

MTEF for 2003-2005

Introduction

MTEF plays an important role in giving an impetus to poverty reduction and economic development. Thus, the preparation of the mid-term indicators identifies which problems have been set by the government to be addressed in the forthcoming years. By including the MTEF in the SPPRED the Government laid the basis for the activities to be carried out as part of the State Programme. The Law of AR "On budget system" prepared by the Government jointly with the international organizations in 2002 provides a legal framework in this area. According to the relevant articles of the Law, the state budget indicators for the next and subsequent three years started to be prepared in 2004.

Before analyzing the MTEF it should be noted that the majority of measures reflected in the Fiscal Policy section of the SPPRED have been implemented. It describes the steps taken by the Government to increase transparency and control over the collection and spending of budget resources. The above-mentioned Law of AR "On budget system" is given as an example. Apart from the previous laws (Laws of AR "On budget system" adopted in 1992 and "On the State Budget" adopted in 1999), which regulate the preparation of draft state budget, this Law provides the legal framework for full transparency in the use of budget resources. The principles of transparency include a "consolidated budget" definition; preparation and approval of budget on paragraph level of functional and economic classifications; preparation of the medium-term budget indicators and preliminary budget; increasing the number of documents submitted to the legislative body of the country; and publishing the documents related to the budget in the press and etc.

Legal and normative acts indicated in the Decree on the introduction of the Law of AR "On budget system", which includes the rules for the preparation and execution of the state budget, single budget classification and the rules of using the resources of the state budget reserve fund, have been approved by the relevant resolutions. All these legal and regulatory documents promote the improvement and transparency of the budget process.

In addition, the use of extra-budgetary resources of budget-funded organizations by including in the state budget could be considered as one of the major steps taken in the fiscal sector. Unlike the previous years, full supervision over the preparation and execution of these resources was restored and their random use prevented.

The Decrees on the annual budget laws, based on the comments of international organizations, instructed the CM to prepare a breakdown of estimates for revenues and expenditures of the following organizations: enterprises of the Ministry of Communication and Information Technologies, State Oil Company of Azerbaijan Republic, "Azerenergy" JSC, "Azersu" JSC, Azerbaijan State Railway Department, Azerbaijan State Caspian Shipping Company, "Azerigas" JSC, "Azerkimiya" State Company, "Azerbaijan Airlines" State Concern and the Baku Underground.

In 2004 the Government made another step towards the management of oil revenues. Thus, if the market oil price becomes higher than a price forecasted in the state budget, the surplus revenues are accumulated in a separate account of the Treasury and would be used in case of the price decreasing below the level forecasted in the budget.

State Budget Revenues for 2003-2005

As it is seen, the state budget revenues have recently increased compared to GDP. While the State Budget revenues in 2003 made 17.1% of GDP, it was

Table 1. State budget revenues for 2003-2005 (by the organizations providing revenues)

	<i>bln. AZM</i>		
	<i>Execution for 2003</i>	<i>Forecast for 2004</i>	<i>Forecast for 2005</i>
State budget revenues	6104.5	7518.4	9422.0
<i>Compared to GDP, in percentage</i>	17.1	19.5	19.7
for the Ministry of Taxes	4113.7	4900.0	6632.0
<i>share, percentage</i>	67.39	65.17	70.39
for the SCC	1061.2	1200.0	1450.0
<i>share, percentage</i>	17.38	15.96	15.34
for the SOFAR	500.0	650.0	750.0
<i>share, percentage</i>	8.19	8.65	7.96
Other sources	429.6	768.4	590.0
<i>share, percentage</i>	7.04	10.22	6.26

19.5% in 2004 and 19.7% in 2005. Revenues of the Ministry of Taxes and the SCC differed in proportion in the structure of budget revenues during these years. The revenues accumulated through these two organizations increased from 84.77% (2003) to 85.73% (2005). Although the revenues accumulated through the SCC increased in value, it decreased in percentage. This could be due to an increased rate of revenues accumulated through the Ministry of Taxes and due to the creation of other new sources of income. Since the transfers to the state budget from the SOFAR have recently increased, the revenues from the Fund started playing an important role in the state budget revenues. A number of social and investment projects were implemented through the resources of this Fund (750 bln. AZM in 2005), which was established as a result of a prudent policy of the national leader Heydar Aliyev. A sudden increase was observed in the revenues accumulated through the other sources in 2004. Thus, the percentage of these revenues, which increased 3.18 items in 2004 compared to 2003, could reach 6.26% in 2005 by decreasing 3.96 items. It was mainly caused by the inclusion of the idle balance, left in a single treasury account of the state budget for the beginning of the year (201.4 bln. AZM), in the revenues part of the state budget in 2004. This balance was 2.68% of the state budget revenues in 2004.

Table 2. State budget revenues for 2003-2005 (by the sources of revenue)

bln. AZM

	Execution for 2003	Forecast for 2004	Forecast for 2005
State budget revenues	6104.5	7518.4	9422.0
<i>Compared to GDP, in percentage</i>	<i>17.1</i>	<i>19.5</i>	<i>19.7</i>
Individual income tax	752.1	840.0	1206.0
Profit tax of legal entities (except municipal enterprises and organizations)	891.5	1117.0	1495.0
Value-added tax	2048.6	2324.0	2754.0
<i>including:</i>			
- value-added tax on the goods imported to the territory of AR	717.6	844.0	1024.0
Excises	335.2	350.0	655.0
<i>including:</i>			
- excises on the goods imported to the territory of AR	43.3	50.0	50.0
Property tax of legal entities	133.0	160.0	200.0
Land tax of legal entities	56.6	70.0	75.0
Road tax	5.4	6.0	51.0
Mine tax (except for mine tax for the construction materials of local importance)	283.6	489.0	490.0
Simplified tax	63.3	80.0	106.0
Customs duties	294.9	300.0	370.0
State duties	116.5	120.0	130.0
Lumpsum duty	6.2	7.0	
Other non-tax revenues	188.1	237.0	550.0
Receipts from leasing of public property	12.7	12.0	12.0
European Union grant extended to the Republic of Azerbaijan	28.4	50.0	50.0
Receipts from credits extended to the governments of foreign countries	2.4	17.9	17.4
Dividends received from the banks with the state shares	8.3	10.1	26.6
Dividends received from non-financial state enterprises		45.0	25.0
Receipts from the NB profit	60.0	30.0	30.0
Receipts from the SOFAR	500.0	650.0	750.0
Receipts from credits issued from the budget		1.8	1.0
Receipts from the credits with the state guarantee	0.4		3.9
Receipts from subsidiary loan agreements	11.6	44.7	52.1
Receipts from the sale of excise marks	8.1	5.5	6.0
Extra-budgetary revenues of the institutions financed by the state budget	297.6	350.0	366.0
Idle balance left in a single treasury account of the state budget for the beginning of the year		201.4	

The share of value-added tax, profit tax of legal entities, individual income tax still takes an important place in the state budget revenues. Despite the receipts on these three types of taxes were 60.48% in 2003, this figure dropped to 57.9% in 2005. As a result of wage reforms (which includes an increase in the average wages, as well as increases in the minimum wages and wages of budget-funded organizations), the anticipated individual income tax for 2005 will be 12.8% of budget revenues. The receipts from value-added tax are still traditionally on the first place among the revenues in the state budget. However, its percentage in the state budget dropped from 33.56% in 2003 to 29.23% in 2005. Creation of the other sources and expansion of simplified tax coverage could be the main reasons of this decrease. While the rate of this tax has not been decreased, exemptions from the same tax have been reduced during the last period.

Receipts from the NB profits have decreased twice and its forecasted amount is 30 bln. AZM for 2005.

Additional sources have been sought by the government to increase the state budget revenues. Thus, starting from 2004 it is forecasted that the state budget will receive dividends from non-financial state enterprises. The State Budget was forecasted to receive 25 bln. AZM from the enterprises of the Ministry of Communication and Information Technologies and 20 bln. AZM from Azerbaijan State Caspian Shipping Company in 2004.

As part of fiscal reforms, extra-budgetary revenues of institutions financed by the state budget have been abolished through recording in the state budget. Starting from 2002 considerable measures have been taken in this regard. Thus, extra-budgetary revenues of several organizations have been abolished. This will continue during the next years and the receipts were included in the State Budget. While extra-budgetary revenues of budget-funded organizations were 4.88% of the state budget in 2003, it dropped to 4.66% in 2004 and to 3.88% in 2005. The Government has increased attention to targeted spending of these funds. If a breakdown of these funds were approved based on the main items of budget in 2003, the CM approved a breakdown on the directions and organizations starting from 2004. To increase supervision over the accumulation and spending of these funds, heads of the budget-funded organizations have been instructed to transfer these funds to the accounts of the Treasury in a non-cash form and only through the authorized banks determined by the State Treasury.

Many steps have been taken to reduce the tax burden, which enabled to increase entrepreneurial activity and improve the living conditions of the population. As a result of reforms carried out at the Ministry of Taxes and SCC, the Government achieved a reduction of the tax rates and at the same time, an increase of tax receipts.

A number of additions and amendments have been recently made to the Tax Code of AR adopted in 2000. The main goal of these changes and amendments was to give an impetus to the development of entrepreneurship through reducing the tax burden in the country. If simplified tax turnover, i.e. the volume of taxable operations for the previous 3 month period, was 300 times less than non-taxable monthly income, it was increased by 22500 times (up to 123.75 mln. AZM) of nominal financial unit in 2004. At the same time, the rate of this tax for the regions was differentiated (4% – in Baku City, 2% – in other regions), which reflects prioritization of regional development.

The rate of profit tax of legal entities has also been decreased within this period. Enterprise profit tax was lowered from January 1, 2003 from 27% to 25%. At the same time, differentiated taxation principle on profit tax was introduced in the regions (80% of estimate profit tax for Ganja, Sumgait, Mingachevir and Ali-Bairamly Cities, 40% for the mountain regions and Nakhchivan AR, 60% for the other regions (except for Baku City and Absheron District). However, observations made by the Government in various regions in 2003 found this differentiation ineffective. Thus, differentiated tax rates were abolished from January 1, 2004 and the profit tax of legal entities decreased to 24%.

Regarding the individual income tax, the Government has implemented reforms in this area taking into consideration the underprivileged and an increase in the average monthly income of the population. At present, non-taxable monthly income was increased to 150000 AZM. This type of tax was transferred to a 3-stage tax system.

The work carried out to reduce the tax burden has also covered social insurance contributions. Social insurance contributions to the SSPF decreased from 29% to 27% from January 1, 2003 and to 22% from January 1, 2005.

The coverage of a road tax was expanded in 2005. Thus, individuals having vehicles in their property in the Republic of Azerbaijan have been included in the list of taxpayers.

At the same time, it should be noted that one of the considerable changes made to the Tax Code was replacing “non-taxable monthly income” by “nominal financial unit”. It excludes the necessity to make changes to the Code when increasing non-taxable monthly income. Thus, necessary changes are required in the relevant articles to increase this amount, which provides the basis for the evaluation of taxes, turnover and etc.

State budget deficit and its financing

Table 3. State budget deficit and the sources of its financing

bln. AZM

	Execution for 2003	Forecast for 2004	Forecast for 2005
State budget deficit	68.2	315.0	579.0
<i>Compared to GDP, in percentage</i>	<i>0.2</i>	<i>0.8</i>	<i>1.2</i>
Sources of financing the deficit	240.6	315.0	579.0
Domestic sources	71.6	215.5	480.6
- receipts from privatization	97.9	160.0	90.0
- receipts from the sale of short-term state bills (T-bills)	-29.6	50.5	85.0
- receipts from the sale of domestic state premium bonds (lottery bonds)	3.3	5.0	5.6
- idle balance left in a single treasury account of the state budget for the beginning of the year			300.0
External sources	169.0	99.5	98.4

The state budget deficit remained stable at approximately 1% of GDP in 2003-2005. The reason for increasing the state budget deficit compared to GDP in 2005 was the inclusion of the idle balance, left in a single treasury account of the state budget for the beginning of the year, in the state budget deficit (unlike the state budget for 2004). The state budget deficit will be 0.6% of GDP in 2005 if these funds are not taken into consideration. Another attractive point in the state budget deficit was the increased receipts from the sale of short-term state bills in 2005. The debts on this source were repaid in 2003 and it is envisaged to involve 85.0 bln. AZM from this source in 2005 or 59.4% more funds than forecasted in 2004 to cover the state budget deficit.

State budget expenditure for 2003-2005

Table 4. State budget expenditure of the Republic of Azerbaijan for 2003-2005 (by functional classification)

bln. AZM

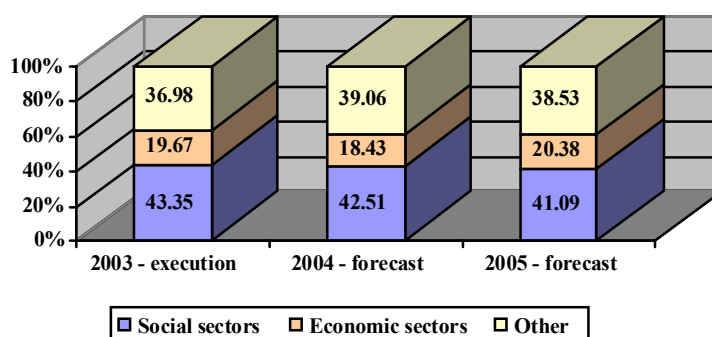
	Execution for 2003	Forecast for 2004	Forecast for 2005
State budget expenditure	6172.7	7833.4	10001.0
<i>Compared to GDP, in percentage</i>	<i>17.3</i>	<i>20.3</i>	<i>20.9</i>
General public services expenditures	488.6	665.9	903.2
<i>share, in percentage</i>	<i>7.92</i>	<i>8.50</i>	<i>9.03</i>
- maintenance expenditure of legislative and executive bodies and local self-governments	343.7	476.3	663.0
<i>share, in percentage</i>	<i>5.57</i>	<i>6.08</i>	<i>6.63</i>
- membership fee to the international organizations	41.4	48.1	39.9
<i>share, in percentage</i>	<i>0.67</i>	<i>0.61</i>	<i>0.4</i>
- expenditure on science	83.1	108.7	147.4
<i>share, in percentage</i>	<i>1.35</i>	<i>1.39</i>	<i>1.47</i>
- general public services expenditures, not elsewhere classified	20.4	32.8	52.9
<i>share, in percentage</i>	<i>0.33</i>	<i>0.42</i>	<i>0.53</i>
Defense expenditure	679.6	903.2	1206.1
<i>share, in percentage</i>	<i>11.01</i>	<i>11.53</i>	<i>12.06</i>

Maintenance expenditure of judicial authority, law-enforcement, security bodies and Prosecutors' Office	602.8	810.8	1075.0
<i>share, in percentage</i>	9.77	10.35	10.75
Education expenditure	1174.2	1541.2	1782.2
<i>share, in percentage</i>	19.02	19.67	17.82
Health expenditure	276.6	396.2	577.8
<i>share, in percentage</i>	4.48	5.06	5.78
Social protection and social security expenditure	1070.0	1192.0	1498.9
<i>share, in percentage</i>	17.33	15.22	14.99
- social protection expenditure	768.0	848.0	1072.0
<i>share, in percentage</i>	12.44	10.83	10.72
- social security expenditure	302.0	344.0	426.9
<i>share, in percentage</i>	4.89	4.39	4.27
Expenditure on cultural, art, mass media, physical training and religious activities	155.2	200.6	250.5
<i>share, in percentage</i>	2.52	2.56	2.5
- expenditure on cultural and art activities	139.9	179.7	229.2
<i>share, in percentage</i>	2.27	2.29	2.29
- expenditure on the measures related to physical training and youth policy	15.3	20.9	21.3
<i>share, in percentage</i>	0.25	0.27	0.21
Housing and community amenities	146.9	150.0	176.6
<i>share, in percentage</i>	2.38	1.91	1.77
Expenditure on agriculture, forestry and fishery	268.2	317.1	490.5
<i>share, in percentage</i>	4.34	4.05	4.9
Industrial and construction expenditures	515.5	503.6	665.9
<i>share, in percentage</i>	8.35	6.43	6.66
<i>including:</i>			
-public investment expenditure	434.4	480.0	650.0
<i>share, in percentage</i>	7.04	6.13	6.5
Transport and communication expenditures	219.8	329.8	477.5
<i>share, in percentage</i>	3.56	4.21	4.77
Other expenditure related to the economic activity	64.2	143.3	227.8
<i>share, in percentage</i>	1.04	1.83	2.28
Expenditure not included in the main sections	408.6	539.7	515.0
<i>share, in percentage</i>	6.62	6.89	5.15
<i>including:</i>			
- extra-budgetary expenditures of of the institutions financed by the state budget	295.8	350.0	366.0
<i>share, in percentage</i>	4.79	4.47	3.66
- subsidies allocated to the local budgets	5.0	10.0	10
<i>share, in percentage</i>	0.08	0.13	0.1
Expenditure on the state debt and liabilities service	102.5	140.0	154.0
<i>share, in percentage</i>	1.66	1.79	1.54
- payment of interests and other liabilities for domestic debts	38.8	49.1	52.4
<i>share, in percentage</i>	0.63	0.63	0.52
- payment of interests and other liabilities for external debts	63.7	90.9	101.6
<i>share, in percentage</i>	1.03	1.16	1.02

The ratio of the state budget expenditures to GDP increased from 17.3% to 20.9% in 2003-2005. At the same time, some changes in the structure of the state budget expenditures occurred within this period.

Generally, the following could be noted when the state budget expenditures are grouped in 3 parts: social sectors (education, health, social protection and social security, culture, art, mass media, physical training and religious activity); sectors related to economic activity (housing and community amenities, agriculture, forestry, fishery, industry and construction, transport and communication and other expenditures related to economic activity) and other sectors. Despite the decrease in funds allocated to social sectors within this period, its percentage in the budget remains high. The share of economic sectors in the state budget expenditures decreased from 19.67% in 2003 to 18.43% in 2004. It increased approximately 2 items in 2005 and reached 20.38% which could be noted as a positive progress in the state budget expenditures.

Figure 1. State budget expenditure for 2003-2005 (%)



A high share of education expenditure in the state budget expenditures was maintained throughout the reported period. Thus, while education expenditure was 19.02% of the state budget expenditures in 2003, it reached 19.67% in 2004. Percentage of education expenditures dropped to 17.82% only in 2005.

Table 5. Education expenditure in 2003-2005

bln. AZM

	Execution for 2003	Forecast for 2004	Forecast for 2005	Increase in 2005 compared to 2003	
				absolute	relative
Education expenditure	1174.2	1541.2	1782.2	608.0	51.8
<i>share in the state budget expenditures, in percentage</i>	19.02	19.67	17.82	-1.2	
- remuneration of labor and extra wage payments	957.8	1268.3	1420.3	462.5	48.3
- payments to the population (benefits and pensions)	18.3	30.9	39.9	21.6	118.0
- purchase of goods and payment for services	175.0	217.5	293.4	118.4	67.7
- capital expenditure	23.1	24.5	28.6	5.5	23.8
including:					
- capital repair	23.0	24.2	28.0	5.0	21.7

As can be seen, expenditures on labor remuneration constitute the majority of education expenditures. A 50% increase in the wages in 2003 provided a requirement for a higher percentage in education expenditures. While both expenditures on labor remuneration and extra wage payments made 81.57% of education expenditures in 2003 and 82.29% in 2004, it reduced to 79.7% in 2005. The main reason is the decrease of contributions to the SSPF from 27% to 22%. Increase in scholarships in 2004 resulted in 12.6 bln. AZM more payments to the population in comparison with 2003. Percentage of this expenditure in education expenditures increased from 1.56% in 2003 to 2.24% in 2005. The main reason of increase in expenditures on the purchase of goods and payment for services in the education sector was increased funds allocated for utility services, supply of free textbooks and computers to schools.

Table 6. Health expenditure in 2003-2005

bln. AZM

	Execution for 2003	Forecast for 2004	Forecast for 2005	increase in 2005 compared to 2003	
				absolute	relative
Health expenditure	276.6	396.2	577.8	301.2	108.9
<i>share in the state budget expenditures, in percentage</i>	4.48	5.06	5.78	1.3	
- remuneration of labor and extra wage payments	136.1	241.3	340.1	204.0	149.9
- purchase of goods and payment for services	122.0	137.5	217.2	95.2	78.0
- capital expenditure	18.5	17.4	20.5	2.0	10.8
including:					
- capital repair	17.0	16.3	18.5	1.5	8.8

Health expenditures forecasted in the state budget increased approximately 2.1 times in 2005 compared to 2003. Absolute increase made up 301.2 bln. AZM. As it is seen from the table, the main part of this increase, i.e. 204.0 bln. AZM or 67.7% of overall increase, take the expenditures on wages. 97.2 bln. AZM or 32.3% of increase falls to the share of other expenditures. As in education expenditure, the share of expenditures related to labor remuneration is high in health expenditures, as well. The share of health expenditure increased from 49.2% in 2003 to 58.86% in 2005 due to an increase in the minimum wages. Expenditures on the purchase of goods and services increased (95.2 bln. AZM) in comparison with 2003. The majority of this expenditure was spent on strengthening material and technical base of the health sector, purchasing medicines and payment for utilities as it is envisaged in the SPPRED.

The percentage of social protection and social security expenditures in the state budget has dropped. Apart from this, the funds allocated to these sectors increased from 1070 bln. AZM in 2003 to 1498.9 bln. AZM in 2005. A total of 768 bln. AZM, 848 bln. AZM, 1072 bln. AZM for a "social protection" and 302 bln. AZM, 344 bln. AZM, 426.9 bln. AZM for a "social security" sub-sector are envisaged in the state budget for 2003-2005. The Ministry of Labor and Social Protection of Population has started the payment of child benefits from 2004 onwards in line with the SPPRED and 163 bln. AZM and 157 bln. AZM were forecasted in the state budget for 2004-2005. Increases in the "social security" sub-sector are mainly caused by the following: monthly food benefits for the IDPs were increased 5000 AZM and reached 30000 AZM since 2005, and an additional 29.8 bln. AZM has been forecasted in the state budget. International humanitarian organizations stopped their activities in the Republic. In this regard, 15.9 bln. AZM in 2004 and 32 bln. AZM in 2005 was forecasted to provide food assistance to the IDPs.

The following changes occurred in the expenditures related to economic activity in 2003-2005. The expenditures on housing and community amenities dropped from 2.38% to 1.77%, industry and construction expenditures from 8.35% to 6.66%, while expenditures on agriculture, forestry and fishery increased from 4.34% to 4.9%, transport and communication expenditures from 3.56% to 4.77% and other expenditures related to the economic activity from 1.04% to 2.28%. At the same time, as can be seen from Table 4, expenditures for all sectors have increased in the absolute terms. The main reason of the decrease in the industrial and construction expenditures sector was the provision of 62 bln. AZM to "Azerkimya" State Company in 2003 to cover losses. It is forecasted that the public investment expenditures (industrial and construction expenditures) will increase 49.6% in 2005 compared to 2003 and reach 650 bln. AZM, which constitutes 6.5% of the state budget expenditures. Increase in the state investment expenditures enables to carry out a number of state projects. According to the Decree of the President of AR "On additional measures for the state care to the development of entrepreneurship in the Republic of Azerbaijan" dated September 10, 2002, budget resources (other expenditures related to the economic activity) allocated to the development of entrepreneurship were increased. While 50 bln. AZM were allocated for this purpose in 2003, 200.2 bln. AZM will be allocated in 2005, which will be 2% of the state budget expenditures.

Despite the reforms implemented in state administration, the percentage of expenditures for the legislative and administrative bodies increased within the reported period. While these expenditures were 5.57% of the state

budget expenditures in 2003, they made 6.08% and 6.63% within the next years. The resources allocated to this sub-sectors increased 319.3 bln. AZM or 92.9% in absolute terms compared to 2003 and made up 663 bln. AZM.

The Government pays special attention to the international commitments and kept their timely fulfillment in focus. A total of 39.9 bln. AZM (1.5 bln. AZM less than in 2003) will be allocated for the membership fees to the international organizations in 2005. A total of 101.6 bln. AZM are envisaged for the external debt interests and other liabilities in 2005, which is 37.9 bln. AZM and 10.7 bln. AZM higher than the relevant indicators of 2003 and 2004 respectively. Despite an increase of funds allocated for internal debts during this period (from 13.6 bln. AZM in 2003 to 52.4 bln. AZM in 2005), no constructive steps have been taken to repay the savings of the population kept at the Saving banks of former USSR.

Table 7. State budget expenditure of the Republic of Azerbaijan for 2003-2005 (by economic classification)

	bln. AZM		
	Execution for 2003	Forecast for 2004	Forecast for 2005
State budget expenditure	6172.7	7833.4	10001.0
<i>Compared to GDP, in percentage</i>	17.3	20.3	20.9
Remuneration of labor and extra wage payments	1907.2	2740.6	3377.9
Purchase of goods and services	2014.5	2503.0	3097.6
Payments to the population	1094.0	1214.1	1581.7
Capital expenditure	839.9	990.8	1497.1
Other expenditures	317.1	384.9	446.7

The priority of social expenditures in the state budget was maintained. While the share of these expenditures were 54.95% in 2003 and 55.99% in 2004, it is forecasted to be 54.73% in 2005. In 2005 this type of targeted expenditures will make 5473.5 bln AZM and will be spent on the following: labor remuneration and extra wage payments – 3377.9 bln. AZM; purchase of foodstuffs – 445.9 bln. AZM; purchase of medicines and bandages – 68 bln. AZM and payments to the population – 1581.7 bln. AZM. As can be seen, only wages and extra wage payments make more than one-third of the state budget expenditures. It means that the social targeting principle of expenditures will be protected within the nearest future.

The wages of employees of all budget-funded organizations have been increased. According to the relevant Presidential Decrees, the minimum wages increased from 27500 AZM from September 1, 2003 to 45000 AZM, to 60000 AZM from January 1, 2004 and to 100000 AZM from July 1. This amount increased 25% since 2005 and reached 125000 AZM. According to the Law of AR “On Civil Service”, which is effective from September 1, 2001, the payment of additions to civil servants in line with the labor record and qualifications was launched in September 1, 2003. A new wage scheme was introduced for the civil service from August 1, 2004. According to the relevant Resolution of the CM, the regulation of monthly wages of the employees of budget-funded sectors, as fixed by a Single Tariff Scheme, started from July 1, 2004. Employees of budget-funded sectors were divided into three groups each with 19 categories according to the above-mentioned Resolution. The first group includes the employees of the following sectors: health, social security, sport, youth, culture, art, mass media, education (except for teachers), agriculture, forestry, melioration and water industry, ecology and hydrometeorology, mobilization warehouses subordinate to city (regional) executive powers and reserves management centers, budget-funded agencies under the State Committee for Material Resources. The second group includes a pedagogical staff, while the third group the employees of scientific and scientific-research organizations subordinate to the National Academy of Sciences, ministries, state committees and concerns.

At the same time, major steps have been taken to cover utility fees. It should be noted that the Decrees on the implementation of annual budget laws instructed the heads of budget-funded organizations to observe strictly the limits allocated from the budget for utility and communication services. 467.2 bln. AZM were forecasted for utility fees in 2005, which totals to 157.6 bln. AZM more than the relevant indicator of 2003, and 68.7 bln. AZM of 2004.

Consolidated budget for 2003-2005

According to the Law of AR “On Budget System”, the consolidated budget is a mix of the state budget, budget of Nakhchivan AR (including extra-budgetary transactions), revenues and expenditures of extra-budgetary state funds. At the same time, indirect subsidies for energy, gas and chemical sectors were included both in the

revenues and expenditures parts of the consolidated budget in compliance with the relevant laws on annual state budget adopted for 2003-2005.

The Government started preparing consolidated budget indicators and included them in a budget envelope when preparing the draft state budget for 2004.

Table 8. Consolidated budget of the Republic of Azerbaijan for 2003-2005

bln. AZM

	Execution for 2003	Forecast for 2004	Forecast for 2005
Revenues of consolidated budget	10225.0	10976.9	12300.2
<i>Compared to GDP, in percentage</i>	28.6	28.5	25.7
<i>including:</i>			
- State budget revenues	6104.5	7518.4	9422.0
- Revenues of state extra-budgetary funds*	3727.6	2899.4	3556.5
- Indirect subsidies to the energy, gas and chemical sectors from the state budget**	1976.5	2332.0	1470.0
Expenditures of consolidated budget	9625.0	11252.2	12858.2
<i>Compared to GDP, in percentage</i>	26.9	29.2	26.9
<i>including:</i>			
- State budget expenditures	6172.7	7833.4	10001.0
- Expenditures of state extra-budgetary funds	3059.4	2859.7	3535.5
- Indirect subsidies to the energy, gas and chemical sectors from the state budget	1976.5	2332.0	1470.0
Deficit of consolidated budget	600.0	-275.3	-558.0
<i>Compared to GDP, in percentage</i>	1.7	0.7	1.2
Deficit of consolidated budget excluding the SOFAR revenues	-1220.5	-1204.0	-1636.0

* State extra-budgetary funds consist of the SSPF and SOFAR, which were established by the state as legal entities with their own budget separate from the state budget.

** The 2003 state budget envisaged indirect subsidies to the energy and gas sectors and to all the three sectors in 2004. However, indirect subsidies will be allocated only to the energy sector in 2005.

According to the existing legislation, all the expenditures of state extra-budgetary funds are included in the consolidated budget expenditures, except for the operation costs of the SOFAR and the costs related to the allocation of funds to the international banks and other financial institutions. At the same time, the consolidated budget deficit should be confirmed regardless of the revenues of the SOFAR.

It is forecasted that the revenues of the consolidated budget will increase 2.1 trln. AZM and will be 12.3 trln. AZM in 2005. This means that the consolidated budget expenditures will increase 3.2 trln. AZM and reach its forecasted amount of 12.9 trln. AZM in 2005. Increase in the consolidated budget expenditures is mainly linked to an increase in state budget expenditures. This is mainly caused by increased state budget expenditures following an increase of the state budget revenues due to the economic changes during this period.

The SOFAR, which is one of the extra-budgetary state funds, was established according the Decree of the President of AR "On Establishment of the SOFAR" dated December 29, 1999. The main goal of establishing the Fund is effective management of revenues generated from the implementation of oil contracts.

Another step has been taken to eliminate the negative impacts of oil revenues on the country's economy and their efficient and targeting management. In this regard, the Decree of the President RA "On approval of a long-term strategy for oil and gas revenues management" was issued in September 27, 2004. The strategy identified principles for a long-term use of oil and gas revenues and the main areas to use these revenues. The strategy aims at maintaining macro-economic stability by using oil revenues, to be rapidly increased, as an integral part of a single economic policy. Implementation of investment-oriented expenditures under the Public Investment Program could be provided as an example.

Execution of the SOFAR budget for 2003 was 1820.5 bln. AZM for the revenues part and 1180.1 bln. AZM for the expenditures part. The fixed amount was 928.7 bln. AZM and 843.7 bln. AZM in 2004 respectively. The scope of funds accumulated at the Fund reached approximately USD 1 bln. as of the end of 2004.

A forecasted budget of another extra-budgetary state fund – State Social Protection Fund – for 2005 is 2478.5 bln. AZM. Improvement of the living conditions of pensioners has always been an important objective. Thus, the minimum amount of pensions was increased to 125000 AZM from January 1, 2005.

The number of sectors receiving indirect subsidies from the state budget has been reduced since 2005. These subsidies will be only available to the energy sector. Reduction of these subsidies is a very positive step as it increases transparency of the state expenditures and reduces a burden in this area.

Summarizing the above-mentioned, it could be noted that the Government has made effective steps in the implementation of measures stipulated in the SPPRED during the last period and is planning further activities in this regard. Adoption of the Law of AR “On Budget System” prepared on the basis of international standards, approval of a “Long-term strategy for oil and gas revenues management”, various changes and amendments made to the Tax Code annually for the benefit of the taxpayers and could be taken as an example of this.

At the same time, increase in the wages of the institutions financed by the state budget, pensions, various social payments and benefits, the minimum wages, which have direct impact on population’s welfare, resulted in improved living conditions of the poor in the country. Thus, money income of the population has increased as well as the average monthly wages in the country.

MTEF for 2003-2005

Introduction

MTEF plays an important role in giving an impetus to poverty reduction and economic development. Thus, the preparation of the mid-term indicators identifies which problems have been set by the government to be addressed in the forthcoming years. By including the MTEF in the SPPRED the Government laid the basis for the activities to be carried out as part of the State Programme. The Law of AR "On budget system" prepared by the Government jointly with the international organizations in 2002 provides a legal framework in this area. According to the relevant articles of the Law, the state budget indicators for the next and subsequent three years started to be prepared in 2004.

Before analyzing the MTEF it should be noted that the majority of measures reflected in the Fiscal Policy section of the SPPRED have been implemented. It describes the steps taken by the Government to increase transparency and control over the collection and spending of budget resources. The above-mentioned Law of AR "On budget system" is given as an example. Apart from the previous laws (Laws of AR "On budget system" adopted in 1992 and "On the State Budget" adopted in 1999), which regulate the preparation of draft state budget, this Law provides the legal framework for full transparency in the use of budget resources. The principles of transparency include a "consolidated budget" definition; preparation and approval of budget on paragraph level of functional and economic classifications; preparation of the medium-term budget indicators and preliminary budget; increasing the number of documents submitted to the legislative body of the country; and publishing the documents related to the budget in the press and etc.

Legal and normative acts indicated in the Decree on the introduction of the Law of AR "On budget system", which includes the rules for the preparation and execution of the state budget, single budget classification and the rules of using the resources of the state budget reserve fund, have been approved by the relevant resolutions. All these legal and regulatory documents promote the improvement and transparency of the budget process.

In addition, the use of extra-budgetary resources of budget-funded organizations by including in the state budget could be considered as one of the major steps taken in the fiscal sector. Unlike the previous years, full supervision over the preparation and execution of these resources was restored and their random use prevented.

The Decrees on the annual budget laws, based on the comments of international organizations, instructed the CM to prepare a breakdown of estimates for revenues and expenditures of the following organizations: enterprises of the Ministry of Communication and Information Technologies, State Oil Company of Azerbaijan Republic, "Azerenergy" JSC, "Azersu" JSC, Azerbaijan State Railway Department, Azerbaijan State Caspian Shipping Company, "Azerigas" JSC, "Azerkimiya" State Company, "Azerbaijan Airlines" State Concern and the Baku Underground.

In 2004 the Government made another step towards the management of oil revenues. Thus, if the market oil price becomes higher than a price forecasted in the state budget, the surplus revenues are accumulated in a separate account of the Treasury and would be used in case of the price decreasing below the level forecasted in the budget.

State Budget Revenues for 2003-2005

As it is seen, the state budget revenues have recently increased compared to GDP. While the State Budget revenues in 2003 made 17.1% of GDP, it was

Table 1. State budget revenues for 2003-2005 (by the organizations providing revenues)

	<i>bln. AZM</i>		
	<i>Execution for 2003</i>	<i>Forecast for 2004</i>	<i>Forecast for 2005</i>
State budget revenues	6104.5	7518.4	9422.0
<i>Compared to GDP, in percentage</i>	17.1	19.5	19.7
for the Ministry of Taxes	4113.7	4900.0	6632.0
<i>share, percentage</i>	67.39	65.17	70.39
for the SCC	1061.2	1200.0	1450.0
<i>share, percentage</i>	17.38	15.96	15.34
for the SOFAR	500.0	650.0	750.0
<i>share, percentage</i>	8.19	8.65	7.96
Other sources	429.6	768.4	590.0
<i>share, percentage</i>	7.04	10.22	6.26

19.5% in 2004 and 19.7% in 2005. Revenues of the Ministry of Taxes and the SCC differed in proportion in the structure of budget revenues during these years. The revenues accumulated through these two organizations increased from 84.77% (2003) to 85.73% (2005). Although the revenues accumulated through the SCC increased in value, it decreased in percentage. This could be due to an increased rate of revenues accumulated through the Ministry of Taxes and due to the creation of other new sources of income. Since the transfers to the state budget from the SOFAR have recently increased, the revenues from the Fund started playing an important role in the state budget revenues. A number of social and investment projects were implemented through the resources of this Fund (750 bln. AZM in 2005), which was established as a result of a prudent policy of the national leader Heydar Aliyev. A sudden increase was observed in the revenues accumulated through the other sources in 2004. Thus, the percentage of these revenues, which increased 3.18 items in 2004 compared to 2003, could reach 6.26% in 2005 by decreasing 3.96 items. It was mainly caused by the inclusion of the idle balance, left in a single treasury account of the state budget for the beginning of the year (201.4 bln. AZM), in the revenues part of the state budget in 2004. This balance was 2.68% of the state budget revenues in 2004.

Table 2. State budget revenues for 2003-2005 (by the sources of revenue)

bln. AZM

	Execution for 2003	Forecast for 2004	Forecast for 2005
State budget revenues	6104.5	7518.4	9422.0
<i>Compared to GDP, in percentage</i>	<i>17.1</i>	<i>19.5</i>	<i>19.7</i>
Individual income tax	752.1	840.0	1206.0
Profit tax of legal entities (except municipal enterprises and organizations)	891.5	1117.0	1495.0
Value-added tax	2048.6	2324.0	2754.0
<i>including:</i>			
- value-added tax on the goods imported to the territory of AR	717.6	844.0	1024.0
Excises	335.2	350.0	655.0
<i>including:</i>			
- excises on the goods imported to the territory of AR	43.3	50.0	50.0
Property tax of legal entities	133.0	160.0	200.0
Land tax of legal entities	56.6	70.0	75.0
Road tax	5.4	6.0	51.0
Mine tax (except for mine tax for the construction materials of local importance)	283.6	489.0	490.0
Simplified tax	63.3	80.0	106.0
Customs duties	294.9	300.0	370.0
State duties	116.5	120.0	130.0
Lumpsum duty	6.2	7.0	
Other non-tax revenues	188.1	237.0	550.0
Receipts from leasing of public property	12.7	12.0	12.0
European Union grant extended to the Republic of Azerbaijan	28.4	50.0	50.0
Receipts from credits extended to the governments of foreign countries	2.4	17.9	17.4
Dividends received from the banks with the state shares	8.3	10.1	26.6
Dividends received from non-financial state enterprises		45.0	25.0
Receipts from the NB profit	60.0	30.0	30.0
Receipts from the SOFAR	500.0	650.0	750.0
Receipts from credits issued from the budget		1.8	1.0
Receipts from the credits with the state guarantee	0.4		3.9
Receipts from subsidiary loan agreements	11.6	44.7	52.1
Receipts from the sale of excise marks	8.1	5.5	6.0
Extra-budgetary revenues of the institutions financed by the state budget	297.6	350.0	366.0
Idle balance left in a single treasury account of the state budget for the beginning of the year		201.4	

The share of value-added tax, profit tax of legal entities, individual income tax still takes an important place in the state budget revenues. Despite the receipts on these three types of taxes were 60.48% in 2003, this figure dropped to 57.9% in 2005. As a result of wage reforms (which includes an increase in the average wages, as well as increases in the minimum wages and wages of budget-funded organizations), the anticipated individual income tax for 2005 will be 12.8% of budget revenues. The receipts from value-added tax are still traditionally on the first place among the revenues in the state budget. However, its percentage in the state budget dropped from 33.56% in 2003 to 29.23% in 2005. Creation of the other sources and expansion of simplified tax coverage could be the main reasons of this decrease. While the rate of this tax has not been decreased, exemptions from the same tax have been reduced during the last period.

Receipts from the NB profits have decreased twice and its forecasted amount is 30 bln. AZM for 2005.

Additional sources have been sought by the government to increase the state budget revenues. Thus, starting from 2004 it is forecasted that the state budget will receive dividends from non-financial state enterprises. The State Budget was forecasted to receive 25 bln. AZM from the enterprises of the Ministry of Communication and Information Technologies and 20 bln. AZM from Azerbaijan State Caspian Shipping Company in 2004.

As part of fiscal reforms, extra-budgetary revenues of institutions financed by the state budget have been abolished through recording in the state budget. Starting from 2002 considerable measures have been taken in this regard. Thus, extra-budgetary revenues of several organizations have been abolished. This will continue during the next years and the receipts were included in the State Budget. While extra-budgetary revenues of budget-funded organizations were 4.88% of the state budget in 2003, it dropped to 4.66% in 2004 and to 3.88% in 2005. The Government has increased attention to targeted spending of these funds. If a breakdown of these funds were approved based on the main items of budget in 2003, the CM approved a breakdown on the directions and organizations starting from 2004. To increase supervision over the accumulation and spending of these funds, heads of the budget-funded organizations have been instructed to transfer these funds to the accounts of the Treasury in a non-cash form and only through the authorized banks determined by the State Treasury.

Many steps have been taken to reduce the tax burden, which enabled to increase entrepreneurial activity and improve the living conditions of the population. As a result of reforms carried out at the Ministry of Taxes and SCC, the Government achieved a reduction of the tax rates and at the same time, an increase of tax receipts.

A number of additions and amendments have been recently made to the Tax Code of AR adopted in 2000. The main goal of these changes and amendments was to give an impetus to the development of entrepreneurship through reducing the tax burden in the country. If simplified tax turnover, i.e. the volume of taxable operations for the previous 3 month period, was 300 times less than non-taxable monthly income, it was increased by 22500 times (up to 123.75 mln. AZM) of nominal financial unit in 2004. At the same time, the rate of this tax for the regions was differentiated (4% – in Baku City, 2% – in other regions), which reflects prioritization of regional development.

The rate of profit tax of legal entities has also been decreased within this period. Enterprise profit tax was lowered from January 1, 2003 from 27% to 25%. At the same time, differentiated taxation principle on profit tax was introduced in the regions (80% of estimate profit tax for Ganja, Sumgait, Mingachevir and Ali-Bairamly Cities, 40% for the mountain regions and Nakhchivan AR, 60% for the other regions (except for Baku City and Absheron District). However, observations made by the Government in various regions in 2003 found this differentiation ineffective. Thus, differentiated tax rates were abolished from January 1, 2004 and the profit tax of legal entities decreased to 24%.

Regarding the individual income tax, the Government has implemented reforms in this area taking into consideration the underprivileged and an increase in the average monthly income of the population. At present, non-taxable monthly income was increased to 150000 AZM. This type of tax was transferred to a 3-stage tax system.

The work carried out to reduce the tax burden has also covered social insurance contributions. Social insurance contributions to the SSPF decreased from 29% to 27% from January 1, 2003 and to 22% from January 1, 2005.

The coverage of a road tax was expanded in 2005. Thus, individuals having vehicles in their property in the Republic of Azerbaijan have been included in the list of taxpayers.

At the same time, it should be noted that one of the considerable changes made to the Tax Code was replacing “non-taxable monthly income” by “nominal financial unit”. It excludes the necessity to make changes to the Code when increasing non-taxable monthly income. Thus, necessary changes are required in the relevant articles to increase this amount, which provides the basis for the evaluation of taxes, turnover and etc.

State budget deficit and its financing

Table 3. State budget deficit and the sources of its financing

bln. AZM

	Execution for 2003	Forecast for 2004	Forecast for 2005
State budget deficit	68.2	315.0	579.0
<i>Compared to GDP, in percentage</i>	<i>0.2</i>	<i>0.8</i>	<i>1.2</i>
Sources of financing the deficit	240.6	315.0	579.0
Domestic sources	71.6	215.5	480.6
- receipts from privatization	97.9	160.0	90.0
- receipts from the sale of short-term state bills (T-bills)	-29.6	50.5	85.0
- receipts from the sale of domestic state premium bonds (lottery bonds)	3.3	5.0	5.6
- idle balance left in a single treasury account of the state budget for the beginning of the year			300.0
External sources	169.0	99.5	98.4

The state budget deficit remained stable at approximately 1% of GDP in 2003-2005. The reason for increasing the state budget deficit compared to GDP in 2005 was the inclusion of the idle balance, left in a single treasury account of the state budget for the beginning of the year, in the state budget deficit (unlike the state budget for 2004). The state budget deficit will be 0.6% of GDP in 2005 if these funds are not taken into consideration. Another attractive point in the state budget deficit was the increased receipts from the sale of short-term state bills in 2005. The debts on this source were repaid in 2003 and it is envisaged to involve 85.0 bln. AZM from this source in 2005 or 59.4% more funds than forecasted in 2004 to cover the state budget deficit.

State budget expenditure for 2003-2005

Table 4. State budget expenditure of the Republic of Azerbaijan for 2003-2005 (by functional classification)

bln. AZM

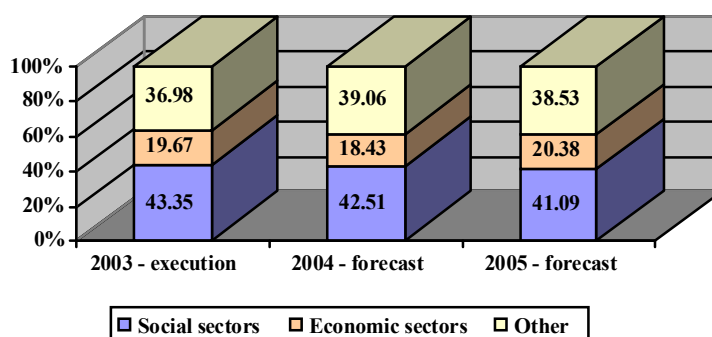
	Execution for 2003	Forecast for 2004	Forecast for 2005
State budget expenditure	6172.7	7833.4	10001.0
<i>Compared to GDP, in percentage</i>	<i>17.3</i>	<i>20.3</i>	<i>20.9</i>
General public services expenditures	488.6	665.9	903.2
<i>share, in percentage</i>	<i>7.92</i>	<i>8.50</i>	<i>9.03</i>
- maintenance expenditure of legislative and executive bodies and local self-governments	343.7	476.3	663.0
<i>share, in percentage</i>	<i>5.57</i>	<i>6.08</i>	<i>6.63</i>
- membership fee to the international organizations	41.4	48.1	39.9
<i>share, in percentage</i>	<i>0.67</i>	<i>0.61</i>	<i>0.4</i>
- expenditure on science	83.1	108.7	147.4
<i>share, in percentage</i>	<i>1.35</i>	<i>1.39</i>	<i>1.47</i>
- general public services expenditures, not elsewhere classified	20.4	32.8	52.9
<i>share, in percentage</i>	<i>0.33</i>	<i>0.42</i>	<i>0.53</i>
Defense expenditure	679.6	903.2	1206.1
<i>share, in percentage</i>	<i>11.01</i>	<i>11.53</i>	<i>12.06</i>

Maintenance expenditure of judicial authority, law-enforcement, security bodies and Prosecutors' Office	602.8	810.8	1075.0
<i>share, in percentage</i>	9.77	10.35	10.75
Education expenditure	1174.2	1541.2	1782.2
<i>share, in percentage</i>	19.02	19.67	17.82
Health expenditure	276.6	396.2	577.8
<i>share, in percentage</i>	4.48	5.06	5.78
Social protection and social security expenditure	1070.0	1192.0	1498.9
<i>share, in percentage</i>	17.33	15.22	14.99
- social protection expenditure	768.0	848.0	1072.0
<i>share, in percentage</i>	12.44	10.83	10.72
- social security expenditure	302.0	344.0	426.9
<i>share, in percentage</i>	4.89	4.39	4.27
Expenditure on cultural, art, mass media, physical training and religious activities	155.2	200.6	250.5
<i>share, in percentage</i>	2.52	2.56	2.5
- expenditure on cultural and art activities	139.9	179.7	229.2
<i>share, in percentage</i>	2.27	2.29	2.29
- expenditure on the measures related to physical training and youth policy	15.3	20.9	21.3
<i>share, in percentage</i>	0.25	0.27	0.21
Housing and community amenities	146.9	150.0	176.6
<i>share, in percentage</i>	2.38	1.91	1.77
Expenditure on agriculture, forestry and fishery	268.2	317.1	490.5
<i>share, in percentage</i>	4.34	4.05	4.9
Industrial and construction expenditures	515.5	503.6	665.9
<i>share, in percentage</i>	8.35	6.43	6.66
<i>including:</i>			
-public investment expenditure	434.4	480.0	650.0
<i>share, in percentage</i>	7.04	6.13	6.5
Transport and communication expenditures	219.8	329.8	477.5
<i>share, in percentage</i>	3.56	4.21	4.77
Other expenditure related to the economic activity	64.2	143.3	227.8
<i>share, in percentage</i>	1.04	1.83	2.28
Expenditure not included in the main sections	408.6	539.7	515.0
<i>share, in percentage</i>	6.62	6.89	5.15
<i>including:</i>			
- extra-budgetary expenditures of of the institutions financed by the state budget	295.8	350.0	366.0
<i>share, in percentage</i>	4.79	4.47	3.66
- subsidies allocated to the local budgets	5.0	10.0	10
<i>share, in percentage</i>	0.08	0.13	0.1
Expenditure on the state debt and liabilities service	102.5	140.0	154.0
<i>share, in percentage</i>	1.66	1.79	1.54
- payment of interests and other liabilities for domestic debts	38.8	49.1	52.4
<i>share, in percentage</i>	0.63	0.63	0.52
- payment of interests and other liabilities for external debts	63.7	90.9	101.6
<i>share, in percentage</i>	1.03	1.16	1.02

The ratio of the state budget expenditures to GDP increased from 17.3% to 20.9% in 2003-2005. At the same time, some changes in the structure of the state budget expenditures occurred within this period.

Generally, the following could be noted when the state budget expenditures are grouped in 3 parts: social sectors (education, health, social protection and social security, culture, art, mass media, physical training and religious activity); sectors related to economic activity (housing and community amenities, agriculture, forestry, fishery, industry and construction, transport and communication and other expenditures related to economic activity) and other sectors. Despite the decrease in funds allocated to social sectors within this period, its percentage in the budget remains high. The share of economic sectors in the state budget expenditures decreased from 19.67% in 2003 to 18.43% in 2004. It increased approximately 2 items in 2005 and reached 20.38% which could be noted as a positive progress in the state budget expenditures.

Figure 1. State budget expenditure for 2003-2005 (%)



A high share of education expenditure in the state budget expenditures was maintained throughout the reported period. Thus, while education expenditure was 19.02% of the state budget expenditures in 2003, it reached 19.67% in 2004. Percentage of education expenditures dropped to 17.82% only in 2005.

Table 5. Education expenditure in 2003-2005

bln. AZM

	Execution for 2003	Forecast for 2004	Forecast for 2005	Increase in 2005 compared to 2003	
				absolute	relative
Education expenditure	1174.2	1541.2	1782.2	608.0	51.8
<i>share in the state budget expenditures, in percentage</i>	19.02	19.67	17.82	-1.2	
- remuneration of labor and extra wage payments	957.8	1268.3	1420.3	462.5	48.3
- payments to the population (benefits and pensions)	18.3	30.9	39.9	21.6	118.0
- purchase of goods and payment for services	175.0	217.5	293.4	118.4	67.7
- capital expenditure	23.1	24.5	28.6	5.5	23.8
including:					
- capital repair	23.0	24.2	28.0	5.0	21.7

As can be seen, expenditures on labor remuneration constitute the majority of education expenditures. A 50% increase in the wages in 2003 provided a requirement for a higher percentage in education expenditures. While both expenditures on labor remuneration and extra wage payments made 81.57% of education expenditures in 2003 and 82.29% in 2004, it reduced to 79.7% in 2005. The main reason is the decrease of contributions to the SSPF from 27% to 22%. Increase in scholarships in 2004 resulted in 12.6 bln. AZM more payments to the population in comparison with 2003. Percentage of this expenditure in education expenditures increased from 1.56% in 2003 to 2.24% in 2005. The main reason of increase in expenditures on the purchase of goods and payment for services in the education sector was increased funds allocated for utility services, supply of free textbooks and computers to schools.

Table 6. Health expenditure in 2003-2005

bln. AZM

	Execution for 2003	Forecast for 2004	Forecast for 2005	increase in 2005 compared to 2003	
				absolute	relative
Health expenditure	276.6	396.2	577.8	301.2	108.9
<i>share in the state budget expenditures, in percentage</i>	4.48	5.06	5.78	1.3	
- remuneration of labor and extra wage payments	136.1	241.3	340.1	204.0	149.9
- purchase of goods and payment for services	122.0	137.5	217.2	95.2	78.0
- capital expenditure	18.5	17.4	20.5	2.0	10.8
including:					
- capital repair	17.0	16.3	18.5	1.5	8.8

Health expenditures forecasted in the state budget increased approximately 2.1 times in 2005 compared to 2003. Absolute increase made up 301.2 bln. AZM. As it is seen from the table, the main part of this increase, i.e. 204.0 bln. AZM or 67.7% of overall increase, take the expenditures on wages. 97.2 bln. AZM or 32.3% of increase falls to the share of other expenditures. As in education expenditure, the share of expenditures related to labor remuneration is high in health expenditures, as well. The share of health expenditure increased from 49.2% in 2003 to 58.86% in 2005 due to an increase in the minimum wages. Expenditures on the purchase of goods and services increased (95.2 bln. AZM) in comparison with 2003. The majority of this expenditure was spent on strengthening material and technical base of the health sector, purchasing medicines and payment for utilities as it is envisaged in the SPPRED.

The percentage of social protection and social security expenditures in the state budget has dropped. Apart from this, the funds allocated to these sectors increased from 1070 bln. AZM in 2003 to 1498.9 bln. AZM in 2005. A total of 768 bln. AZM, 848 bln. AZM, 1072 bln. AZM for a "social protection" and 302 bln. AZM, 344 bln. AZM, 426.9 bln. AZM for a "social security" sub-sector are envisaged in the state budget for 2003-2005. The Ministry of Labor and Social Protection of Population has started the payment of child benefits from 2004 onwards in line with the SPPRED and 163 bln. AZM and 157 bln. AZM were forecasted in the state budget for 2004-2005. Increases in the "social security" sub-sector are mainly caused by the following: monthly food benefits for the IDPs were increased 5000 AZM and reached 30000 AZM since 2005, and an additional 29.8 bln. AZM has been forecasted in the state budget. International humanitarian organizations stopped their activities in the Republic. In this regard, 15.9 bln. AZM in 2004 and 32 bln. AZM in 2005 was forecasted to provide food assistance to the IDPs.

The following changes occurred in the expenditures related to economic activity in 2003-2005. The expenditures on housing and community amenities dropped from 2.38% to 1.77%, industry and construction expenditures from 8.35% to 6.66%, while expenditures on agriculture, forestry and fishery increased from 4.34% to 4.9%, transport and communication expenditures from 3.56% to 4.77% and other expenditures related to the economic activity from 1.04% to 2.28%. At the same time, as can be seen from Table 4, expenditures for all sectors have increased in the absolute terms. The main reason of the decrease in the industrial and construction expenditures sector was the provision of 62 bln. AZM to "Azerkimya" State Company in 2003 to cover losses. It is forecasted that the public investment expenditures (industrial and construction expenditures) will increase 49.6% in 2005 compared to 2003 and reach 650 bln. AZM, which constitutes 6.5% of the state budget expenditures. Increase in the state investment expenditures enables to carry out a number of state projects. According to the Decree of the President of AR "On additional measures for the state care to the development of entrepreneurship in the Republic of Azerbaijan" dated September 10, 2002, budget resources (other expenditures related to the economic activity) allocated to the development of entrepreneurship were increased. While 50 bln. AZM were allocated for this purpose in 2003, 200.2 bln. AZM will be allocated in 2005, which will be 2% of the state budget expenditures.

Despite the reforms implemented in state administration, the percentage of expenditures for the legislative and administrative bodies increased within the reported period. While these expenditures were 5.57% of the state

budget expenditures in 2003, they made 6.08% and 6.63% within the next years. The resources allocated to this sub-sectors increased 319.3 bln. AZM or 92.9% in absolute terms compared to 2003 and made up 663 bln. AZM.

The Government pays special attention to the international commitments and kept their timely fulfillment in focus. A total of 39.9 bln. AZM (1.5 bln. AZM less than in 2003) will be allocated for the membership fees to the international organizations in 2005. A total of 101.6 bln. AZM are envisaged for the external debt interests and other liabilities in 2005, which is 37.9 bln. AZM and 10.7 bln. AZM higher than the relevant indicators of 2003 and 2004 respectively. Despite an increase of funds allocated for internal debts during this period (from 13.6 bln. AZM in 2003 to 52.4 bln. AZM in 2005), no constructive steps have been taken to repay the savings of the population kept at the Saving banks of former USSR.

Table 7. State budget expenditure of the Republic of Azerbaijan for 2003-2005 (by economic classification)

	bln. AZM		
	Execution for 2003	Forecast for 2004	Forecast for 2005
State budget expenditure	6172.7	7833.4	10001.0
<i>Compared to GDP, in percentage</i>	17.3	20.3	20.9
Remuneration of labor and extra wage payments	1907.2	2740.6	3377.9
Purchase of goods and services	2014.5	2503.0	3097.6
Payments to the population	1094.0	1214.1	1581.7
Capital expenditure	839.9	990.8	1497.1
Other expenditures	317.1	384.9	446.7

The priority of social expenditures in the state budget was maintained. While the share of these expenditures were 54.95% in 2003 and 55.99% in 2004, it is forecasted to be 54.73% in 2005. In 2005 this type of targeted expenditures will make 5473.5 bln AZM and will be spent on the following: labor remuneration and extra wage payments – 3377.9 bln. AZM; purchase of foodstuffs – 445.9 bln. AZM; purchase of medicines and bandages – 68 bln. AZM and payments to the population – 1581.7 bln. AZM. As can be seen, only wages and extra wage payments make more than one-third of the state budget expenditures. It means that the social targeting principle of expenditures will be protected within the nearest future.

The wages of employees of all budget-funded organizations have been increased. According to the relevant Presidential Decrees, the minimum wages increased from 27500 AZM from September 1, 2003 to 45000 AZM, to 60000 AZM from January 1, 2004 and to 100000 AZM from July 1. This amount increased 25% since 2005 and reached 125000 AZM. According to the Law of AR “On Civil Service”, which is effective from September 1, 2001, the payment of additions to civil servants in line with the labor record and qualifications was launched in September 1, 2003. A new wage scheme was introduced for the civil service from August 1, 2004. According to the relevant Resolution of the CM, the regulation of monthly wages of the employees of budget-funded sectors, as fixed by a Single Tariff Scheme, started from July 1, 2004. Employees of budget-funded sectors were divided into three groups each with 19 categories according to the above-mentioned Resolution. The first group includes the employees of the following sectors: health, social security, sport, youth, culture, art, mass media, education (except for teachers), agriculture, forestry, melioration and water industry, ecology and hydrometeorology, mobilization warehouses subordinate to city (regional) executive powers and reserves management centers, budget-funded agencies under the State Committee for Material Resources. The second group includes a pedagogical staff, while the third group the employees of scientific and scientific-research organizations subordinate to the National Academy of Sciences, ministries, state committees and concerns.

At the same time, major steps have been taken to cover utility fees. It should be noted that the Decrees on the implementation of annual budget laws instructed the heads of budget-funded organizations to observe strictly the limits allocated from the budget for utility and communication services. 467.2 bln. AZM were forecasted for utility fees in 2005, which totals to 157.6 bln. AZM more than the relevant indicator of 2003, and 68.7 bln. AZM of 2004.

Consolidated budget for 2003-2005

According to the Law of AR “On Budget System”, the consolidated budget is a mix of the state budget, budget of Nakhchivan AR (including extra-budgetary transactions), revenues and expenditures of extra-budgetary state funds. At the same time, indirect subsidies for energy, gas and chemical sectors were included both in the

revenues and expenditures parts of the consolidated budget in compliance with the relevant laws on annual state budget adopted for 2003-2005.

The Government started preparing consolidated budget indicators and included them in a budget envelope when preparing the draft state budget for 2004.

Table 8. Consolidated budget of the Republic of Azerbaijan for 2003-2005

bln. AZM

	Execution for 2003	Forecast for 2004	Forecast for 2005
Revenues of consolidated budget	10225.0	10976.9	12300.2
<i>Compared to GDP, in percentage</i>	28.6	28.5	25.7
<i>including:</i>			
- State budget revenues	6104.5	7518.4	9422.0
- Revenues of state extra-budgetary funds*	3727.6	2899.4	3556.5
- Indirect subsidies to the energy, gas and chemical sectors from the state budget**	1976.5	2332.0	1470.0
Expenditures of consolidated budget	9625.0	11252.2	12858.2
<i>Compared to GDP, in percentage</i>	26.9	29.2	26.9
<i>including:</i>			
- State budget expenditures	6172.7	7833.4	10001.0
- Expenditures of state extra-budgetary funds	3059.4	2859.7	3535.5
- Indirect subsidies to the energy, gas and chemical sectors from the state budget	1976.5	2332.0	1470.0
Deficit of consolidated budget	600.0	-275.3	-558.0
<i>Compared to GDP, in percentage</i>	1.7	0.7	1.2
Deficit of consolidated budget excluding the SOFAR revenues	-1220.5	-1204.0	-1636.0

* State extra-budgetary funds consist of the SSPF and SOFAR, which were established by the state as legal entities with their own budget separate from the state budget.

** The 2003 state budget envisaged indirect subsidies to the energy and gas sectors and to all the three sectors in 2004. However, indirect subsidies will be allocated only to the energy sector in 2005.

According to the existing legislation, all the expenditures of state extra-budgetary funds are included in the consolidated budget expenditures, except for the operation costs of the SOFAR and the costs related to the allocation of funds to the international banks and other financial institutions. At the same time, the consolidated budget deficit should be confirmed regardless of the revenues of the SOFAR.

It is forecasted that the revenues of the consolidated budget will increase 2.1 trln. AZM and will be 12.3 trln. AZM in 2005. This means that the consolidated budget expenditures will increase 3.2 trln. AZM and reach its forecasted amount of 12.9 trln. AZM in 2005. Increase in the consolidated budget expenditures is mainly linked to an increase in state budget expenditures. This is mainly caused by increased state budget expenditures following an increase of the state budget revenues due to the economic changes during this period.

The SOFAR, which is one of the extra-budgetary state funds, was established according the Decree of the President of AR "On Establishment of the SOFAR" dated December 29, 1999. The main goal of establishing the Fund is effective management of revenues generated from the implementation of oil contracts.

Another step has been taken to eliminate the negative impacts of oil revenues on the country's economy and their efficient and targeting management. In this regard, the Decree of the President RA "On approval of a long-term strategy for oil and gas revenues management" was issued in September 27, 2004. The strategy identified principles for a long-term use of oil and gas revenues and the main areas to use these revenues. The strategy aims at maintaining macro-economic stability by using oil revenues, to be rapidly increased, as an integral part of a single economic policy. Implementation of investment-oriented expenditures under the Public Investment Program could be provided as an example.

Execution of the SOFAR budget for 2003 was 1820.5 bln. AZM for the revenues part and 1180.1 bln. AZM for the expenditures part. The fixed amount was 928.7 bln. AZM and 843.7 bln. AZM in 2004 respectively. The scope of funds accumulated at the Fund reached approximately USD 1 bln. as of the end of 2004.

A forecasted budget of another extra-budgetary state fund – State Social Protection Fund – for 2005 is 2478.5 bln. AZM. Improvement of the living conditions of pensioners has always been an important objective. Thus, the minimum amount of pensions was increased to 125000 AZM from January 1, 2005.

The number of sectors receiving indirect subsidies from the state budget has been reduced since 2005. These subsidies will be only available to the energy sector. Reduction of these subsidies is a very positive step as it increases transparency of the state expenditures and reduces a burden in this area.

Summarizing the above-mentioned, it could be noted that the Government has made effective steps in the implementation of measures stipulated in the SPPRED during the last period and is planning further activities in this regard. Adoption of the Law of AR “On Budget System” prepared on the basis of international standards, approval of a “Long-term strategy for oil and gas revenues management”, various changes and amendments made to the Tax Code annually for the benefit of the taxpayers and could be taken as an example of this.

At the same time, increase in the wages of the institutions financed by the state budget, pensions, various social payments and benefits, the minimum wages, which have direct impact on population’s welfare, resulted in improved living conditions of the poor in the country. Thus, money income of the population has increased as well as the average monthly wages in the country.