Two New Budget Rules in Three Years. What Changed and Why?

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In the summer of 2018, the Azerbaijani government applied a new budget rule which introduced some restrictions on the spending of revenue from the sale of natural resources. This new rule was adopted following lengthy deliberations and almost 15 years after oil money started flowing into the Azerbaijani economy.[i] This rule was used only once in the Budget Review of 2019. In 2020 the government suspended implementation of the rule until 2022, arguing that it urgently needs to increase budget expenditures to tackle the negative impacts of the COVID-19 pandemic. Now, on the eve of 2022, the government is adopting an amendment to the Law on the Budget System, which envisages another budget rule.[ii]

In this piece we will try to explain the essence and importance of this latest budget rule as well as how it differs from the previous one.

What are budget rules and why are they implemented?

The mechanisms known in the world as budget or fiscal rules are meant to apply quantitative limits to various parameters of state budgets. On the one hand, budget rules are an important tool in protecting the long-term strategic interests of the state from the short-term interests of officials who make political decisions; on the other hand, it is an important tool for the implementation of counter-cyclical budget policy to maintain macro-economic stability. Roughly said, budget rules are a mechanism meant to suffocate the appetite of greedy officials and restrict them from exploiting the budget. However, in some countries budget rules exist as pro-forma quasi-regulations. In these cases, governments formally apply budget rules; however, at the same time, the same governments create loopholes which allow them to spend revenue from the sale of natural resources lavishly. For instance, in Russia, in the early 2000s, successive governments applied various models, yet oil and natural gas revenues continued to be spent without restriction. Only recently, in 2018, was a new rule implemented, which applies restrictions based on oil prices, with the intention of guaranteeing counter-cyclic budget policy.[iii] With this mechanism in place, beginning in 2018, 40 USD is set as a base oil price (indexed by 2% every year), and only the portion of oil revenues gained from sales in excess of this price point can be used for fiscal purposes; the rest must be saved.

Studying the experiences of other countries is helpful in the preparation of perfect budget rules: those experiences prove that the effectiveness of budget or fiscal rules occurs only when the right set of mechanisms and norms are in place.

In addition, it is also important to have a responsible budget policy, particularly, guarantees of conservative budget planning and economic stability as well as the existence of an institutional environment for budget rules.

In practice there are many forms of implementation of budget restrictions. In various countries restrictions within the budget are defined by state debt, budget deficit, budget expenditures or by fluctuations in natural resource revenues.

Budget rules are particularly important for the implementation of counter-cyclic budget policy of natural resource-rich countries. This kind of policy ensures that the government spends less than its total revenues when there are favorable economic conditions in order to meet government needs for financial resources and compensate for lost revenues during years of economic crisis. The opposite of this kind of policy is referred to as pro-cyclic budget policy, which means that a government lavishly spends without applying any restrictions during years of large revenues, and during years of crisis, it continues with these types of expenditures by using its reserves or by taking loans.

Well-developed budget rules are able to prevent some risks. For instance, they create a safety net for institutions implementing macroeconomic policy (by creating reserve funds), neutralize high inflation by guaranteeing the stability of currency, prevent high-level budget deficits in its non-natural resource revenues, etc. Budget rules are a mechanism implemented in more than 80 countries. The majority of them implement rules to limit debt and budget deficit, while others apply it to limit expenditures and revenues.

The Formula of the 2019 Budget Rule Implemented in Azerbaijan

The Budget rule implemented in 2019 implied the following:

- The forecasted amount of expenditures of budget review for the next year will exceed the expenditures of the previous year only by 3% (after adjustment to inflation);
- For each subsequent year, the ratio of basic deficit of the non-oil budget to non-oil GDP must be forecasted as less than that of the previous year;
- The mid-term debt burden of the government and state enterprises must be less and goals for this should be set;

The fundamental mechanisms to implement these rules were based on two concepts: pure financial assets and expendable oil revenues. ***Pure financial assets*** were calculated as the difference between the total sum of assets of the State Oil Fund; reserves of the unified treasury account (including funds given to management); debts of foreign states to the Azerbaijani state; the total sum of commitments of state enterprises to the state budget for the current year, and the total sum of internal and external state debt. ***Expandable oil revenue*** was calculated in two steps: *(i) first, the budget review calculated 20 percent of the difference between 30 percent of pure financial assets and oil revenues of review budget; (ii) Then that 20 percent difference was added to* *either pure financial actives or expandable oil revenues (whichever was lesser).*

Thus, this rather complicated formula defined the budget rule. Yet the problem was not in the complexity of the formula. The formula and the above rules did not pave the way for achieving the state’s intended goals i.e., the reduction of the pro-cyclic nature of the budget policy and an increase of reserves by reducing expenditure of oil revenues. The formula was designed such that money was only reserved when the price of oil was higher than 55-60 USD per barrel. In some resource-rich countries (like Chile and Russia, for instance) fiscal rules apply restrictions on budget expenditures based on the prices of natural resources on the world market. While this would have been the most straightforward way for the Azerbaijani state to achieve its goals, it did not do this, and instead used the formula and rules noted above.

Moreover, the budget rule of 2019 did not take into account currency value risks. For instance, pure financial assets were valued in USD. In this case, for example, a 20% devaluation of the Azerbaijani national currency (AZN) would result in a 20% increase in pure financial assets value in AZN, despite no additional revenue having been produced.

In the end this complicated set of rules and formula did not deliver the expected result and thus, it was implemented for only one year. First, the government halted its implementation and then subsequently used the effects of the pandemic as an excuse for the decision. The government thus accepted the 2019 rule’s ineffectiveness and replaced it with a new rule. However, this new rule is not entirely new. It keeps only one of the restrictions proposed in the previous rule while dropping all others. The preserved restriction is the ratio of the non-oil base deficit of the review budget to non-oil GDP.

Expectations from the simplified budget rule

The newly proposed simplified rule drops such notions as *expendable oil revenues* and *pure financial assets*, and as indicated above, only restricts the limits of the non-oil budget’s deficit. The non-oil base deficit is the difference between total non-oil revenues of the review budget and base expenditures of the budget. For instance, let us say that in 2022, the revenues of the review budget without inclusion of oil revenues total 10 billion AZN, and expenditures without inclusion of interest on the state debt due for payment is 29 billion AZN. In this case, the non-oil base deficit of review budget will be 19 billion AZN. In this case, if a decision is made that the non-oil base deficit cannot exceed 25% of non-oil GDP in the next year’s budget and if the government forecasts 80 billion AZN of non-oil GDP for that period, the maximum amount of the non-oil budget deficit cannot exceed 20 billion AZN. The rationale behind the implementation of this rule is that if there is no restriction on the non-oil base budget deficit, the state would have to implement indirect restrictions to oil money allocations to the budget as needed to cover the deficit.

Will this expectation be realized? Will the newly implemented budget rule, unlike the previous one, help keep oil revenues allocated to the budget under control? Will it be effective in avoiding pro-cyclic budget policy?

Some risks inherent in the proposed formula may prevent the realization of the aforementioned goals. Those risks would be higher especially if the sum of the non-oil budget deficit will be calculated based on a ratio to GDP as in the example above. Because in this case, the proposed formula is not able to account for inflation risks. Let us have a look at a very simple example. As indicated above, let us imagine that the government establishes 25% as the highest allowed limit for the ratio of the non-oil budget deficit to non-oil GDP. If there is high inflation in the country for an extended period and deflation of non-oil GDP reaches 115-120%, as a result of the increase in nominal GDP due to that inflation, the nominal non-oil budget deficit will increase as well, and this, in turn, will require more oil revenues to close that deficit. To avoid this risk, the amount of the non-oil budget deficit should be established as an absolute figure instead of a ratio.

Additional risk is that budget restrictions will be implemented not by the law *On Budget System* and will instead be carried out by the executive responsible for the expenditures of the budget. The law, at least, could articulate criteria and principles to define the non-oil base deficit as well as legal boundaries.

Another potential problem is that legal requirements allowing the suspension of the budget rule during the fiscal year are too soft, and under these circumstances, the regular suspension (or change) of the rule significantly reduces the role and authority of fiscal regulations.

The Finance Ministry, along with its initiation of the budget rule change, could have provided Parliament, before their recent confirmation of the rule, with some forecast calculations to support the initiative. These calculations could have included: clarification on what price of crude oil would be enough for the required volume of oil revenues to cover the non-oil budget deficit in the first year of implementation; the projected dynamics of the non-oil base deficit in the next five years; the level of dependence of the budget on oil; the oil price point needed for financial resources to cover the deficit. Only based on this kind of supportive document would it be possible to determine the effectiveness of the proposed model over the course of the next 5 years.

To conclude, I would like to underline two important issues. First of all, the government chose the long way around. If the state’s intention was to lessen the budget’s dependence on oil and escape pro-cyclic budget policy, then, as in the case of the Russian model, there is shorter and more effective path i.e., the application of a price ceiling. For instance, the Azerbaijani budget rule could have simply been that revenues received from the part of oil priced above 50 USD will only be accumulated as reserves. Alternatively, the state could have established a limit for the amount allocated from the State Oil Fund to cover budget deficits. In this case, let us say, the government could have amended the law to allow a maximum 50% usage of the State Oil Fund’s annual revenues. This would also require the establishment of a very important mechanism envisaging legal boundaries for the usage of Oil Fund assets to cover the deficit of the review budget. Currently, there are no restrictions on the usage of oil funds to cover non-oil deficits of the review budget. The most important issue, ultimately, is that, regardless of the quality of the budget rule itself, its effectiveness is only possible if there is effective parliamentary and civil society control over its implementation.

Notes and References:

[i] http://e-qanun.az/framework/39838

[ii] https://www.meclis.gov.az/news-layihe.php?id=1621&lang=az&par=0&fbclid=IwAR34fxtp4qQglObrs29j82YcEamBUTXX4o4s-gJyxZCtPHbJz6Ke7aEB1JY

[iii] Бюджетные правила как инструмент сбалансированной бюджетной политики. https://www.csr.ru/news/byudzhetnye-pravila-kak-instrument-sbalansirovannoj-byudzhetnoj-politiki/