or -4.2%), “Education” (-121.0 million manat or -3.8%), including the “Defense and national security” (-49.4 mln. manat or -1.3%) and etc (Table 4).

According to the obvious differences, the decision on the revision of the budget seems crucial for further economic development opportunities and maintaining balance.

**Table 4. Amendments provided by the functional classification in the state budget expenditures for 2020, thousands of manat**

Numbers	Directions of expenses	Initially approved		Revised		Comparison		
		Forecast	Specific weight	Forecast	Specific weight	Absolute	Relative	Difference between specific weights
1	General public services	4 009 674,8	14,9	3 839 732,7	14,0	-169 942,1	-4,2	-0,9
2	Defense and national security	3 853 585,7	14,3	3 804 168,0	13,8	-49 417,7	-1,3	-0,5
3	Judiciary, law and enforcement system	1 970 437,1	7,3	1 936 720,0	7,0	-33 717,1	-1,7	-0,3
4	Education	3 155 797,7	11,7	3 034 767,8	11,0	-121 029,9	-3,8	-0,7
5	Health	1 369 011,9	5,1	1 716 595,5	6,2	347 583,5	25,4	1,2
6	Social protection and social security	3 244 591,9	12,1	3 237 037,2	11,8	-7 554,7	-0,2	-0,3
7	Culture, art, information, physical education, youth policy and other activities of this kind	441 921,5	1,6	426 092,4	1,5	-15 829,1	-3,6	-0,1
8	Housing and utilities	249 112,1	0,9	248 182,0	0,9	-930,1	-0,4	0,0
9	Agriculture	920 990,1	3,4	897 675,9	3,3	-23 314,2	-2,5	-0,2
10	Environmental Protection	279 886,4	1,0	273 314,3	1,0	-6 572,1	-2,3	0,0
11	Economic activity	5 602 460,3	20,8	5 832 835,5	21,2	230 375,2	4,1	0,4
12	Not related to the main sections' expenses	1 797 230,5	6,7	2 245 078,7	8,2	447 848,2	24,9	1,5
Total		26 894 700,0	100,0	27 492 200,0	100,0	597 500,0	2,2	0,0

Source: *The Chamber of Accounts of the Republic of Azerbaijan, 2020*

Taking into account the amendments in the revised budgetary proposal, the classification goes as following:

1. The amount of 3839.7 million manat is considered for "General public services" which is 169.9 million manat or 4.2% less, compared to the initially approved amount of 2020.
2. The expenditures on "Defense and National Security" are assumed at 3804.2 million manat. The decrease is composed of 49.4 million manat or 1.3% in comparison with the previously confirmed amount.

3. In the "Judiciary, law and enforcement system" section, the initial amount was approved at 1970.4 million manat, whereas during the revision the decline in the expenditure accounted per 33.7 million or -1.7%.

4. The expenditures on the "Education" section at the revision of the state budget project are forecasted at 3034.8 million manat, which is 121.0 million manat or 3.8% less than the approved amount of 2020. Meanwhile, the expenditures of this section are expected to decrease by 0.7 percentage points to 11.0%.

5. The expenditures on the "Health" section during the revision of the state budget are forecasted at 1716.6 million manat, which is 347.6 million manat or 25.4% more than the approved amount of 2020.

6. The amount of 3237.0 million manat is expected at the revised state budget for the expenditures on the "Social protection and social security" section, which is 7.6 million manat or 0.2% less than the approved amount of 2020.

7. The amount of 426.1 million manat is forecasted at the revised state budget project amount for the expenditures on the "Culture, arts, information, physical education, youth policy and other activities" section, which is 15.8 million manat or 3.6% less than the approved amount of 2020.

8. The amount of 248.2 million manat is forecasted at the revised state budget project amount for the expenditures on the "Housing and utilities" section, which is 930.1 thousand manat or 0.4% less than the initially approved amount of 2020.

9. The amount of 897.7 million manat is considered for "Agriculture" section which is 23.3 million manat or 2.5% less compared to the initially approved amount of 2020.

10. The amount of 273.3 million manat is considered for the "Environmental protection" which is 6.6 million manat or 2.3% less compared to the initially approved amount of 2020.

11. The amount of 5602.5 million manat was approved as an initial amount for the "Economic activity" section. During the revision of these expenses, the amount has increased per 230.4 million manat or by 4.1%.

12. In the revised state budget project, the specific weight is expected to increase per 1.5 percentage points and account to 8.2% in the "Expenditures not related to the main sections".

#### **4. Conclusion and Recommendations**

It goes without a doubt that the procedure of revising the budget was impossible to avoid due to the factors described above. Generally speaking, we may conclude that the pandemic brought devastating results and led to an economic recession affecting all sectors one by one. Due to the quarantine measures applied by the government, a significant decline in the revenues was observed. It is expected that the downward trend in the amount of revenues will continue in the second half of 2020 as well.

A considerable number of companies was severely hit by the reduced demand for products and services. As a result, the government had to implement particular measures and reforms in order to provide support for the affected businesses and sectors. This program had a direct impact on the budget which led to instability and compelled for the amendments, respectively.

Additionally, it is worth mentioning that the largest amount of contribution was made through the oil revenues which undoubtedly leads to the deepening of oil dependency. As it was noted above, on the basis of the provided data on the reconsideration of the parameters of the state budget, it is assumed to increase SOFAZs transfers from 850 million manat to 12200 million manat. Meanwhile, a decline per more than 40% is expected in the amount of SOFAZ revenues.

The increase in the money supply causes a negative impact on the currency market. Countercyclical policy applied within the country was meant to maintain the stability among the revenues and expenditures. However, it is hard not to notice that as the volume of expenditures rise steadily, the deficit will increase respectively.

Taking into consideration the current circumstances and challenges, it seems necessary to anticipate and minimize the transition to a new countercyclical fiscal policy, taking into account the negative effects of this policy in the post-pandemic period.

It goes without a doubt that the dependency on oil has significantly risen, thus, it seems important to implement optimization of cost in order to prevent this process. On the basis of the indicators related to the contribution made by the oil sector, we may conclude that the share of oil in the revised budget will increase, and the Ministry of Finance needs to take steps to reduce this dependence.

Optimization of import obligations has to be taken into consideration as well. Revenues from customs duties are projected at 910.0 million manat, which is 40.0 million manat (4,2%) less compared to the approved forecast for 2020 and 199.5 million manat less in comparison with 2019.



On the background of the recent difficulties in the water management system, the expenses of the "Azerbaijan Amelioration and Water Farm" Open Joint-Stock Company responsible for the irrigation of water supply cut costs by 13.9 million manat, which is not considered appropriate. The cost has to be reconsidered.

The reductions in 3 out of 4 research subsections are not appropriate. The expenses of the sub-section "Applied research in the field of health" are reduced by 70.4%, applied research in the field of education is reduced by 3.2%, while the decline in the sub-section "Applied research in the field of defense and national security" is composed of 2.5%.

Furthermore, it seems reasonable to justify the suspension of the budget rule. There is a need to consider the effects of external shocks. In addition, there is a need to improve the structure and content of the proposed amendments of the Chamber of Accounts on budget amendments. Current content is based on a more narrative description, and there are no alternative scenarios and recommendations.

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