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### Personal Income Tax in Azerbaijan and Global Practices

**Abstract:** This article examines the importance of implementing a more suitable tax policy regarding personal income tax. Author tries to analyze the current state of the tax system, identifying key problems and suggesting options to optimize the tax burden on individuals. The focus is primarily on the effectiveness of tax rates and the stimulation of taxpayers.

The discussion also covers practices in foreign jurisdiction and their applicability to the national tax system. The article includes an analysis of statistical data, regulatory framework, and economic theories. The findings of the study may serve as a basis for developing recommendations for improving tax policy, aimed at increasing the efficiency of tax collection and ensuring social justice.

**Keywords:** tax policy; personal income tax; progressive taxation; tax burden on wages; bracket creep.

Every individual within the current societal structure encounters taxes, both direct and indirect, throughout much of their life. In Azerbaijan, indirect taxes include VAT and excises, which represents the added value on goods and services that forms part of the final price. Direct taxes cover personal income tax, corporate income tax, property tax, land tax on entities, road and industrial taxes, including a simplified tax paid from the quarterly turnover.

A significant portion of the population earns their livelihood through wages (salaries), making personal income tax a subject of heightened public interest. This is particularly relevant considering that property taxation, collected by municipalities for non-commercial ownership, is often found to be ineffective in practice. When analyzing the structure of personal income tax in Azerbaijan, it is crucial to highlight its key elements. The taxpayer is identified as an individual, and the object of taxation comprises their total income, excluding those amounts eligible for deductions as stipulated by the Tax Code of the Republic of Azerbaijan, approved by Law No. 905-IQ dated July 11, 2000 ("Tax Code"). For residents, the object of taxation includes all income, both domestic and international, while for non-residents, only income from sources within the country is taxed.

Pursuant to Section 96 of the Tax Code, if the tax is withheld at the source of payment, the object of taxation becomes the taxable income. The subsequent provisions divide incomes into: (i) those related to employment, (ii) those not related to employment, and (iii) others, excluding tax-exempt incomes and incomes from capital revaluation. An integral component of any tax is its rate, which, according to the Tax Code, varies depending on the taxpayer and the field of activity in Azerbaijan. For instance, the rate for incomes from non-entrepreneurial activities is set at fourteen per cent, whereas for entrepreneurs, it equals 20 per cent. For notaries, as well as for incomes from winnings in sports betting, lotteries, and other competitions, after deducting investments, a rate of ten per cent is applied. Temporary reliefs are provided for individuals working in the field of system

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integration and software development outside of a technological park but who are its residents: if their monthly income does not exceed AZN8,000, a rate of zero per cent is applied, and five per cent for the amount exceeding this threshold. Starting from January 1, 2026, the tax will be five per cent on the entire monthly income for the next seven years [1].

Highlighting employment income as a distinct category, the legislation also establishes differentiated tax rates for income from employment. Specifically, for the oil and gas industry and the public (state) sector, the following rates apply: fourteen percent for incomes up to AZN2,500 and 25 percent for incomes exceeding this threshold. As a tax incentive for the private sector, a rate of zero percent is set for employment income not exceeding AZN8,000, and a rate of fourteen percent for the amount exceeding this threshold, effective until January 1, 2026.

It is noteworthy that for the year 2022, the share of government employees in the total employed population amounted to 21.9 percent, while the share of private sector workers reached 79.1 per cent [23]. Considering the data available from the State Statistics Committee of the Republic of Azerbaijan, in 2022, the employed population in Azerbaijan was 4,901.1 thousand [24].

Projections from the German platform Statista indicate that, by 2024, the number of employed individuals in Azerbaijan will reach 5.19 million, accounting for 65.35 per cent of the country's population [25]. Thus, the relevance of the income tax related to employment (withheld from wage labor) (in Azerbaijani: “muzdlu işlə əlaqədar tutulan gəlir vergisi”), or otherwise known in other countries as “payroll tax”, is undeniable. It is important to consider, even with the potential for additional sources of income for taxpayers, that personal income tax directly impacts the net salary level, which constitutes the primary livelihood source for a significant part of the population. In general, net salary, *i.e.*, take-home pay, is the amount that remains with the employee after deducting all mandatory contributions (payments) and taxes from the gross salary, *i.e.*, the amount specified in the employment contract.

The Tax Code asserts that tax legislation must be founded on the principles of (a) universality, (b) equality, and (c) fairness in taxation. In light of these provisions and the foregoing discussion, questions arise regarding the alignment of contemporary practices of personal income tax rates and the application of the payroll tax in Azerbaijan to the employed population, especially considering the presence of mandatory social insurance contributions, which impose an additional burden on employees' incomes.

Progressive taxation, employing a multi-tiered income tax rate system, plays a crucial role in the tax policies of numerous countries. For the 2024 tax year, the United States has implemented a seven-tier structure for individual income taxes, with inflation-adjusted rates and brackets. The system is structured as follows: (i) a 10 per cent rate for single individuals earning up to USD11,600; (ii) 12 per cent for income exceeding this threshold; (iii) 22 per cent for those above USD47,150; (iv) 24 per cent for incomes over USD100,525; (v) 32 per cent for earnings beyond USD191,950; (vi) 35 per cent for amounts over USD243,725 - with these thresholds doubled for married couples filing jointly; and a top rate of 37 per cent applied to incomes over USD609,350 for single filers and USD731,200 for married couples [27]. These rates and brackets undergo periodic adjustments to ensure the tax system remains aligned with economic fluctuations. Another example is Luxembourg. In 2024, Luxembourg's income tax system for wage earners introduces even greater specificity, with 23 tiers. Taxpayers are divided into three categories according to their personal circumstances: Class 1 for single persons, featuring tax rates that start at 0 per cent for incomes up to EUR12,438 and rise to 42 per cent for those exceeding EUR220,788; Class 2 for married or part-

nered individuals; and Class 1a for single persons with dependents or those aged 65 and above. Each category is designed with unique rate structures to accommodate the varying financial responsibilities and living conditions of the taxpayers [28].

Given that one of the primary goals of taxation is to redistribute financial resources, the current arrangement in Azerbaijan for income tax on individuals, featuring a two-tiered rate system and a temporary two-tiered preferential rate for the private non-oil and gas sector, which may potentially be extended after 1 January 2026, does not sufficiently address the financial conditions of low-income segments and the excessive incomes of successful entrepreneurs. Surprisingly, the legislation preceding the current Tax Code, specifically, repealed Law No. 181 *On Income Tax from Individuals in the Republic of Azerbaijan* dated June 24, 1992 (“*Law On Personal Income Tax*”), aimed to integrate a progressive rate targeting super incomes. Under the *Law On Personal Income Tax*, the tax object was determined as a total income over the calendar year, monthly income, or income derived from civil contracts for work performed. The Law specified the following individuals with permanent residence in the Republic of Azerbaijan as subjected to income tax: a) those earning income outside Azerbaijan from direct or indirect use of the country's material, intellectual, or other resources, including its continental shelf and economic zone; b) entrepreneurs operating without opening an entity whose average monthly income exceeds twelve times the minimum wage set by law; c) individuals receiving copyright royalties, including the authors' heirs initially acquiring such rights; d) those income from interest and winnings on deposits in non-state banks and credit institutions, as well as winnings from lotteries conducted by non-state entities in accordance with the law. This approach appears to have been abandoned in favor of a simpler two-tiered system, potentially due to perceived inefficiencies [15].

This practice of employing a two-tiered rate system is not unique to Azerbaijan and can be observed in other countries as well. For instance, in Russia, a 13 per cent tax rate is applied if the tax base for the tax period is less than or equal to 5 million rubles; for tax bases exceeding this amount, the tax comprises RUB650,000 plus 15 per cent of the excess amount [29]. Similarly, in Poland, the basic personal income tax rates are set at 12 per cent and 32 per cent. The lower rate is applicable if the tax base does not exceed PLN120,000, while incomes surpassing this threshold are taxed at 32 per cent, with the 12 per cent rate further mitigated by a degressive tax-reducing amount of PLN3,600 [30].

The previously non-valid *Law On Personal Income Tax*, as specified above, outlined a multi-tiered progressive tax rate as follows: (i) for annual income, 12 per cent up to 72 times the minimum wage, 15 per cent for income from 72 to 144 times the minimum wage, 20 per cent from 144 to 240 times, 30 per cent from 240 to 420 times, 40 per cent from 420 to 600 times, and 55 per cent for income over 600 times the minimum wage; (ii) for income from works and services under civil law contracts, 2 per cent up to 0.5 times the minimum wage, 6 per cent from 0.5 to 1 times, 10 per cent from 1 to 3 times, 12 per cent from 3 to 6 times, and rates based on the specified monthly income for over 6 times the minimum wage; (iii) for monthly income, 12 per cent from 1 to 6 times the minimum wage, 15 per cent from 6 to 12 times, 20 per cent from 12 to 20 times, 30 per cent from 20 to 35 times, 40 per cent from 35 to 50 times, and 55 per cent for income over 50 times the minimum wage; (iv) for income from periodic royalties paid to the heirs of authors, 60 per cent up to three times the minimum wage, 65 per cent from 3 to 6 times, 70 per cent from 6 to 18 times, 75 per cent from 18 to 36 times, 80 per cent from 36 to 72 times, and 85 per cent for income over 72

times the minimum wage in the Azerbaijan, Republic [15]. This may be taken into consideration when applying a multi-tiered progressive tax rate, based on previous experience.

In the application of progressive tax rates, individuals with higher incomes not only pay a larger sum in taxes but also a larger proportion of their income as tax [18, p. 2]. The economy is inherently subject to inflation, which ultimately affects nominal wage increases. Meanwhile, the “tax brackets” *i.e.*, ranges of income subject to certain income tax rates, remain unchanged. Developed countries are familiar with the phenomenon known as “bracket creep”. Bracket creep refers to the situation where income increases lead individuals to pay higher average income tax rates each year, primarily affecting those with high incomes. This phenomenon occurs when inflation pushes taxpayers into higher tax brackets or diminishes the value of tax credits, deductions, and exemptions [31]. As a result, bracket creep leads to an increase in income tax without a corresponding increase in real income. For this reason, governments regularly need to apply indexation to these thresholds, as is most likely practiced in USA for income tax, as indicated above, to avoid fiscal drag, *i.e.*, when taxpayers are ‘dragged’ into paying more taxes or paying taxes at a higher rate than is generally necessary.

In the context of additional financial burdens on employee incomes, particularly concerning mandatory social insurance contributions from wages, it is important to draw a clear distinction between these contributions and taxes. According to regulatory framework, taxes defined in Section 11 of Tax Code are classified as compulsory, individual, and non-gratuitous payments remitted to state and local budgets in the form of expropriation of taxpayer funds. These funds are allocated for financing state and municipal needs. In previous versions of the Tax Code, the wording “ [...] as well as to targeted state funds...” was present, which is also characteristic of mandatory social contributions [1].

These contributions, with the assumption of reciprocity, are subsequently returned based on accumulated pension capital, length of service, and other conditions, whereas taxes primarily involved in redistribution. Presently, the minimum amount of pension capital accumulation must be 40,320 manats [26], although in practice, ensuring the receipt of pensions or allowance is not solely limited to such capital, but also sourced from the state budget, financed by taxes.

Nevertheless, the guarantee of receiving social payments is not absolute. There may be circumstances where the necessary capital is not accumulated or certain conditions are not met, such as reaching the prescribed retirement age. Thus, although social contributions presuppose reciprocity, it is not guaranteed, emphasizing the risks associated with the social insurance system.

In its work, the Organisation for Economic Co-operation and Development (“OECD”) compares non-tax compulsory payments (“NTCPs”), including compulsory social insurance contributions, with taxes, as both types of payments are mandatory for the state. However, the OECD also distinguishes between taxes and NTCPs, stating that NTCPs differ in being reciprocated and directed not to the state budget, but to extra-governmental social insurance funds. This underscores their specialized purpose and differentiation from traditional taxes. Thus, the OECD provides the following definition: “Required and unrequited compulsory payments to privately-managed funds, welfare agencies or social insurance schemes outside general governments and to public enterprises” [19, p. 5].

In Azerbaijan, mandatory social contributions vary by sector. For wage-employed individuals in the public sector, contributions include three per cent for mandatory state social insurance, half a per cent for unemployment insurance, and compulsory medical insurance calculated at two per cent

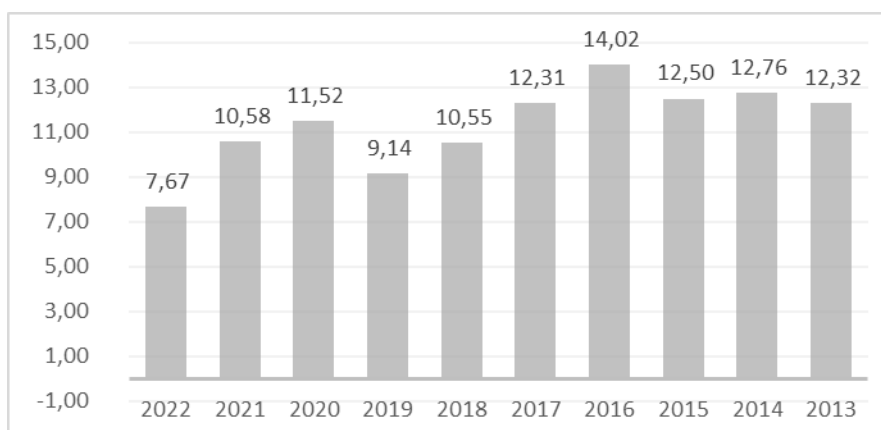
of the employee salary up to AZN8,000. Salaries exceeding AZN8,000 incur a fixed charge of AZN160, representing two per cent of this threshold, plus an additional half a per cent on the amount exceeding thereof for compulsory medical insurance. In the private sector, for salaries up to AZN200, mandatory state social insurance is three per cent, and for salaries above this sum, a fixed AZN6, equivalent to three per cent of AZN200, with an added ten per cent on the amount over thereof. Unemployment insurance is standardized at half a per cent for everyone, and compulsory medical insurance rates are the same for both sectors [2], [3], [4]. This applies exclusively to contributions from wage-employed individuals, *i.e.*, those working under employment contracts, as different amounts are levied for other categories.

In the context of integrating a progressive tax system and based on principles of taxation equity, the legislature could consider the experience of other countries and exclude mandatory social insurance contributions from the tax base when calculating personal income tax on salaries. For example, in Republic of Turkey, Social Security and Unemployment Insurance contributions are excluded from the tax base when calculating income tax on salaries [17]. A similar practice exists in Republic of Poland, where pension insurance contributions are excluded from the tax base, as well as in Iceland and many other Western countries [19, p. 11-13].

For legal precision, the juridical technique employed should specifically address the exclusion of mandatory social contributions from the taxable base of income derived from employee salaries. This necessitates a clear amendment to Section 98.2 of the Tax Code, which pertains to income received in connection with employment. For reference, it should be noted that, as per Section 108.1, “mandatory payments” are deducted from the income [1].

This approach would reduce the additional burden on salaries, albeit not significantly, without affecting pension capital accumulation. Since the percentage of NTCPs applies to the nominal salary, deducting these amounts from the taxable base would decrease the amount of personal income tax.

Based on the analysis of a chart that displays the share of personal income tax in the total tax revenues of Azerbaijan's state budget, utilizing data from the Laws On the Execution of the State Budget for the period from 2013 to 2022, the following changes can be noted: in 2013, this share was 12.32 percent, slightly increased to 12.76 percent in 2014, then decreased again to 12.50 in 2015, rose to 14.02 percent in 2016, and continued to fluctuate, falling to 12.31 percent in 2017, 10.55 percent in 2018, 9.14 percent in 2019, then increased to 11.52 percent in 2020, standing at 10.58 percent in 2021 and ultimately dropping to 7.67 percent, *i.e.*, AZN1,474,403,755 in 2022 [5; 6; 7; 8; 9; 10; 11; 12; 13; 14].



Considering that the (personal) income tax on wages constitutes only a portion of the overall tax revenues from personal income tax, alterations to its taxable base, *i.e.*, the quantitative amount to which the tax rate is applied, should not significantly impact the total volume of collections into the state budget.

In Azerbaijan, trade unions, primarily found in governmental entities and large organizations, may not always be effectively operational but still have a financial impact on salaries. According to second paragraph of Section 20 of the Law No. 792 of the Republic of Azerbaijan On Trade Unions, dated 24 February 1994, it states that “[...] the employer ensures withholding of trade union membership fees from the salaries of employees who are members of the trade union through accounting records...” [16]. In Azerbaijan, these fees often represent two per cent of the nominal salary, and there are no provisions for employees to deduct these membership fees, *i.e.*, trade union dues, when calculating taxable income base for tax purposes. Although this practice is also observed in CIS countries, in other countries, such as the UK, a tax deduction from the income tax is available under Section 344 (1) of the Income Tax (Earnings and Pensions) Act 2003 [20]. Similarly, in Canada, union dues according to subparagraph 8(1)(i)(iv) of the Income Tax Act (R.S.C., 1985, c. 1 (5th Supp.)), are deductible from the taxable base of annual income if paid for such professional contributions [21]. In Australia, individuals are allowed to claim a deduction of up to USD42 per income year for such expenses [22, p. 52]. Naturally, there are exceptions, for instance, in Canada according to subsection 8(5), dues are non-deductible for tax purposes if they are for (a) superannuation funds, (b) insurance (except for necessary professional liability insurance), or (c) unrelated to a union or association's main operational costs [21].

In light of the foregoing, it is advisable for Azerbaijan to take into account not only its historical experiences but also the varied approaches adopted by other nations in the realm of tax policy concerning personal income. This entails considering the implementation of multi-tiered progressive taxation as well as the deployment of other institutional mechanisms aimed at facilitating tax burden.

In summation, the imperative for government action centers on adopting equitable tax policies to reduce tax evasion incentives and motivate higher taxpayer earnings. This strategy is expected to augment state budget revenues, crucial for government support and national welfare enhancement. Such an approach, critical for fiscal policy effectiveness, merits detailed examination and application in legal-economic discourse.

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### Налог на физических лиц в Азербайджане и мировая практика

**Аннотация:** Рассматривается важность проведения более адекватной налоговой политики в отношении налога на доходы физических лиц. Предпринята попытка проанализиро-

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вать текущее состояние налоговой системы, выявить ключевые проблемы и предложить варианты оптимизации налоговой нагрузки на физических лиц. Основное внимание уделяется эффективности налоговых ставок и стимулированию налогоплательщиков.

Также рассматриваются практики зарубежных юрисдикций и их применимость к национальной налоговой системе. Статья включает в себя анализ статистических данных, нормативно-правовой базы и экономических теорий. Результаты исследования могут послужить основой для разработки рекомендаций по совершенствованию налоговой политики, направленных на повышение эффективности сбора налогов и обеспечение социальной справедливости.

**Ключевые слова:** налоговая политика; налог на доходы физических лиц; прогрессивное налогообложение; налоговая нагрузка на заработную плату; движение (налогового) разряда.

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