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IMPROVING THE EFFICIENCY AND EFFECTIVENESS OF AZERBAIJAN'S TAX SYSTEM

səh. 161-178

Abstract

Purpose – despite the exciting progresses that Azerbaijan has made in the reform of its tax system since the 1990s, some knotty issues still remained germane that are affecting the effectiveness and efficiency of the current system. This paper takes a critical assessment and analysis of different areas of the system that could still be inhibiting tax efficiency.

Design/methodology – we adopted data comparison approach. We compared data from Azerbaijan's system with that of its peer in Eastern Europe and Central Asia (ECA) in the World Bank designation.

Findings – we found various issues limiting tax efficiency and earnings in the areas of licensing fees, tax base, tax rates, complexity of the system, tax spread and the size of the country's informal sector. The five key recommendations are: Streamlining the tax code to block loopholes for corruption; reviewing PSA agreements made in the 1990s to reflect the present realities; improving tax enforcement to deter tax avoidance; across the board tax increases and increasing revenue from consumption-based activity; and reducing the cost of doing business legally, while increasing the punishment of illegal business activities in order to reduce the size of the informal sector.

Researh limitations – the comparative analysis is limited to ECA countries.

Practical implications – findings of the research would arrest the tax losses and improve Azerbaijan's earnings from tax revenues.

Originality/value – the study took an original and new multi-faceted approach to areas that are still problematic after the tax improvements that have been made.

Keywords: *Azerbaijan, Eastern Europe and Central Asia, informal sector, optimal taxation, tax system, tax laws.*

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1. Introduction

Tax, the monetary charge or levy imposed by a state upon individuals, property, businesses or any legal entity within its domain remain a crucial sources of public revenue for the state. *(Garner, 1999: 1469*).For Azerbaijan, as with other states, revenue from taxation is an important source of revenue for the state and its fiscal stability. The country has some impressive economic indices when compared with its peers, the other European and Central Asia (*ECA*) countries. With a GDP purchasing power parity of $98.16 billion according to a 2012 estimate, Azerbaijan is ranked 75th in the world. Azeri GDP in 2012 was $71.04 billion and the real growth estimate for 2012 was 3.8%, while the GNI was 82.1 billion USD (*CIA World Factbook: 2013*).

Tax system of Azerbaijan revenue was $23.25 billion USD, with expenditures at $25.55 billion USD. Taxes are estimated to be 32.7% of GDP. The country's public debt is put at 5.4% of the country's GDP. Profit tax is 25.9%, income tax is 11.3%, Azeri VAT is 39.3%, and excise tax is 9.5%, while other taxes are at 14%.[i] Generally, the period from 2006 to 2010 is one of high economic growth, growth that is largely attributable to the large and growing oil and gas exports.

Yet there is a potential problem. Although some non-oil export sectors featured double-digit growth, (*construction, banking, and real estate*) yet the economy remained driven by the oil sector. There is even further fear that, the non-oil sector growth may be driven primarily by government investments, which therefore raises concern of fiscal stability if oil production continue to decline from current production levels, as projected (*Zermeno, 2008*). The problem does not end there. Compared to its peers, estimates of Azerbaijan's tax revenue for 2012, as percentage of total government revenue is put at 49.7%; the lowest percentage contribution to total revenue when compared with other countries in the ECA Region.[ii]

Apart from the above, Azerbaijan may be facing huge tax losses or unrealized tax potentials. The IMF estimates that of the potential 1.79 billion manat in 2007, about 31.5% is lost to exemptions and inefficient tax administrations (*Zermeno, 2008: 8*). Although, Azerbaijan has adopted modernization policies in tax administrations starting from the early 2000s, like the creation of a large tax payers unit, a state-of-the-art online system, and one-stop window for taxpayer registration, the system is not perfect yet. (*Zermeno 2008: 7*) Our question therefore is, despite the reforms in the Azerbaijan tax system what are the other ways to improve the efficiency and effectiveness of the tax system, and prevent revenue losses?

2. Method

To answer this question comprehensively, we broke it down further into five other sub-questions based on issues identified in the existing literatures as affecting the efficiencies and effectiveness of the tax system. (*Tanzi and Shome, 1993; Boadway and Sato, 2007*) First, we looked at the high value targets (*the hydrocarbon sector*) and the various tax exemptions and asked, are taxes on high value targets too low or are there too many exemptions? Is the tax system too complex to yield maximum revenue? Second, we examined the licensing fees in the major sector of the economy: oil sector, and asked, are licensing fees and other government incomes from the oil sector at appropriate levels? Third, we examined the current tax base and asked, if it is possible to spread the tax base, and is a wealth tax possible/desirable? Fourth, we realized that raising tax bases could be tricky in a number of ways, especially in relations to growth and total tax revenue. We therefore asked can tax rates for different tax base (*labor, individuals, corporate*) be raised without lowering total revenue? Fifth and finally, we examined the size of the informal sector of the economy. In other words we asked, is the informal sector a significant source of revenue loss?

Our analysis is based on a comparison of countries in the ECA region according to the World Bank's designation.[iii] We believe these are peer countries of Azerbaijan, and basing our evaluations on comparison among peers would yield a rather more fair expectation and results. However, most of these countries are former states of the Soviet Union, and therefore transitions states and therefore sometimes, the data is not as easily available.

3. Are taxes on high value targets too low or with too many exemptions? Is the tax system too complex to yield maximum revenue?

On the 2010 tax code of Azerbaijan everything seemed perfect on paper. Corporate tax rate was put at 20% of profit for all legal entities of Azerbaijan. However, there are two exemptions to this rule that undermine the general revenue from taxes. First under the Production Sharing Agreement (*PSA*) in the oil sector, companies partaking in these agreements are not subjected to the 20% corporate tax rate.[iv] The PSAs were ratified by the legislature/National Assembly (*Milli Majlis*) and granted the force of law. Each PSA has its own exclusive tax regime in Azerbaijan that would be pre-negotiated by the government. Sub-contractors of PSAs generally also pay a withholding tax ranging from 5% to 8% of the gross payments received as consideration for work or services performed in Azerbaijan. The PSA agreements extends to foreign subcontractors (*FSC*) of the oil firms, and are subject to a simplified tax regime (*Withholding Tax instead of Profits Tax*). This simplified corporate income tax regime does not apply to Azerbaijani legal entity subcontractors. PSA signatories are also exempt from VAT taxes, and do not pay custom duties on goods imported for their activities.

The implication of this is that the advantages of modernization and electronic systems introduced into the tax system to remove the human factor does not apply to many players in the biggest sector of the economy. This human factor leaves the room for favoritism and corrupt practices through negotiations. Again, Overreliance on the hydrocarbon sector of the economy and a difficult private business economy has created an unsteady foundation for the Azerbaijani tax system. It has ensured that maximum attention is paid to the oil sector, while small and medium scale private businesses are receiving less attention. In other words, it is the companies that have the highest capacity to pay that get exemptions, while the lowly ones that needed help to develop have to pay the flat rate.

The economic growth provided by the revenue from the oil industry has allowed for a massive amount of social spending and infrastructure spending. Spending that has dramatically reduced the level of poverty in Azerbaijan. However, the increased social spending has also allowed the oil sector to gain a privileged position with the government tax structure ensuring that oil companies can negotiate better terms and rates for their companies. Examples of the exempted activity include pipeline building and related pipeline activities.[v] For instance, the difference in revenue between a corporate tax rate of 30% compared to lower PSA rates which constitutes a severe loss of revenue on high value target.

Another hindrance to the maximization of revenue for Azerbaijani Government is the difficulties faced by small and medium sized enterprises (*SME*). As earlier stated, and cited by Albino-War and Shahmoradi (*2012: 2*), among the top primary challenges to SMEs that is restricting growth, and therefore tax revenue, is regulations and other obstacles put in place by the Azerbaijani government. Although the non-oil sector of the economy has provided more steady and stable growth over the last several years and is predicted to continue to grow at steady and less volatile rates through 2016, this growth could still be hurt by some factors. Excessive regulation, corruption, and lack of transparency in government all act as a brake on the growth of SMEs and therefore artificially reduce revenues for the government.

In order to create a sustainable private sector that produces a steady stream of revenue for the Azerbaijani Government, that is more reliable than the revenue provided by the volatile oil sector; increased focus should be on reducing regulations and corruption. Azerbaijan has made improvements in increasing transparency and reducing corruption in recent years, however significant issues remain and the country ranks well below average even among its peers. For instance, The Heritage Foundation's freedom of business report ranked Azerbaijan 24 over 100 in the freedom from corruption index for 2013 (*Heritage Foundation Country Data index*).[vi] By streamlining the tax code, reducing exemptions in the tax code, and taking steps to increase competition in the private sector, additional tax revenue could be raised even without any increase in rates.

One way to boost efficiency in this sector is the streamlining of the tax system of Azerbaijan.[vii] The average number of tax payments made in a year for Azerbaijan is

18. While this may be substantially better than other countries in our sample set, it falls well below the other economically competitive and growing post-Soviet economies such as Belarus, Latvia, Georgia, and the Russian Federation. Additionally, the number of hours it takes to prepare tax returns in Azerbaijan is 214 (*in a year*). Again, this is better than some other countries in our sample set, yet other post-Soviet economics are more competitive in this area. Countries such as Lithuania, the Russian Federation, and Kazakhstan perform much better on this metric (*World Bank/PWC, Doing Business Report, 2013*) The IMF ranked Azerbaijan 76, in its "Ease of Paying Taxes" compilation. Some comparison countries in our data set rank significantly higher. Again, post-Soviet economics of Estonia and Georgia rank substantially better. The Russian Federation and Latvia also score better in this metric.

With revenue from oil exploration and production a volatile source of revenue, Azerbaijan would be well served to explore ways to strengthen, expand, and improve other sources of tax revenue.

4. Are licensing fees and other government incomes from the oil sector at the appropriate levels?

There are several ways for Azerbaijan to capitalize on the resource from oil licenses and fees, and taxes from the workers and products in the sector. Of the total Azerbaijan's GNI of $56,401,665,101 per year, 9.5% or (*485 million manats*) comes from excise taxes on commodities taxes and special licenses related to Azeri oil. On average, the Azerbaijan government receives rents or royalties of 99.48 million manat a year. But is this the optimum revenue that could be reaped from this sector to benefit the economy?

The State Oil Company of Azerbaijan Republic (*SOCAR*) is responsible for producing oil and natural gas in Azerbaijan, operating the country's two refineries, running the country's pipeline system, and managing the country's oil and natural gas imports and exports. Although the Ministry of Industry and Energy handles exports as well as exploration and production agreements with foreign companies, SOCAR participates in all of the international consortia developing oil and gas projects in Azerbaijan. However, on its own, SOCAR produces less than 20 percent of Azerbaijan's total output, with the remaining 80 percent being produced by the BP-operated Azerbaijan International Operating Company (*AIOC*).[viii] AIOC is a consortium of 10 petroleum companies that have signed extraction contracts with Azerbaijan. The AIOC is led by BP and includes Chevron, Statoil, Turkiye Petrolleri, Exxon Mobil, and SOCAR (*Ministry of Taxation Azerbaijan*).

There are four major oil fields in Azerbaijan; ACG, Shah-Deniz, Nakhchivan, Kursangi and Karabagli. The Azeri Chirag Guneshli field is Azerbaijan's most important oil field, it accounted for nearly 80 percent of Azerbaijan's total oil output in 2010. The ACG field has an estimated 5 billion barrels of reserves, and it is being operated by BP. The terms of the Azerbaijan's PSA agreement with BP over ACG are critical to determine if Azerbaijan is losing revenue.

The major problem stems from the terms of the contracts. Parties are not subject to any existing or future taxes of any nature whatsoever in respect of their hydrocarbon activities in Azerbaijan outside of the Production Sharing Agreement (*PSA*). The agreement states that each contractor party shall pay profit tax in respect of its hydrocarbon activities in accordance with the law of the Azerbaijan Republic on taxes on profit and certain types of income of legal entities, dated 9 November 1991, as enacted, and as generally applicable and in force in the Azerbaijan Republic on 1 January 1993, except where double taxation applies.[ix]

The terms of BP's PSA in the ACG field are becoming inefficient, and may result in tax revenue loss. BP is the largest stakeholder in the Azerbaijan's largest oil field in the Caspian Sea; it controls 34.137 percent of this field which produces 80 percent of Azeri Oil. This field holds 5 billion barrels of Azerbaijan's estimated reserve of 7 billion barrels of oil. Therefore, BP alone controls 1.7 billion barrels of Azerbaijan's oil reserves. BP's stake in this single oil field represents 24.28% of Azeri Oil reserves. Shah Deniz Full Field Development (*FFD*) is expected to have peak capacity of 560 Bcf (*billion cubic feet*) in addition to the 315 Bcf in Phase 1, making it one of the largest gas development projects anywhere in the world. BP controls 25.5 percent of the Shah Deniz field, which contains an estimated reserve of roughly 30 Tcf of natural gas. Statoil is another shareholder, it owns 25.5% of the field, and together they own 51 percent of the one of the largest natural gas producing fields in the world. This field is only growing in importance, and will soon be expanded to serve the natural gas needs of Europe. Direct foreign investment on behalf of Azerbaijan International Operating Company since the year 2000 has averaged 2.92 billion dollars a year. In addition, BP owns 25.5% of the South Caucasus Pipeline (*Ministry of taxes of the Republic of Azerbaijan*).

Direct foreign investment under BP's leadership is a significant part of the Azerbaijan economy. BP oil and natural gas sales, and wages for workers are taxed at a rate determined in 1991 and enacted in 1993. No new taxes can or will be levied on BP or its workers. BP workers enjoy freedom from double taxation due to Azerbaijan's agreements with 35 countries. BP also enjoys the relatively low profit tax rate of 25%, this is in addition to low income, excise, and other tax rates that BP also enjoys. The income tax rates applicable to monthly income vary between 0% and 30% depending on the level of income. The fields BP are associated with have the privilege of having the least amount of tax withheld; in ACG the withhold rate is 5%, and in Shah-Deniz the withhold rate is 6.25%. Under the South Caucasus Pipeline (*SCP*) Agreement the Azeri government provides for full exemption from taxes by all legal entities providing works, services or goods in respect of the relevant project. BP is a large shareholder of this pipeline. The Republic of Azerbaijan provides for 0% rated VAT for all goods, services, works purchased or imported on credits and loans extended by international financial organizations, foreign governments, or foreign legal entities and individuals under interstate and intergovernmental treaties. This is one tax loophole for major corporates such as BP. Another tax loophole for major corporations like BP is that the purchase of goods, works and services at the expense of grants received from abroad are subject to VAT of 0% rate.

There are several ways to recover revenue from this sector. The government of Azerbaijan could reduce the monopolistic interests of BP in the ACG and Shah Deniz fields. This can be done by offering to buy a percentage of their current interests through SOCAR. The Azeri government should also work to have taxes updated; oil and natural gas sales, and wages for workers. The previous agreement was made in 1991 and does not reflect the current needs and realities. The terms of the South Caucasus Pipeline (*SCP*) Agreement should be renegotiated so Azerbaijan government can raise taxes on goods and services on the pipeline. Azerbaijan provides for 0% rated VAT for all goods, services, works purchased or imported on credits and loans extended by international financial organizations, foreign governments, or foreign legal entities and individuals under interstate and intergovernmental treaties. This VAT should be increased to realize potential revenue. With the removal of these loopholes, the tax base and revenue in Azerbaijan would receive a boost.

5. Is it possible to spread the current tax base, and is a wealth tax possible/desirable and to what extent?

Existing tax rates shows that for individuals in Azerbaijan, all income up to 2,000 manats is taxable at 14%. There are exceptions to this first bracket, as individuals who make less than 200 manat a month have the first 93.50 manats exempt from taxes. The next bracket is for individuals who earn more than 2000 manats a month, specifically the rate is "280 manat + 30% of the amount exceeding 2000 manats". When we look to foreign individuals working in Azerbaijan who dwell in the country for more than 182 days, they are subjected to the annual rate of 14% for income up to 24,000 manats, for individuals who make less than 2,400 manats a year; the first 1,122 manats are not taxable.[x] Then for foreign individuals whose annual income exceeds 24,000 manats, they must pay 3,360 manats and 30 % of the amount that exceeds 24,000 manats. The Corporate Profits tax rate is currently at 20% for companies whose gross income is above 150,000 manats consecutively during a twelve month cycle.

In the IMF's 2012 Country Report for Azerbaijan, the Fund notes that in order for the country to better secure itself against threats at the macroeconomic level it needs to increase the role of non-oil related taxes and to dip less into their oil savings. The IMF observed that while non-oil tax revenues did well between 2004 and 2007, tax revenue has declined notably since 2008 (*Albino-War and Shahmoradi, 2012; 9*). The decline can be attributed to the measures taken by the state to lessen the effect on the country by the global economic crisis that occurred around this time, and has not been removed since then. While the country has recovered economically from the crisis, it still hasn't withdrawn from implementing crisis measures. Specifically, Azerbaijan carried out a reduction in the corporate and personal income taxes, an exemption for banks and insurance companies from having their profits taxed, increment in the VAT threshold and creating several VAT exceptions.

In addition to not scaling back on crisis measures, other negative impacts include the ability of Cabinet Ministers to grant tax exemptions without consulting the parliament. In other to deal with these malaises certain measures should be adopted to address the issue of broadening the tax base.

The state should rescind the measures that it implemented during the global economic crisis, as clearly the crisis has passed and the Azerbaijani economy has mostly recovered. Another avenue that the fund recommends for broadening the tax base in Azerbaijan is the creation of a new "one-stop facility" and an improved registration system for businesses to better include the informal economy into the tax base. Measures should be taken to make changes to how the tax rates and exemptions are determined. Specifically, this needs to become a function of the Azerbaijani Parliament and be included in the tax code. Any calls for exemption should be presented before the Parliament with an assessment of the fiscal costs and an explanation for why it should be established or maintained. These issues were part of the IMF highlights as well on how to help broaden Azerbaijan's tax base (*Albino-War and Shahmoradi, 2012; 12-15*).

On the issue of labor tax, and problems of effective tax collection in Azerbaijan, the country has come a long way in its reforms in tax collection capabilities. Within the opening decade of 21st century Azerbaijan has been able to, among other reforms: create a modern and consolidated tax system, allow for electronic filing of taxes, and the creation of an integrated computer system for all taxes.

In an IMF working paper, Zermeno (*2008; 11-15*) identifies further measures needed to improve tax collection in Azerbaijan. Generally these include a simplification of the country's tax laws to make sure taxpayers understand their obligations. An overly complex tax system tends to encourage low compliance. The forms and procedures necessary for filing taxes should be easy for taxpayers to understand and submit. Improved tax enforcement should also be implemented. Tax evaders should be investigated and penalized severely.[xi] Zermeno (*2008; 15*) advises that down the line that Azerbaijan should follow a similar path taken by other countries in the ECA and create a single corporate and income tax rate, or a "flat tax". One can definitely agree with the need for an improved tax enforcement system in order to address the issue of tax evasion in Azerbaijan.

6. Can rates for different tax base targets (*Labor, individuals, corporate, etc.*) be raised without lowering total revenue?

Studies suggest that higher tax rates are associated with lower internal investment as well as lower rates of incoming foreign investments. Hence, there is an inverse relationship between complexity of country's tax system and its GDP growth. In the "Paying Taxes 2013: The Global Picture" section of the 2013 doing business report (*PWC/World Bank, Doing Business Report, 2013*), research suggests that complex tax systems and high tax rates hinder economic growth. Globally, higher number of payment and total tax rates caused a "tax drag" equal to -1.2% on GDP growth.

However, a country-specific approach to tax policy and its role in a nation's overall fiscal policy may reveal varying needs that can be met with a balanced approach that can encourage economic growth while improving living standards for current and future generations. Given that large portion of revenue is derived from such a finite source as oil, the government of Azerbaijan must begin to tailor its long-term fiscal plans to address the eventual decline in oil-based revenue. To that end, we will analyze the Azeri tax system, how it compares with its regional peers and proposes a possible approach to developing a tax base that is sustainable beyond its current resource boom.

6.1.Key government priorities

The State Treasury Agency of the Ministry of Finance of the Republic of Azerbaijan's (*MoF*) is a constitutionally-governed charged with implementing the nation's fiscal policy[xii] through the collection and allocation of the state's revenue. It uses revenue sources including grants, taxes and oil-based revenue to pay for operational expenses *(salaries etc.*), social services and infrastructure investments.

The MoF's stated key fiscal policy is to fund and execute balanced budgets. We add that it is safe to assume that budget surpluses are also desirable outcomes.

6.2.Tax revenue

According to figures released by Azerbaijan's Ministry of Finance, government income for 2011 was 15.7 billion manats, of which 5.5 billion manats came from tax revenue. The remainder was provided by various sources, the largest of which was a transfer from the State Oil Fund in the amount of approximately 9 billion manats.

The most recent tax revenue breakdown data available (*2009*) reveal that Azerbaijan's tax revenue accounted for 49.7% of its total government income.[xiii] Table 1 presents the tax revenue breakdown, which shows that makes up the highest percentage contribution.

Table 1. Tax Revenue Breakdown

Profit	**25.9%**
Income	**11.3%**
VAT	**39.3%**
Excise	**9.5%**
Other	**14.0%**

Source: The Ministry of Finance for the Republic of Azerbaijan.

Compared to the ECA average, Azerbaijan receives a significantly lower portion of its overall revenue from taxes - 49.7% compared to 76.7% for the region. Moreover, we found that profit taxes made up a larger portion of tax revenue (25.9%) versus the regional average of 9.6%.

Table 2. Tax Revenue Breakdown: Azerbaijan versus ECA Region

	Azerbaijan	**ECA Region**
Profit	**25.9%**	**9.6%**
Income	**11.3%**	**14.6%**
VAT	**39.3%**	**41.0%**
Excise	**9.5%**	**13.8%**
Other	**14.0%**	**21%**

Source: The IMF and The Ministry of Finance for the Republic of Azerbaijan

6.3. Tax rate structure

Azerbaijan's general profit tax rate is 20%, which is applicable to Azerbaijani companies, branches of foreign corporations or their representative offices.[xiv] Individual tax rates for residents of Azerbaijan are generally applied using an income cutoff of 2,000 manat. Individual monthly income up to 2,000 manat is subject to a tax rate of 14% while income above 2,000 manat is subject to a tax rate of 30%. The standard value added tax (*VAT*) rate is 18%, which applies to goods and services provided by domestic and foreign commercial entities.

Excise taxes are levied on domestically produced hydrocarbon products, alcoholic beverage, tobacco products and imported automobiles and yachts using different calculations applicable to each product (*per liter, engine size etc.*)

6.4. Revenue and expenditure

A study of Azerbaijan's tax revenue and expenditures (*both actual and projected*) from 2007 through 2012 shows a trend of growing deficits when oil-based revenue is excluded.

Budget data in the latest IMF Article IV report (*2011*) show that total revenue was projected to increase by an average of 21% from 2007 to 2012. However, the total non-oil deficit was expected to increase by 41%, reflecting average growth of 19% in total expenditure only partially offset by tax revenue growth of 8%. Looking at current expenditures (*excluding future investments*) we observer a 1.0 billion manats surplus in 2007 declining to a 3.2 billion manat projected deficit in 2012.

While Azerbaijan's State Oil Fund continues to offset budget deficits, long-term fiscal planning needs to address the widening gap between expenditure growth and the tax revenue that must pay for it. It is particularly relevant, in our view, in the context of Azerbaijan's finite hydrocarbon resources.

6.5. Bridging the gap

Many fiscal policy decision-makers tend to pair revenue and increases and expenditure reductions to balance budgets. However, since expenditure issues are outside the scope of this paper, we will instead focus on revenue maximization. Specifically, ways to increase tax revenue while maintaining Azerbaijan's economic health.

We begin with the IMF's (*Albino-War and Shahmoradi, 2012: 8*) projected current deficit for 2012: 3.2 billion manat. While there is sufficient oil revenue to offset the deficit, we can use this scenario as a useful starting point to analyze potential future changes in tax rates. According to projections, Azerbaijan would collect 8.2 billion manat in tax revenue while spending 11.4 billion manat in current expenditures. Assuming a balanced approach to deficit reduction, 1.6 billion manat (*50%*) would need to come from tax increases, and the remainder from spending cuts. In this scenario, the State would need to increase overall tax revenue by 19.5%.

Across the board tax increases with relatively low impact on income and profit taxes to maintain investment and minimize the burden on wage earners, while increasing revenue from consumption-based activity may present a viable option. For example, a 10% increase in income taxes, social contributions, trade and other taxes combined with a 20% increase in VAT and excise taxes would eliminate 78% of the tax deficit (*and 39% of the current deficit*) without any spending cuts. Table 3 below shows a scenario of this increase.

Table 3. Tax rate increase scenario: proposed increment of taxes across board

Manat (M)	Projected 2012	Adjusted 2012	Change
Income & Profit	3,004	3,304	10%
Social Contributions	831	997	20%
VAT	2,807	3,386	20%
Excise	591	709	20%
Trade	681	749	10%
Other	319	351	10%
Tax Revenue	8,234	9,479	15%
Current Expenditure	11,443	11,443	
Deficit	-3,209	-1,964	-39%
Tax deficit	-1,604	-359	-78%

7. Is the informal sector a significant source of revenue loss? If so, how can this be resolved in a cost effective manner?

The informal or shadow sector of the economy is the economic units which do not comply with one or more government-imposed taxes and regulations, but whose product is considered legal. (*Braun and Loayza, 1994; 2*) This is another aspect of the economy from which tax and revenue losses and can be considerate, depending on the size of the informal sector. In Azerbaijan, the ills to the state's purse and the negative impacts of the informal economy, estimated at above 60% of the entire GDP, are unmistakable. While this sector does not pay taxes, it makes use of state amenities like roads, emergency services and generally public goods and services.

While considerably large informal sectors are usually general characteristics of the developing economics, the informal sector in Azerbaijan is beyond the average by all measurements, either in the region, among developing economics or even in the world. According to Schneider et al. (*2010*), at an average of 60.9% Azerbaijan, is the second highest in the region after Georgia. As is presented in Table 4, Schneider et al. (*2010*) finds Azerbaijan's informal economy is higher than that of the ECA region by more than 60% from 1999 to 2007. If the informal sector of the economy was at 60.6% of total GNP in 2000, in 2000 dollars equivalent this amounts to $29.8 billion dollars of untaxed profit. At a tax rate of about 40% for that year, it would amount to $11.92 billion.

Braun and Loayza (*1994; 2*) identified vital factors that encourage the growth of the informal sectors. "The informal sector exists when high tax rates, and a high cost for entering the formal sector is coupled with an inefficient and corrupt system of compliance control." In other words high tax rates and other costly regulation fees makes the formal sector too expensive to remain legal, businesses are more likely to resort to the informal sector resulting in more loss in tax for the government.

Table 4. Size of Informal Economy among ECA countries

Countries	1999	2000	2001	2002	2003	2004	2005	2006	2007	Average
Georgia	66.2	67.3	67.4	67.4	68.7	69.2	69.5	71.1	72.5	68.8
Azerbaijan	60.2	60.6	60.9	61.2	62.2	62.7	64.7	67.6	69.6	63.3
Ukraine	51.7	52.2	53	53.7	55	55.9	57	57.5	58.1	54.9
Belarus	47.9	48.1	48.3	48.6	49.2	50.1	51.1	52.1	53	49.8
Armenia	46	46.3	47.2	48.1	48.8	49.1	50	50.7	51.7	48.7
Russian Federation	45.1	46.1	47	47.8	48.8	49.5	50.1	50.8	52	48.6
Moldova	44.6	45.1	46.1	45.8	45.7	46.2	46.8	46	-	45.8
Kazakhstan	42.6	43.2	43.9	44.5	45.4	45.9	46.7	47.7	48.2	45.3
Tajikistan	42.9	43.2	43.5	43.8	44.3	44.8	45	45.3	45.5	44.3
Kyrgyz Republic	41	41.2	41.6	41	41.9	42.6	42.4	42.6	43.6	42.0
Latvia	39.6	39.9	40.4	40.9	41.4	42	42.7	43.7	44.3	41.7
Estonia	-	38.4	38.8	39.3	40	40.3	41.1	41.9	42.3	40.3
Bulgaria	36.5	36.9	37.2	37.7	38.3	39	39.7	40.4	41.2	38.5
Albania	34.9	35.3	35.7	35.9	36.2	36.7	36.9	37.3	37.7	36.3
Romania	34.6	34.4	35.1	35.4	36.1	37	37.3	38.3	38.9	36.3
Macedonia, FYR	34.9	35.7	34.8	35.1	35.5	36.4	36.9	37.7	38.8	36.2
Bosnia & Herzegovina	33.9	34.1	34.2	34.3	34.7	34.6	35	35.3	35.4	34.6
Turkey	31.5	32.1	31.4	31.8	32.4	33.2	34.2	34.7	35.2	32.9
Lithuania	30.2	30.3	30.7	31.2	31.9	32.2	32.8	33.4	34	31.9
Hungary	24.8	25.1	25.4	25.7	25.8	26.1	26.2	26.5	26.4	25.8
Mongolia	18.5	18.4	18.5	18.8	19.1	19.5	19.8	20.1	20.5	19.2

Source: Schneider et al (2010)

To arrest the trend of a burgeoning informal sector, the government should either make the cost of doing of doing legal business cheaper by reducing tax rates, entry or registration costs it could raise the cost of illegal business very high by raising penalties and fine. Another aspect apart from the overall tax is the social security contribution burdens, especially with regards to labor cost. Studies have shown when there is a huge the difference between the total cost of labor in the official economy and the after-tax earnings (*from work*); the greater the incentive to avoid this cost and rather businesses would embrace the informal economy. Schneider, Buehn and Montenegro therefore maintains that; "since this difference depends largely on the social security burden/payments and the overall tax burden, the latter are key features of the existence and the increase of the shadow economy (*Schneider, Buehn, and Montenegro, 2010; 5*).

8. Conclusion

Tax system of Azerbaijan despite the modernization moves in the last decade still contains inefficiencies and lack in effectiveness in some aspects. As a result of this, Azerbaijan is losing out on vital revenue that it could have earned. We have examined different phenomena, angles and perspectives to unravel the problems and improve on the system.

We found that the hydrocarbon resources extraction contractors of Azerbaijan enjoy a privileged place within the tax structure with many exemptions written into the tax code. These exemptions artificially lower the revenue that the Azerbaijan Government can collect. Reforms to this section of the tax code, along with reforms to combat corruption and increase the competitiveness of small and medium sized businesses would increase tax revenue and provide a stable foundation for future growth and tax revenue.

Tax inefficiencies do not stop with tax exemptions in the oil sector. Azerbaijan's terms with contractors in their Production Sharing Agreements (*PSA*) do not adequately raise revenue. Oil fields are not adequately divided, ensuring market dominance by contractors, therefore leaving the state at the mercy of BP, and further tax losses through generous PSAs. The taxes on the hydrocarbon sector are too low and with too many exemptions for the high targets. Higher taxes will allow the Azerbaijani government to further increase the amount of tax revenue it receives.

To address the problem of the informal sector, i.e. to reduce its size and prevent leakage of taxes from this unregistered market the government should make the formal sector less expensive and therefore more attractive to businesses, and at the same time imposing heavy penalties and punishment on the informal sector. This way businesses would hedge against the cost of falling victim to the heavy penalties and fines of participating in the informal sector.

We have shown in section 6, that a viable option to resolve spending deficits without arresting spending could be across the board tax increases. This could be implemented with relatively low impact on income and profit taxes in order to maintain investment and minimize the burden on wage earners, while increasing revenue from consumption-based activity. We are confident that with the implementation of these suggestions across the several roots of inefficiency and loss generating issues, tax revenue would definitely take a jump in Azerbaijan.

End notes

[i] These are estimates based on the value of 2012 US dollars. See Azerbaijan, CIA Fact book, 2013. https://www.cia.gov/library/publications/the-world-factbook/geos/aj.html

[ii] From the breakdown of State's budgets and revenue on the website of the Ministry of Finance for the Republic of Azerbaijan, accessed on 25th April, 2013. http://www.maliyye.gov.az/en/node/943.

[iii] We compare with countries that are grouped by the World Bank under the ECA category, largely former Soviet republics. These countries includes: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Estonia, Georgia, Hungary, Kazakhstan, Kosovo, Kyrgyz Republic, Latvia, Lithuania, Macedonia FYR, Moldova, Mongolia, Montenegro, Romania, Russian Federation, Serbia, Tajikistan, Turkey, Turkmenistan, Ukraine and Uzbekistan. Geographically these countries are in Eastern Europe, Central Asia and the Trans-Caucasus.

[iv] The Ministry of Taxes of the Republic of Azerbaijan, General Overview of Tax regime in Azerbaijan, accessed on April 26, 2013. See http://www.taxes.gov.az/eng/psa/.

[v] There are several PSA agreements for different activities on the oil fields. For a compendium of the different agreements, see: The Ministry of Taxes of the Republic of Azerbaijan; accessed on April 26, 2013. See http://www.taxes.gov.az/eng/psa/.

[vi] The Heritage foundation freedom of business report ranked Azerbaijan 24 over 100 in the freedom from corruption index for 2013. See Heritage Foundation Country Data index, Accessed on April 26, 2013, http://www.heritage.org/index/visualize?countries=azerbaijan&type=9.

[vii] The Doing Business Report by the World Bank/PWC has shown that streamlined tax systems with less number of payments and hours it take to prepare payment fare better for businesses. See 'Doing Business Report 2012 and 2013' by the World Bank and PWC at http://doingbusiness.org/reports/global-reports/doing-business-2013.

[viii] See Ministry of Taxation Azerbaijan http://www.taxes.gov.az/eng/psa/

[ix] Information on the agreements with the PSAs is available on the website of the Ministry of Taxation of Azerbaijan. See, BP PSA with Azerbaijan for ACG and http://subsites.bp.com/caspian/ACG/Eng/agmt1/agmt1.pdfothers includes, 'Protocol on the joint development of Shikhzegirli, Sheytanud, Burgut, Donguzdug, Nardaran, Ilkhichy, West Hajiveli, Sundi, Ost Hajiveli, Turagay, Kenizdag, West Duvanny, Solakhay and Dashgill oilfields in the Azeri sector of the Caspian Sea and on the Production Sharing Agreement.' See http://www.taxes.gov.az/eng/psa/

[x] The Ministry of Taxes of the Republic of Azerbaijan, General Overview of Tax regime in Azerbaijan, accessed on April 26, 2013. See http://www.taxes.gov.az/

[xi] IMF Working Paper, Zermeno, 2008, 11-15.

[xii] The Ministry of Finance for the Republic of Azerbaijan, accessed on 25th April, 2013, http://www.maliyye.gov.az/en/node/1040

[xiii] The Ministry of Finance for the Republic of Azerbaijan.

[xiv] Ernst & Young, accessed on April 18, 2013.http://www.ey.com/GL/en/About-us/Azerbaijan

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Azərbaycanın vergi sisteminin səmərəsinin və səmərəliliyinin yüksəldilməsi

Xülasə

Tədqiqatın məqsədi - Azərbaycanın 1990-cı illərdən bugünə vergi sistemində çox mühüm mütərəqqi dəyişikliklərə nail olmuşdur. Bununla belə qarşıda mövcud sistemin səmərəliliyinə və effektivliyinə təsir göstərən bir sıra tədbirlərin də həyata keçirilməsi vacib hesab olunur. Bu tədqiqat ölkənin vergi sisteminin səmərəliliyinin daha da artırılmasına təsir göstərən müxtəlif sahələrdəki vəziyyətin təhlili və qiymətləndirməsinə həsr edilmişdir.

Tədqiqatın metodologiyası - tədqiqatda Dünya Bankının müəyyənləşdirdiyi bəzi Şərqi Avropa və Mərkəzi Asiya ölkələrinin vergi sistemlərinin müvafiq məlumatlarının Azərbaycanla müqayisəsi aparılmışdır.

Tədqiqatın nəticələri - tədqiqatda bir sıra təkliflər irəli sürülmüşdür: qanunvericilikdə korrupsiyaya imkan verəbiləcək boşluqların bir daha müəyyən edilməsi və aradan qaldırılması, vergidən yankeçmənin qarşısını almaq üçün müvafiq vergi mexanizminin daha da inkişaf etdirilməsi, gizli iqtisadiyyatı məhdudlaşdırmaq məqsədilə leqal biznes etmə xərclərinin azaldılması və qeyri-leqal biznes fəaliyyətləri üzrə cəzaların artırılması.

Tədqiqatın məhdudiyyəti - tədqiqatda müqayisəli təhlil yalnız Mərkəzi və Şərqi Avropa ölkələri ilə məhdudlaşdırılmışdır.

Tədqiqatın praktiki əhəmiyyəti - əldə olunan nəticələr bir sıra parametrlərdə ölkənin vergi sisteminin səmərəliliyinin artırılması üçün mühüm hesab edilmişdir. Alınan nəticələr vergi itkilərinin qarşısını almaq və vergi gəlirlərini yüksəltmək məqsədilə görülən tədbirlərdə istifadə edilə bilər.

Tədqiqatın orijinallığı və elmi yeniliyi - tədqiqat orjinal xarakter daşıyır və vergi təkmilləşmələrindən sonra hələ də problemli olan sahələrə yeni çoxtərəfli yanaşmanı özündə birləşdirir.

Açar sözlər: *Azərbaycan, Şərqi Avropa və Mərkəzi Asiya, gizli sektor, optimal vergitutma, vergi sistemi, vergi hüququ.*

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