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IMPEDIMENTS TO EFFECTIVE DECENTRALIZATION IN AZERBAIJAN: THE
PROBLEM OF COMPETENCIES AND RESOURCES IN LOCAL SELF-
GOVERNMENT

A Thesis

Submitted to the Graduate Center for Social and Public Policy

McAnulty College & Graduate School of Liberal Arts

Duquesne University

In partial fulfillment of the requirements for
the degree of Master of Public Policy

By

Elvin Yusifli

August 2013

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PROBLEM OF COMPETENCIES AND RESOURCES IN
LOCAL SELF-GOVERNMENT

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ABSTRACT

IMPEDIMENTS TO EFFECTIVE DECENTRALIZATION IN AZERBAIJAN: THE PROBLEM OF COMPETENCIES AND RESOURCES IN LOCAL SELF- GOVERNMENT

By

Elvin Yusifli

August 2013

Thesis supervised by Lew Irwin, Ph D.

This study explores the role of two institutional impediments, namely a lack of power and resources, which slow the development of Azerbaijan's local self-government. In spite of the fact that the last two Azerbaijani governments have accepted the rationale for and have taken steps towards democratic decentralization, local self-government has remained a weak component of the country's political and administrative system. The study argues that limited municipal powers, combined with a scant and unsustainable revenue stream, are one of, if not the most important, barrier to the institutionalization of Azerbaijan's local self-government. The study employs a descriptive mixed methods case research method to analyze the current state of municipal powers and finances. The end of the paper briefly discusses the changing structure of incentives, which may compel the

government to reexamine its previously passive approach towards the problems and suggests a number of areas from which improvements should begin.

TABLE OF CONTENTS

	Page
Abstract	iv
List of Tables	viii
Introduction.....	x
1. Research Design	1
Conceptual Framework	1
Defining Decentralization.....	1
Rationale for Democratic Decentralization	2
Power and Resource Dimensions of Devolution.....	5
Research Questions	9
Research Methods	9
Data Collection and Analysis	10
Desk Research	11
Quantitative Research.....	12
2. Powers of Local Self-Government: Clear, Comprehensive and Sufficient?	14
Introduction	14
Constitutional and Legislative Framework for Local Self-Government.....	14
Constitution and Municipalities.....	14
European Charter of Local Self-Government.....	16
Law on Status of Municipalities	17

Municipalities and Local Executive Authorities	19
Functions of Economic Development	22
Functions of Social Development.....	24
Summary	31
3. Revenues of Local Self-Government: Sufficient and Sustainable?.....	34
Introduction	34
Formal Framework of Municipal Finances	34
Problem of Funding.....	36
Case of 16 Municipalities: General Picture	38
Revenue Sources.....	45
Summary	51
4. Discussion.....	53
Obstacles to Good Decentralization Policy.....	53
Rising Cost of the Status Quo	55
The Way Forward.....	63
Endnotes.....	Error! Bookmark not defined.
Bibliography.....	74
Appendix	79

LIST OF TABLES

	Page
Table 1: Comparing municipal and state revenues, AZN, 2002-2010.	37
Table 2: Comparing the state grants and municipal revenues, 2002-2009.	37
Table 3: Forecasted and actual total revenues of municipalities for 2011, AZN.	39
Table 4: Share of administrative expenses in the total budgets of city municipalities in 2011.	40
Table 5: Share of salaries in the total expenditures of village municipalities in 2011, AZN.	41
Table 6: Comparing monthly wages of village municipalities and the regional averages, AZN, 2011-2012.	42
Table 7: Percentage of city municipalities' spending on administration, infrastructure and communal services in 2011.	43
Table 8: Percentage of village municipalities' spending on salaries/SSPF payments, infrastructure and communal services in 2011.	43
Table 9: Condition of local roads, 2011.	44
Table 10: Condition of drinking water infrastructure in municipalities, 2011.	45
Table 11: Revenues from sale and lease of municipal lands, 2010-2011.	47
Table 12: Revenues of municipalities from three sources: land tax on private individuals, property tax on private individuals, and mining tax on construction materials, 2011.	49
Table 13: Comparing the state grants and total municipal revenues, 2011.	51
Table 14: Share of public sector employment in total employment in Armenia, Azerbaijan and Georgia, expressed as a percentage, 1995-2008.	56

Table 15: Are you satisfied with the economic reforms in your region? (%).....	58
Table 16: How would you evaluate the performance of the local executive authority? (%)	59
Table 17: Are you satisfied with the performance of your municipality? (%)	60
Table 18: Rank the obstacles to local development in order of importance. (%).....	61

Introduction

Weak local self-government, which is exercised by the municipalities, is a major public policy problem in Azerbaijan. The political decentralization process the country undertook in the late 1990s has failed to produce a functioning system of local governance. While in the past two decades, most countries in Central and Eastern Europe have significantly reformed their political systems by establishing effective local authorities, Azerbaijan's municipalities have remained an institutionally weak component of the country's administrative system.

Compared to other policy issues, however, far too little attention has been paid to institutional impediments to democratic decentralization in the country. The objective of this research is to examine the role of two institutional problems, the lack of powers and resources, in the country's persistently weak local self-government.

This study has been divided into four sections. Section 1 provides the conceptual and methodological framework of the study. The conceptual framework draws on the decentralization literature to define the key notions used in this study and explain the importance of local government powers and revenues for an effective decentralization policy in Azerbaijan. The methodological framework lays out the data collection and analysis techniques used in this study.

Section 2 illustrates the problems in the formal framework of local self-government and the assignment of functions and competencies between municipalities and the local executive authorities (LEAs). The section, first, identifies the problems in the constitutional and legislative basis of municipal system. It, then, discusses municipal functions within the context of intergovernmental relations and explores the problems in

the areas of economic and social development responsibilities currently assigned to municipalities. In the end, the main points of the section are summed up.

Section 3 deals with the revenue dimension of the problems in local self-government. It analyzes the financial indicators of a sample of 16 municipalities, the Municipal Performance Management System, collected by the Eurasian Partnership Foundation, within its “Transparency in Municipal Service Delivery Program.”¹ This part provides a brief overview of the formal framework of municipal finances. Then, it analyzes the main trends of municipal finances, including the general problems relating to municipal revenues, local infrastructure and the revenue sources. The findings are summarized at the end of the section.

Section 4 discusses the reasons for the absence of an effective local self-government reform and explains how the changing political and economic situation in Azerbaijan may compel the government to reconsider its policy towards municipalities. It finally discusses a number of changes the government should undertake to address the problems of powers and resources in local self-government.

1. Research Design

Conceptual Framework

Defining Decentralization

Decentralization is a broad and ambiguous concept, which entails a number of definitions. Manor identifies six meanings of this term, which range from “decentralization by default,” privatization and delegation to administrative, fiscal, and political decentralization.² This study is focused on the last three forms of decentralization – administrative, fiscal and political decentralization, all of which take place within political systems and concern the idea of local government. Many governments are engaged, at least, in one of these three forms of decentralization.

Administrative decentralization, also known as deconcentration, entails a delegation of authority and responsibility for, at least, one policy area to semiautonomous agents of the state.³ Deconcentration allows the central government to increase the efficiency of local services while preserving its political authority over localities. Fiscal decentralization refers to the shift of authority over budgets and financial decisions to lower levels.⁴ The main argument for fiscal decentralization is that it can improve allocative efficiency of public services.⁵ Finally, devolution, which underlies most political decentralization,⁶ refers to the transfer of decision-making, finances, and management to quasi-autonomous units of local government⁷. Devolution boils down to three key concepts – autonomy (legitimacy), authority, and resources of local self-government.⁸

Azerbaijan has carried out both deconcentration and devolution of government. The local executive authorities (the LEAs), which implement the policies of the central government

in the localities, are deconcentrated units of governments. Locally elected and quasi-autonomous municipalities, on the other hand, are devolved bodies of government.

Rationale for Democratic Decentralization

Decentralization reforms gained popularity in the 1970s and 1980s as a result of the changing political and economic realities in the world. Governments were driven by different motives to decentralize, but the fundamental reason behind these reform initiatives was to improve governance.⁹ The top-down model of government, which had performed reasonably well in the pre and post-World War Two periods, gradually became less responsive and productive vis-à-vis the changing social and economic problems of the time. The trend of democratization and economic liberalization in the past three decades facilitated the widespread application of varying degrees of power redistribution in developed and developing countries alike. After the disintegration of the USSR, the newly independent states, including Azerbaijan, undertook democratic decentralization as part of broader democratic and institutional reforms aimed at state-building.

The argument for devolving government rests on a rich body of decentralization literature. Advocates of decentralization contend that it enhances the quality of government in multiple ways. Democratic decentralization increases the allocative efficiency of local services. Olson's theory of fiscal equivalency posits that for a service to be optimally delivered, the production and consumption areas should overlap. This reduces the free-rider problem in the delivery of public services.¹⁰ Oates' decentralization theorem also points to increased efficiency gains from localized delivery of public services.¹¹ This is because policies of regional and local governments can better reflect

local preferences and circumstances than a central policy, which usually entails a one-size-fits-all approach.

Decentralization also increases the quality of public services by loosening the central government monopoly on power and by creating a competitive environment among units of sub-national government.¹² Inter-jurisdictional competition not only induces local authorities to perform more effectively, but also allows individuals to choose among jurisdictions that offers services better suited to their tastes.¹³

Democratic decentralization leads to more accountability and responsiveness of politicians by bringing government closer to the people.¹⁴ Local politicians, due to their proximity to their constituency, are better aware of the citizens' expectations and needs, and also face more pressure from them, compared to national politicians, to govern in line with their wishes. Local elections provide an important mechanism, through which the citizens can reward or punish their elected officials based on the quality of their performance.

Some authors argue that the transfer of powers to local elected authorities may decrease the overall level of corruption, too. According to Manor, even though the number of corrupt practices may increase as a result of decentralization, the total amount of funds stolen reduces, in part because the reform "provides many more with a little power to peddle."¹⁵ Additionally, increased transparency at the local level curtails the divergence of local funds. Shah argues that decentralized government system reduces corruption in the long run by strengthening accountability and responsiveness of sub-national government.¹⁶

Decentralized management of public affairs thus holds promise for a country like Azerbaijan, where there exist many problems characteristic of centralized political systems. Azerbaijan's top-down administered and large public sector is highly inefficient in service delivery. In 2008, over 36 percent of Azerbaijan's labor force was employed in the public sector, as opposed to 19 percent in Armenia and 21 percent in Georgia (2006).¹⁷ Nonetheless, the standards of public administration in Azerbaijan leave a lot to be desired.

In spite of a steadily growing state budget since 2005, there remain serious structural problems in the management of the state expenditures.¹⁸ Lack of transparency in how the state funds are spent creates a fertile ground for corrupt practices in the state institutions. Azerbaijan ranks 139 out of 174 countries in the Corruption Perception Index of Transparency International.¹⁹ In the Global Competitiveness Report (GCR) 2011-2012 of the World Economic Forum, Azerbaijan is listed 95th in terms of diversion of public funds, and 118th in terms of the absence of irregular payments and bribes among 142 countries.²⁰

The situation is not better when it comes to the quality of social services. Azerbaijan's public education system compares poorly with other European countries. In the same GCR's report, the country ranks 113 among 142 states for the quality of its education system.²¹ In the healthcare sector, many problems persist as well. For instance, life expectancy at birth in Azerbaijan is not only well below the European average, but also lower than its neighbors, Armenia and Georgia, both of which have a smaller GDP per capita.²²

Thus, the theory holds that effective sub-national government can significantly contribute towards addressing some of these problems. However, as the problems in Azerbaijan's local self-government indicate, establishing a functioning local government is easier said than done. The theoretical postulates discussed above proved effective in some countries (both developed and developing), but in others (mostly developing) they failed to yield desired results. The prevailing explanation of these varying degrees of success has been that decentralization works in those countries, where minimum institutional prerequisites for decentralization are satisfied. Whereas Azerbaijan's decentralization reform has not failed (because, it is still incompletely implemented), it nonetheless produced weak local self-government institution, which is not capable of facilitating local development. This study argues that inadequate powers and resources of Azerbaijan's municipalities is one of, if not the most important determinant of Azerbaijan's unfruitful devolution.

Power and Resource Dimensions of Devolution

Inadequate powers, in this study, denote unclear assignment of formal local government functions and competencies, and lack of discretion in carrying out them. Functions are "what governments do or the fields of activities in which they play a de facto role," while competencies refer to "responsibilities and powers, formally bestowed by law, with which public authorities are entrusted in each field of activity."²³

Clarity of responsibility assignment among different levels of government is important to ensure accountability, and to prevent inefficient overlap of authority and legal challenges.²⁴ When the law is unclear on the competencies of local government vis-à-vis other government entities, "instability and controversy in the practice of decentralized systems" arises.²⁵ In developing countries, the obscure and incomplete division of work

among different units of government often creates obstacles to local authorities' exercise of their own share of responsibilities. This problem usually derives from the absence of a clear vision of what decentralization would serve to achieve. An analysis of the decentralization process in 5 transition economies of the Balkans and South Caucasus found that a lack of a comprehensive strategy, and the one-off approach to power distribution, was one of the major challenges to the emergence of competent local authorities in these countries prior to 2005.

Sub-national government should also have enough discretion in performing its formal responsibilities and powers. Page and Goldsmith distinguish between formal responsibilities assigned to local government and their discretion in making a decision in local matters. As they put it, "For local government to "have" or "fulfill" a service, or part of it, means little more than that local authorities have formal responsibility for employing people to carry it out. It does not necessarily mean that they can influence the way in which it is carried out because they may have little discretion to do so."²⁶ Therefore, it is equally important both to set up a clear framework of formal powers and functions and guarantee sufficient local government discretion to make a decision.

Assignment of adequate funds to local government is an equally important determinant of its effective performance. For it to be able to reasonably finance local services and infrastructure needs, local government has to be granted required powers to raise enough revenues.²⁷ In practice, local governments of many countries, including Azerbaijan confront the revenue problem to varying degrees, so providing them with adequate funding is often difficult. However, a number of principles drawn from the theory and

practice of fiscal decentralization are helpful in predicting the success or failure of this process.

There is wide consensus in the decentralization literature that “finance should follow function,”²⁸ or in other words, revenue sources should be determined after the local government functions and competencies are clearly delineated. According to Bahl, the assignment of expenditure responsibility should precede the assignment of revenue responsibility for two reasons, first, to ensure efficient allocation of resources, and second, to better assign the revenue sources.²⁹ The transfer of revenue authority to a lower level without first considering their expenditure needs can lead to tensions in intergovernmental relations and fiscal instability.³⁰

There is also credible evidence indicating that financial decentralization is more successful when local government prioritizes its own taxes to cover its expenditure needs. The more the local government relies on the taxes of its residents, the more it can be held accountable by them.³¹ A larger share of own-taxes in the local budget not only ensures increased downward accountability of local politicians, but also raises the efficiency of local services. Kaelin assigns the better local services in the Scandinavian countries, Great Britain and Switzerland compared to Italy, Spain and France to the relative independence of the former from the center in carrying out their responsibilities and raising their own revenues.³²

However, in many countries own-tax sources are rarely adequate to meet the service and infrastructure requirements of the communities. This is especially true in developing countries, where the local tax base is weak or the dependence on central government subsidies is strong.³³ This problem is usually compounded by many central governments’

shift of expenditure responsibilities to local authorities without concomitant revenues.³⁴

Local tax administration is also hampered by generally lower administrative capacity of local authorities compared to central authorities.³⁵

Given that local taxes are not always proportionate to local needs, how can local authorities effectively finance their services? Two widely used options to bridge the vertical fiscal imbalance (the gap between own spending and own revenues of sub-national government³⁶) are intergovernmental grants (or transfers) and sub-national borrowing. Intergovernmental grants can be used to finance specific local services (earmarked grants) or to complement sub-national budgets (non-earmarked grants). Sub-national government often needs to borrow to finance its long-term investment projects, because a yearly budget is usually inadequate to meet the capital needs of communities. An important caveat to provision of grants and access to credit is that the central government should have a regulatory framework (e.g. hard budget constraint) and accountability mechanisms (e.g. local elections, financial transparency) in place to reduce the moral hazard.

Having considered the institutional significance of clear and adequate powers, and enough revenue (sources) to successful decentralization, this study asks whether these requirements have been satisfied for Azerbaijan's municipalities. Are municipal functions and competencies clearly assigned and municipalities given enough discretion over formal powers? Have municipalities been granted necessary revenue-raising authority? Are there effective transfer and borrowing opportunities available to them? By addressing these questions, the study aims to contribute both to a currently limited body of research on municipal powers and funding in Azerbaijan and the public discourse on how to

improve the country's weak local self-government in order to strengthen its role in the local development.

Research Questions

A limited body of literature indicates that there are serious problems, both in terms of municipal powers and in finances in Azerbaijan. Taking into account the institutional importance of both factors, this study aims to answer the following research questions:

1. Do Azerbaijan's municipalities possess sufficient authority over local matters?
2. Do the country's municipalities have sufficient financial resources to carry out their responsibilities?

Research Methods

A descriptive mixed methods case study approach was chosen to describe the problems pertaining to the municipal powers and resources in Azerbaijan. A mixed methods study employs a combination of quantitative and qualitative techniques in a single or a series of studies.³⁷ The rationale for the use of both approaches is that together they provide a better understanding of a research problem.³⁸ This study draws on both sources of data to illuminate the problem of weak local self-government in Azerbaijan.

The decision to select the case study method is driven by its advantage in investigating a complex problem in its natural setting or context. Yin defines case research "as an empirical inquiry that investigates a contemporary phenomenon within its real-life context; when the boundaries between phenomenon and context are not clearly evident; and in which multiple sources of evidence are used."³⁹ Bhattacharjee also mentions among the unique strengths of case research the fact that it "can help derive richer, more contextualized, and more authentic interpretation of the phenomenon of interest than

most other research methods by virtue of its ability to capture a rich array of contextual data.”⁴⁰ Case research is relevant to the topic of this study in two ways. First, political decentralization is a multi-faceted and intricate reform program that concerns such diverse aspects of governance as legislation, finances, administration and politics. The complexity of the research subject requires a contextualized analysis of competencies and resources of local self-government. Second, Azerbaijan’s municipalities are an understudied subject and rife with “gray areas.” Given a paucity of credible research on this issue, it is often challenging to determine where the problem of competencies ends and the problem of resources start. The case research method allows the examining of challenges in the area of municipal powers and resources in their broader context and provides a holistic view of these problems.

As the research questions indicate, the study is descriptive and uses a “what is?” approach. Also known as “correlational” and “observational” research, this research approach is concerned with the collection and analysis of information without manipulation of the environment. This descriptive research aims to portray the present conditions of municipal authority and their resources to exercise this authority and where possible suggest the explanations of the existing problems.

Data Collection and Analysis

The research has employed both qualitative and quantitative research methods to collect and analyze data. The qualitative approach is used to investigate the problem of authority, while quantitative method is applied to the research of the revenue problem in Azerbaijan’s municipalities.

Desk Research

In order to determine whether Azerbaijan's local governments possess sufficient functions and competencies, the study has focused on the legislative framework of the local government. Desk research, also known as the secondary data collection method, has been used to obtain information for this purpose. The study largely relies on the use of primary sources, such as laws, and secondary sources like reports, research articles, and mass media. The legislation studied in this work primarily concerns the institution of local government in Azerbaijan, and includes the Constitution of the Republic of Azerbaijan, the Law on Status of Municipalities, the Regulations on Local Executive Authorities, as well as other pieces of legislation that deal with particular aspects of local self-government, for example, the Law on Water Management of Municipalities. In order to provide the context for the discussion, academic and media reports are widely cited.

The analysis of the data has been conducted on the basis of the following criteria (or sub-questions):

- Does the current local self-government legislation provide an effective framework for the operation of municipalities?
- Are municipal functions and competencies clearly delineated?
- Do municipalities have sufficient discretion over the functions and competencies assigned to them?

The analysis is done within two general thematic categories:

- The constitutional and legislative status of Azerbaijan's municipalities, and,
- The assignment of responsibilities between them and the local executive authorities.

Quantitative Research

A quantitative approach is employed to explore the problems of municipal finances and administrative resources. This part of the research primarily draws on a sample of raw data from Azerbaijan's 16 municipalities. The Municipal Performance Management System, a set of municipal indicators, have been generated by the Eurasian Partnership Foundation within the framework of its "Transparency in Municipal Service Delivery Program" to help municipalities measure their performance and develop their strategic plans. The dataset includes basic statistics about municipalities, including their budgets, administrative resources, their present social and environmental programs, local infrastructure, etc. The municipalities from which the data has been collected include 7 city municipalities (Gabala, Gusar, Khachmaz, Lankaran, Mingachevir, Salyan, and Siyazan), 8 village municipalities (Aran, Boluslu, Dallar Cayir, Dallar Dashbulag, Garabork, Garakhanli, and Khatinli) and a settlement municipality (Orta Laki).⁴¹ The combined population of 7 city municipalities accounts for approximately 10 percent of the total urban population of Azerbaijan, excluding Baku, the capital city. However, due to the fact that village municipalities account for about 90 percent of Azerbaijan's municipalities, the sample size of 8 municipalities constitutes a smaller proportion of village municipalities.

Due to the near-absence of data on municipal finances, there is little research in the financial situation of individual municipalities. The central government does not share the basic statistics on municipalities in Azerbaijan. Also, most municipalities fail to publish the essential information on their activities, such as municipal budgets, programs, etc. Approximately, 1 percent of Azerbaijan's 1716 municipalities have websites.⁴² Even so,

not all of the municipalities, which have a website, are transparent with respect to their finances. For these reasons, prior studies have mainly focused on the general indicators of municipal finances, such as the total revenues or expenditures of Azerbaijan's municipalities, or the size of intergovernmental transfers to local self-government, on which the information is made available by the State Statistics Committee of Azerbaijan.

The study uses simple quantitative analysis to evaluate the numeric data from 16 municipalities of Azerbaijan. The analysis is primarily based on the use of averages, median, mean and mode, percentages and graphical representations of the data.

To determine if currently municipalities have sufficient revenues to exercise self-government effectively, the study investigates,

- the projected and actual budgets of 16 municipalities,
- the state of local infrastructure,
- the sustainability of municipal revenue sources,
- And the government aid to municipalities.

2. Powers of Local Self-Government: Clear, Comprehensive and Sufficient?

Introduction

This section explores the legislative basis of municipal authority and the framework of intergovernmental relations to determine whether municipalities have been granted clear and adequate functions and competencies, and enough discretion to carry them out. It begins with an examination of the formal status of Azerbaijan's municipalities and identifies the definitional problems pertaining to the status of local government. Then, it analyzes the shortcomings of the present form of responsibility assignment between municipalities and the LEAs, the devolved and deconcentrated units of local government in Azerbaijan. Following a brief examination of obstacles to municipal role in economic development, the section looks more closely at the problems in the assignment of two social development responsibilities, the maintenance of apartment houses and the provision of drinking water. This part ends with a summary of conclusions on the problems of municipal authority.

Constitutional and Legislative Framework for Local Self-Government

Constitution and Municipalities

Azerbaijan's commitment to democratic decentralization is enshrined in two main documents, the Constitution of the Republic of Azerbaijan, which the country adopted in 1995, and the European Charter of Local Self-Government (hereafter, the Charter), which it ratified in 2002. The Constitution provides a basic framework for local self-government in the territory of Azerbaijan. Article 142 of the Constitution stipulates that local self-government is exercised by municipalities, which are elected every 4 years. Articles 142-

146 lay down the key principles of local self-government, including municipal functions and competencies. However, the document neither expressly mentions the people's right to local self-government, nor does it grant municipalities a full and exclusive local authority. The Charter makes it incumbent on the signatories to make formal guarantees about autonomy and exclusivity of powers held by local elected authorities. While the former requirement was later included in the Law on Status of Municipalities, the latter prerequisite of effective local government organization is not incorporated into other local self-government-related legislation.

The constitutional definition of a sub-national government is ambiguous and paradoxical. Although it establishes local self-government, it also creates local units of the executive branch, the LEAs, without clearly articulating the limits of their involvement in local affairs. Municipalities and the LEAs operate in parallel, and as the ensuing discussion will show, often are tasked with similar local responsibilities. Pursuant to Article 124 of the Constitution, the head of the LEA is appointed by the President and is responsible for implementing the central government's policies locally. The same article grants authority to the President to determine the limits of their competencies. This provision effectively subjects the meaning and substance of local self-government to presidential discretion.

The LEAs were modeled on the executive committees of the local councils of people's deputies, a local government system in the USSR. Although the local councils, better known as *the soviets*, formally exercised local self-governance, the real administrative power belonged to their "elected" executive committees. The main function of these committees, within a firmly consolidated political system of the USSR, was to execute

decisions of the central government in localities. The constitution of 1995 annulled the older system, but it handed over the bulk of its powers and responsibilities to the LEAs. As a result, instead of ensuring the exclusive authority of democratically elected municipalities in local affairs, it established an institutional parallelism at the lower level of government.

European Charter of Local Self-Government

Azerbaijan's government signed the Charter as part of reform commitments it undertook by becoming a Council of Europe (CoE) member in 2011. It is a binding international convention that commits the parties to ensuring minimum standards required for political, administrative, and financial independence of local government.⁴³ The fundamental idea lying at the heart of the charter is the principle of subsidiarity. This approach states that public responsibilities should be carried out by those authorities that are closest to the citizen. The allocation of a local responsibility to a higher level of government is only then permissible if the latter can do it more efficiently and economically.⁴⁴

The Charter defines local self-government, as “the right and ability of [elected] local authorities, within the limits of the law, to regulate and manage a substantial share of public affairs, under their own responsibility and in the interests of the local population.”⁴⁵ To empower sub-national government to “manage a substantial share of public affairs,” they should be provided with a number of guarantees. Article 4 states that local authorities should have full discretion in matters that are within their discretion or not assigned to other bodies. Powers granted them should be full and exclusive. Article 9 stipulates that revenues sources of sub-national government should be “sufficiently

diversified and buoyant” to meet their growing expenditure needs adequately. The central governments also undertake the commitment to support weaker local authorities (e.g. most rural municipalities of Azerbaijan) through financial equalization schemes, including grants. The Charter requires that local authorities be able to borrow from national markets for capital investments.

A series of monitoring reports of the Congress of Local and Regional Authorities published after Azerbaijan’s signing of the Charter have pointed out numerous problems in Azerbaijan’s implementation of the responsibilities arising from the aforementioned provisions of the document.⁴⁶ The findings of this section also corroborate the conclusions of these reports that the main provisions of the convention remain unapplied in Azerbaijan.

Law on Status of Municipalities

The Law on Status of Municipalities (1999) provides the main legislative framework for Azerbaijan’s local self-government. Under the law, Azerbaijan has a single-tier local self-government, which is composed of municipalities at different administrative-territorial units (city, city district, settlement and village). Each unit of sub-national government is responsible for providing local services in the territory under its jurisdiction. There is no subordination between municipalities of varying sizes. Currently, there are 1718 municipalities, the majority of which are village municipalities. 18.3 percent of them have a population below 1000 people, 63.8 percent between 1000-5000, and 17.9 percent over 5000.⁴⁷ In terms of territorial and population sizes, Azerbaijan’s municipalities are more fragmented compared to those of other European countries. Municipalities are

headed by directly elected municipal councils. The head and deputy-heads of a municipal council are elected by a simple majority vote of the council members. The law grants authority to municipal authorities to adopt programs in 4 policy areas: social protection, social development, economic development and environment.⁴⁸

Shortcomings of the Law

The Law on Status of Municipalities falls short of establishing an adequate framework for effective performance of municipalities. This study identifies three general deficiencies in the design of the law.

First, the law grants municipalities a limited number of competencies. The primary responsibility for most local services remains vested in the LEAs and line ministries. The law states that municipalities can address only those problems in each category of assignments (e.g. social development), on which the state programs do not take action, or complement what the state already does. This stipulation deters municipalities from introducing policies in many of those areas, because the central government already carries out a wide range of programs in those categories through the LEAs and sectoral ministries. For example, it is practically impossible for municipalities to participate in the maintenance or management of public schools, because the Ministry of Education is responsible for both tasks.

Second, the law fails to clearly delineate the boundaries of municipal functions and competencies. Currently, those responsibilities are so enmeshed that municipalities are not able to perform a task without crossing into the domain of other institutions (especially, the LEAs). For instance, the law lists maintenance of municipal territories,

including waste removal as municipal responsibilities, but other laws state that the LEAs or their contractors can do these tasks.⁴⁹ As noted earlier, the existing body of decentralization literature highlights the importance of clearly articulated boundaries of local government powers and responsibilities to its effective operation. Since there are multiple interacting authority structures in Azerbaijan's localities, the requirement for a precise division of local competencies is even more important there.

Lastly, the law does not specify the mechanisms, through which municipalities can exercise their tasks. Neither does other legislation clarify the guidelines as to how municipalities can perform their duties. The absence of formal mechanisms creates a policy vacuum that affects the efficacy of municipal service delivery. One of the areas this problem manifests itself is the provision of drinking water in Azerbaijan's villages. The law tasks municipalities with supplying drinking water to their residents, but it does not clarify how municipalities can handle this responsibility, if their water-related projects can only take place within the boundaries of municipal lands (not territories), which are often far from residential areas.

These problems can be fully appreciated if considered in the context of municipal relations with the central government bodies, the LEAs and line ministries.

Municipalities and Local Executive Authorities

The LEAs, deconcentrated units of the central government control many of the local service and development assignments in Azerbaijan. They were established earlier than municipalities (patterned after the previous system of executive committees) and were the only sub-national authority until the institution of local self-government in 2000.

Democratic decentralization in Azerbaijan has been, to a large extent, shaped by their presence and active involvement in local affairs. Until recently, the LEAs performed their responsibilities within the framework of the Regulations on Local Executive Authorities of 1999. In June 2012, the President approved the new Regulations, which granted them additional powers, strengthening their dominant position in Azerbaijan's local affairs. According to the latest report of the Congress of Local and Regional Authorities, this statute "provides local executive authorities with almost all the functions of local government, including those that under other laws would fall within the scope of the powers of municipalities."⁵⁰

The new Regulations constitute a significant departure from the government's commitment of democratic decentralization under the Constitution and the Charter. The government of Azerbaijan claims that the purpose of the new law is to enhance the functions of the LEAs, not to curtail the municipal powers.⁵¹ However, the document assigns wide powers and responsibilities to the head of the LEA, which are very detailed compared to those of municipalities, and inclusive of virtually all aspects of local governance and development. The responsibilities of the head of the LEA covers diverse areas such as socio-economic development, agricultural development, budgeting and finances, development of consumer market and businesses, social protection and gender equality, healthcare and ecological safety, labor relations and employment, housing and renovation, construction, education and culture in localities.

Some of these competencies are beyond the capacity of individual municipalities to handle; therefore the involvement of the upper tier authority is necessary. In most

countries, this problem is addressed through the adoption of a multi-tier local government model. In such a system, local functions and competencies are distributed among different levels of elected authority. For instance, Poland has a three-tier local government, composed of *gminas* (the first tier), *powiats* (the second tier) and *voivodeships* (the third tier - regional). Each level of government has their own responsibilities within individual areas of governance. In the area of pre-higher education, *gminas* administer public kindergartens, primary schools and gymnasias. *Powiats* run upper secondary schools, artistic and special schools, and *voivodeships* coordinate function and supervises the implementation of the central government's educational policies.⁵² As stated earlier, in most European countries, including the countries of Eastern Europe, which share a common past with Azerbaijan, the assignment of powers is based on the principle of subsidiarity enshrined in the Charter. The higher tiers of a multi-level government are assigned those responsibilities, which they can perform more efficiently and economically. Functions, which are not clearly assigned to the upper authorities, are usually reserved to the lower.

In Azerbaijan, the distribution of responsibilities between the LEAs and municipalities is not based on the principle of subsidiarity. The LEA, an unelected equivalent of the higher tier authorities in Azerbaijan (e.g. *powiats* in Poland), also controls assignments at municipal level. The chief executive of the *rayon* or district is responsible for almost all socio-economic functions in the territory of that particular region, while his appointees carry out local tasks in smaller administrative-territorial units, such as cities, towns and villages. Since they are not directly elected by the citizens, they cannot be held accountable by the public.

On a number of broader policy issues, the Regulations stipulate that the LEAs should take into account the views and suggestions of municipalities. For instance, under Article 3.2 of the Regulations, the LEAs are tasked with projecting and planning the social-economic development of districts (rayons), cities, and city districts, in collaboration with municipalities and other local institutions. However, since the LEAs prepare proposals of local development programs and receive the state funds to implement them, the role of municipalities in the overall decision-making process is ceremonial.

Some of the formal competencies of the LEAs directly concern the issues, for which municipalities are also responsible under Azerbaijan's laws. Others provide them with far-reaching authority over tasks traditionally done by local self-government, but not clearly assigned to Azerbaijan's municipalities. Since the boundaries of the LEA and municipal authority in local affairs are ill-defined, the new law adversely impacts the political-administrative status of local self-government. Thus, the current framework leaves municipalities little discretion over a significant portion of the responsibilities granted them by the Law on Status of Municipalities.

Functions of Economic Development

The Law on Status of Municipalities broadly defines four areas, agriculture, industry, transportation and communications, in which municipalities can develop their economic programs. But there neither exist necessary formal mechanisms for their exercise of these prerogatives, nor does the current level of municipal resources suffice to enable them to address local economic problems. The revenue problem will be discussed in more detail in the next section.

Despite the fact that the law envisions a role for municipalities in local development, the economic aspect of local governance remains the domain of the LEAs. This is primarily because the state (as noted above, municipalities are not formally part of the state) is the key economic actor in the country's regions outside of the capital city. The oil boom in the second half of the last decade has boosted the public investment in the infrastructure projects and social development in Azerbaijan's relatively poor regions. The central government has exclusively relied on the LEAs and the respective ministries in the management of its fast growing investments in the regions.

The Regulations provide the head of the LEA with broad powers in the economic development of the district, of which he is in charge. Article 4.2 vests the power to execute the socio-economic development of districts (rayons), cities and city districts in the LEAs. The same article also authorizes the LEAs to participate in the programs to improve the industrial potential of the regions, to prepare regional development plans, make relevant recommendations to municipalities, create favorable conditions for investments by physical and legal entities, and manage the construction of social and manufacturing infrastructure. Pursuant to Article 4.3, the LEAs manage the state's investment programs in the agriculture sector, carry out policies to support local farmers and take part in the improvement of local agro-infrastructure in communities.

In contrast, the Law on Status of Municipalities only briefly states that municipalities can develop their plans in the above areas. This situation has led to municipalities' exclusion from local development programs. For instance, municipalities received AZN 1 to 5 million (\$1.27 to \$6.34 million at current exchange rates) annually from the state since

1999. For comparison, one estimate indicates that the amount of public and foreign investments in local projects, such as irrigation, drinking water provision, local roads, schools and hospitals, managed by the LEAs and sectoral ministries in 2012 was in the region of half a billion AZN (approximately 7-8 percent of the total investment for that year).⁵³

The role of municipalities in local development was further undermined by a recent change in the law, which has made the creation of municipal businesses illegal. The Law on Local (Municipal) Taxes and Fees stipulates that property tax on municipally owned legal entities is one revenue source of local self-government. The Law on Status of Municipalities, too, affirms the right of municipalities to set up their own commercial entities. But the Civil Code of Azerbaijan, which under the newly passed Law on Normative Legislative Acts supersedes conflicting municipal legislation, outlaws municipal participation in business partnerships and company associations.⁵⁴ Media reports indicate that the Ministry of Taxes has ceased registering municipal entities, after the Law on Normative Legislative Acts came into effect in 2011.⁵⁵

Functions of Social Development

When it comes to social responsibilities, some authors note that currently municipalities only carry out four of the assignments included in the list: the maintenance of local roads, the provision of social aid to those who are not on the list of the state's programs of social protection, the maintenance of cemeteries and the organization of funerals.⁵⁶ This study explores the direct impact of the legislative loopholes on the provision of two basic social

services, namely communal services to multi-family residential housing in the cities and drinking water supply in the villages.

Maintenance of Apartment Houses

One of the functions, over which municipalities lack decision-making authority, is the provision of basic utility services to the residents of apartment buildings in their territories. Apartment houses are mainly concentrated in the cities of Azerbaijan and accommodate a considerable portion of the urban population, who are also the consumers of communal services. The Law on Status of Municipalities stipulates that municipal programs can also entail the maintenance and management of the residential and non-residential buildings in their territories. The law also lists among environmental programs of municipalities refuse collection and disposal. Currently, the service provision to the majority of apartment houses is under the control of the Housing and Communal Services Departments (HCSDs), the subunits of the LEAs, which are subsidized by the central government. This has resulted in municipal disengagement from the delivery of services to a large percentage of their residents in the urban areas and has also deprived them of the service fees, which could partially alleviate the problem of funding they currently face.

Until recently, under the Housing Code of 1986, the HCSDs were formally responsible for delivering communal services to the state-owned apartment blocks. The recently enacted Housing Code of the Azerbaijan Republic (2009) reformed the ownership of the formerly state-owned apartment houses, and terminated the legal responsibility of the HCSDs to provide communal services to private apartment buildings. However, the institution of the HCSD still retains its monopoly over service delivery to apartment

buildings, regardless of their type of ownership.⁵⁷ In spite of the formal requirement, usually they do not have a contract with the residents of a building they undertake to manage.

Between 2004 and 2010, the state allocations to the HCSDs made up AZN 68.42 million.⁵⁸ The amount of grants in 2012 alone was AZN 18 million. Of this, AZN 10.1 million were for their maintenance costs, doubling the entire government aid to municipalities, and AZN 7.7 million for capital repairs in the state housing fund.⁵⁹ The state subsidies are provided in addition to the revenues they receive in the form of the charges for services, such as waste removal and housing. It is difficult to ascertain if the current level of the revenue allows them to effectively furnish the communal services, but the HCSDs are one of the least transparent state institutions in the country. They do not report to the LEAs about how they spend their funds, nor do they make the information available to the public.⁶⁰ Not surprisingly, the media reports indicate popular dissatisfaction with the institution itself and the quality of the services they provide.⁶¹

There are cases, when municipalities step in to do some of their responsibilities, despite the fact that they do not receive any compensation from the state. In a recent interview, Tahir Rzayev, a member of the ruling party, and the committee on Regional Affairs of the Milli Majlis, the parliament of Azerbaijan, has also confirmed this trend and stressed the need for financially assisting municipalities to reduce the extra cost of municipal programs supplementing ineffective HCSD services.⁶² The deputy has also noted these organizations are not able to cope with their responsibilities anymore and it would be appropriate to transfer those responsibilities to the municipalities.⁶³ In her latest report to

the parliament, Elmira Suleymanova, the Commissioner for Human Rights of Azerbaijan, has noted an increase in the number of complaints about the HCSDs and emphasized the deteriorating quality of their services. As a way-out of this problem, she also recommended termination of this institution, and transfer of their responsibilities to municipalities.⁶⁴ However, these statements should be taken with a grain of salt, because there is a strong institutional resistance to the empowerment of municipalities. For instance, a bill to grant additional powers to municipalities has been on the shelf of the parliament for almost 6 years now.⁶⁵ The original purpose of the legislation was to specify the rules and mechanisms of assigning specific responsibilities to local self-government.

Some authors also point to the interference of the HCSDs in the financial domain of municipalities. Property tax on private individuals is one of the revenue sources of municipalities, but allegedly there are cases, when the HCSDs collect property tax, in addition to housing fees, from the residents of the apartment complexes. Although there is no systematic investigation into the incidence of this violation, anecdotal evidence from some municipalities show that the HCSDs use their administrative powers (e.g. issuance of a residency certification) to collect property tax from the residents of apartment blocks.⁶⁶

The transfer of HCSD responsibilities to municipalities should not be equated with their direct involvement in the management and maintenance of the existing housing stock. It is neither economical nor effective for actors other than the owners of buildings to take care of their property. Some authors argue that the optimal solution to the problem is an

arrangement, such as condominium, in which the residents of the housing complex make their own decisions on the issues concerning their property and pay for the related costs. However, it seems unfeasible, in the light of the existing life standards and the public perception of the state's social responsibilities that the government of Azerbaijan could or would completely disengage from the operation of all apartment houses anytime soon. The transparency of the government spending and the effectiveness of municipal authority could be enhanced though, if the continued government involvement in maintaining and managing of apartment houses is done through municipalities, the elected authority, rather than the HCSDs, the appointed and notoriously inefficient units of the state. Hypothetically, such an arrangement would also increase accountability and citizen involvement in the local decision-making. The citizens would pay the fees or taxes to the local budget and would be able to hold their elected representatives accountable for the services provided.

Provision of Drinking Water

Providing drinking water to households is one of the areas, in which Azerbaijan's rural municipalities, the "weakest link" of the country's local self-government confront major problems. The Law on Status of Municipalities includes "the use of water resources of local importance, the operation, maintenance and development of water supply and sewerage system" in the list of social development competencies of municipalities. However, the other legislation considerably limits the role of municipalities in these areas.

The heart of the problem lies in the Law on Water Management of Municipalities, which defines municipal water management as "policies pertaining to the regulation, use, and

preservation of ground water and surface water of local importance and prevention of water damage in *municipal lands*.⁶⁷ Municipal lands constitute only a fraction of municipal territories, which often overlap with administrative-territorial units, such as cities or villages. By confining municipal involvement to municipal property, the law prevents them from effectively meeting the drinking water needs of rural population. Oftentimes, municipal lands are outside of the housing areas of the villages and water systems in these lands are primarily designed for agricultural purposes.⁶⁸ Therefore, those sources are not always conducive to efficient water delivery to households.

The law also states that not all water systems located within the boundaries of municipal lands belong to municipalities. Some of these properties are either owned by the state or privately. Although 3.1 Article stipulates that the LEAs would transfer the ownership of the state-owned water systems in municipal lands to the respective municipalities, it does not set a timeline for their handover. Decision-making on this issue is left to the discretion of respective LEAs.

Another problem is that municipalities actually do not have sufficient water infrastructure in their lands. Azerbaijan's local self-government was established after the lands formerly owned by the state and kolkhozes (a form of collective farms in the USSR) were privatized. In the aftermath of the privatization, there were left few water systems without ownership. Municipalities thus have inherited pieces of lands mostly devoid of significant water infrastructure.⁶⁹

The data from Azerbaijan's rural regions indicate that the existing ambiguities in the assignment of this particular competency have a direct impact on the water use in the

country's villages. Lack of access to drinking water is a major problem in many of Azerbaijan's villages. The problems in the provision of potable water primarily stem from the deficiencies of the existing infrastructure and the inability of most rural communities to fix these deficiencies within their own means. 29 percent of Azerbaijan's rural population does not have access to potable water.⁷⁰ This is higher than in Azerbaijan's two neighbors, Armenia and Georgia, where 7 and 4 percents of their respective rural populations experience the similar problem. 75 percent of the Azerbaijanis in villages are not connected to a centralized water supply. Only 47 percent of Armenia's and 33 percent of Georgia's rural residents have the same problem. A 2011 survey by the Support for Economic Initiatives in 20 municipalities in 3 regions of Azerbaijan indicates that 5600 (72 percent) of 7900 households in these municipalities did not have a direct access to potable water.⁷¹ The average distance to the closest water source in 17 of 20 villages was over 300 meters.⁷²

Clearly, the legislative problems are not the only cause of the drinking water problem in villages. In less developed rural regions of the country, the vast investment needs cannot simply be addressed with the limited funds of municipalities. Given the weak tax base and lack of access to credit in villages, their full control of water resources in their territory will not be a panacea to serious shortcomings of the potable water supply. However, it is important to establish effective institutions in communities, without which it is impossible to ensure accountability of local authorities in the provision of local public services. When such a simple question as "Who is responsible for which service?" cannot be clearly answered, then the quality of service delivery cannot be expected to exceed the level of mediocrity.

Similarly, the unclear division of responsibilities locally affects the quality of the state investments in communities. Municipalities are often disengaged from the decision-making over and implementation of the state programs related to water facilities in their territories. Anecdotal evidence from municipalities demonstrates at least four problems with the state-managed investment projects involving the construction and improvement of the local water systems. First, there is no public oversight on how the state funds are spent. The institutions that carry out these projects rarely make their financial details available to the public. However, this problem is not specific to the water-related investment projects. The government spending in Azerbaijan is one of the least transparent in the global rankings. Second, the state-managed projects in local communities are usually less efficient. For instance, the comparison of the state and municipally managed water projects in Tartar and Aghjabadi indicate that in terms of accessibility, municipally constructed water facilities are more tailored to the needs and circumstances of each area than those by the state.⁷³ Third, municipalities oftentimes cannot afford to maintain the newly built infrastructure in their territories. As a result, the infrastructure usually ends up in the control of the state institutions, or state associated companies. Finally, when these projects are done without community engagement, there is little sense of ownership of their outcome.

Summary

The examination of the formal framework of municipal functions and competencies demonstrated a multiplicity of problems that adversely impact the effectiveness of Azerbaijan's local self-government. Some of these problems pertain to the design of local

self-government, while others are the result of asymmetric relations between the central and local governments.

The constitutional and legislative basis of the local self-government is flawed, because it fails to fully encompass the principles and requirements of democratic decentralization. The dichotomy of the constitutional definition of local government is the starting point of the consequent contradictions and ambiguities in the local self-government legislation. The most consequential shortcoming of the constitution (with respect to local government) is that it does not provide effective safeguards against the central government's infringement on municipal authority.

Although the Law on Municipal Status recognizes the citizens' right to local self-government, it does not create a viable framework for their exercise of this right. The document enumerates a limited number of municipal competencies; however, it does not ensure full and exclusive municipal authority over them. Instead, by adding the caveat that municipalities can initiate programs in the areas that are not covered by the state programs, it limits the municipal discretion. The law is vague on issues that fall under the authority of both municipalities and the LEAs. Where it states municipal duties in relatively clear terms, it fails to specify the formal mechanisms of their implementation. Other laws do not clear up the confusion, either.

The greatest challenge to local self-government is the LEA control of many competencies, which have also been granted to municipalities under the Law on Status of Municipalities. The heads of the LEAs have more authority in local affairs on account of their stronger position within Azerbaijan's centralized political system and greater

financial resources. The LEAs perform the functions, which are usually done by mid and upper tier elected sub-national authorities in devolved countries. In this respect, their involvement in local and regional development is necessary, given Azerbaijan's single-tier municipal system. However, their engagement in local matters, even those as distant and localized as street lightening, minimizes the utility of municipal authority.

The municipal role in local economic development is minimal, primarily due to their limited financial resources. However, another major reason for this situation is that the central government's local and regional development policy heavily relies on the LEAs and is exclusive of municipal involvement in policy design or implementation. A closer examination of two social development competencies of municipalities demonstrated that while in cities another state institution controls communal services to apartment houses instead of municipalities, in villages, an incomplete legislative framework has paralyzed effective drinking water provision by municipalities.

3. Revenues of Local Self-Government: Sufficient and Sustainable?

Introduction

This section examines the current state of municipal finances in Azerbaijan to find out whether their revenues are adequate and their revenue sources are diversified enough. Ideally, local authorities should have an access to a mixture of taxes, intergovernmental grants and credit to be able to finance their services and capital needs. The availability of raw data from 16 Azerbaijan municipalities allows a systematic investigation of the revenue problem in the country's local self-government. The section begins with a brief overview of the formal framework of municipal finances. Then it provides a detailed analysis of municipal finances and revenue sources. The final section gives a summary of the major findings.

Formal Framework of Municipal Finances

The constitution and a number of laws of Azerbaijan regulate the financial basis of local self-government. Article 144 of the Constitution endows municipalities with the power to impose local taxes and duties to meet their expenditure needs. Articles 31-32 of the Law of the Azerbaijan Republic on the Budget System provides formal guarantees for the independence of municipalities in making their budget decisions and prohibits interference of the legislative and executive branches in their budget activities. The Law on Status of Municipalities addresses different aspects of municipal finances in Section V, which lays down the specifics of “economic basis of local-self government.” Among other things, this law defines the sources of local revenues and the mechanisms of local taxation, the management of municipal properties, etc.

Municipal revenue sources are listed in the Tax Code and the Law on Local (Municipal) Taxes and Fees of Azerbaijan. Under these laws, municipalities can impose the following taxes and fees. The local taxes are:⁷⁴

- Land taxes on private individuals,
- Property taxes on private individuals,⁷⁵
- Mining tax on construction materials of local importance,
- Taxes on the profits of municipally owned enterprises.

The local levies are:

- Levy on posting of street advertisements in the municipal owned territories, buildings and other premises,
- Levy on disposal and letting of the municipal property,
- Levy on fixed and mobile commerce, public catering and other services in the territories under ownership of municipalities,
- Levy on hotels, sanatoria and health resorts, and persons providing tourist services in the territories under ownership of municipalities,
- Levy on parked cars in specialized parkings owned by legal and physical persons in the municipal territories.

Under the Law on Budget System, the central government can provide municipalities with additional financial aid. Article 32.2.2 of this law states that municipalities can receive subsidies and subventions from the state budget if they are not able to finance

local socio-economic development programs. The constitution and other laws also require that the central government earmark funds for each additional expenditure responsibility transferred to municipalities. Currently, the only type of intergovernmental transfers used in Azerbaijan is subsidies, or general purpose grants.

There is no legal barrier to municipal borrowing, but formal mechanisms of taking a loan have not been clarified. As a result, municipalities came to rely on their annual budgets to finance some of their investment needs. There are successful examples of local government financing schemes in some Eastern European countries, which could inform the design of a similar system in Azerbaijan. Some developing countries, where local elected authorities have a greater role in local development, provide them with credit through specialized institutions. For example, Poland's National Economy Bank provides loans for local government's development programs.⁷⁶

Problem of Funding

Compared to Azerbaijan's rapidly growing state revenues, the municipal finances experienced serious fluctuation in the past years. The share of municipal revenues in the consolidated state budget steadily dwindled between 2002 and 2010. The country's oil boom from 2005 onwards led to a drastic rise in the public revenues, but municipal income was almost halved between 2007 and 2010. The sharp fall in municipal revenues occurred due to a temporary ban on the sale of municipal lands between 2007 and 2009, depriving municipalities of their major, but unsustainable revenue source for a while. In the pre-ban period, the revenues from the sale of lands accounted for 40-70 percent of total municipal revenues.⁷⁷ The financial-economic crisis of 2009 also aggravated the

revenue problem, primarily affecting the local property taxes. Since most residents of Azerbaijan’s rural municipalities rely heavily on the remittances of their family members working in Russia, the crisis particularly impacted the budgets of village municipalities by decreasing their tax receipts.

Table 1: Comparing municipal and state revenues, AZN, 2002-2010.

Years	2002	2003	2004	2005	2006	2007	2008	2009	2010
Local (m)	12.8	11.1	17.6	24.3	33.0	50.0	43.0	26.7	28.9
State (bn)	0.9	1.2	1.5	2.0	3.9	6.0	10.8	10.3	11.4
Local r-s as a share of the state r-s	1.4	0.7	1.2	1.2	0.9	0.8	0.4	0.3	0.3

Source: <http://www.budget.az/budget/>

As a partial solution to the revenue problem, some authors have suggested that the central government raise the amount of intergovernmental transfers to help municipalities cover their essential expenditure needs. Despite the calls, the central government has not prioritized the tool of financial aid to bolster municipal budgets. As is seen from Table 2, the amount of intergovernmental transfers reduced as the share of the total state expenditures.

Table 2: Comparing the state grants and municipal revenues, 2002-2009.

Years	2002	2003	2004	2005	2006	2007	2008	2009
Revenues, AZN MM	12.8	11.1	17.6	24.3	33.0	50.0	43.0	26.7
Transfers, AZN MM	5.0	1.0	2.0	2.0	3.0	3.5	3.5	3.5
Transfers, % of state expenditures	0.54	0.30	0.13	0.10	0.08	0.06	0.03	0.03

Source: The State Statistics Committee of Azerbaijan Republic, <http://www.stat.gov.az/>.

Case of 16 Municipalities: General Picture

The EPF data indicates that the problem of funding is real and it impacts municipalities in very diverse ways. Most municipalities reviewed in this study do not have economic, social or environmental development programs. Only three of seven city municipalities, Mingechevir, Gabala and Gusar, and one of the eight village municipalities, Garabork, have a development program in one or more areas of local economy, social development, social protection or environmental protection. The lack of local government programs is likely the symptom of a number of problems, including the unclear assignment of municipal powers and responsibilities, their inadequate administrative capacity, and their weak financial position. The analysis of municipal budgets reveals that the shortage of funding is one of the major causes of the near-absence of local development schemes.

Municipal revenues, as a rule, fall short of their initial projections, or put differently, operate with a negative budget variance. As is seen from Table 3, this problem exists in both urban and rural municipalities. The actual level of revenues did not approximate the forecasted ones in cities, except for Mingachevir. In Mingachevir's case, a windfall of AZN 140,000 in the form of government grant contributed to a positive budget variance. The gap between forecasted and actual revenues is very high in the rest of the cities, excluding Gusar. A similar trend can also be observed in rural municipalities. In villages like Aran, Deller Ceyir and Deller Dashbulag, the difference is particularly visible.

Table 3: Forecasted and actual total revenues of municipalities for 2011, AZN.

Municipality	Forecasted total revenue	Actual total revenue
Cities		
Mingachevir	285,000	369,900
Siyazan	300,000	199,500
Khachmaz	237,400	166,500
Salyan	137,000	98,200
Gusar	71,500	68,800
Lankaran	121,400	65,400
Gabala	411,700	31,700
Villages		
Garabork	27,600	28,200
Nadirkand	12,159	13,911
Aran	24,000	11,400
Boluslu	12,355	8,859
Deller Ceyir	23,000	8,500
Deller Dashbulag	8,200	3,950
Khatinli	2,500	3,550
Garakhanli	3,200	3,094
Orta Laki	-	16,926

Source: EPF Municipal Performance Management System, 2010-2011

Municipalities generally spend the largest portion of their revenues on a limited range of budget items, mainly because the total sum of municipal revenues is very small. As a rule, administrative costs top the list of expenditures. In 4 of 7 city municipalities, the operational expenses make up over half of the total spending. The median share of administrative outlay in the expenditures of urban municipalities is 53 percent. The municipalities of Gabala and Gusar spend almost their entire budgets to meet their expenditure needs, respectively 92 and 74 percent.

Table 4: Share of administrative expenses in the total budgets of city municipalities in 2011.

Municipality	Total expenditure, AZN	Administrative expenses, AZN	Admin. costs as a share of the total, %
Mingechevir	366.393	154.303	33
Siyazan	199.5	86.6	43
Khachmaz	163.9	87.3	53
Salyan	98.2	25.1	26
Gusar	53.3	39.2	74
Lankaran	66.2	39.8	60
Gabala	31.7	29.1	92

Source: EPF Municipal Performance Management System, 2010-2011

Table 5 includes the costs associated with the salaries of municipal employees (and members) and mandatory fees to the State Social Protection Fund (the state pension scheme) in 9 village municipalities. The figures indicate that administrative costs in the villages are much higher compared to the cities. The median share of wages and the insurance fees in the total spending of rural municipalities is approximately 52.8 percent (the mean is 47.4 percent). The number is as high as 61.6 percent in Khatinli.

Table 5: Share of salaries in the total expenditures of village municipalities in 2011, AZN.

Municipality	Total expenditure	Number of employees	Administrative expenses	Admin. costs as a share of the total
Garabork	22,100	3	9,180 (salaries) + 2,020 (SSPF)	50.7
Nadirkand	13,901	2	6,282 (salaries) + 1,521 (SSPF)	56.1
Aran	24,000	1	1,700 (salaries)	7.1
Boluslu	8,859	2	4,119 (salaries) + 974 (SSPF)	57.45
Deller Ceyir	8,500	2	2,805 (salaries) + 250 (SSPF)	35.9
Deller Dashbulag	8,200	3	1,574 (salaries)	19.2
Khatinli	3550 ⁷⁸	3	1,970 (salaries)+ 218 (SSPF)	61.6
Garakhanli	3,196	3	1,703 (salaries) + 100 (SSPF)	56.4
Orta Laki	16,947	3	7,772 (salaries)+ 1,183 (SSPF)	52.8
Median				52.8
Mean				47.4

Source: EPF Municipal Performance Management System, 2010-2011

A relatively high share of salaries in municipal budgets is evidently due to the scantiness of available funds. The comparison of the mean wage of municipal employees in the 8 municipalities with the monthly average of the districts (rayons), in which they are located, shows that the salary of municipal employees are either below the regional averages, or not all employees are compensated for their work. As shown in Table 6, only one-fourth of village municipalities, namely Nadirkand and Garabork have higher average wages than their regional equivalents. In 3 villages, Khatinli, Garakhanli and Deller Dashbulag, the mean wage is not only low, but is below the official poverty threshold, AZN 93.5.

Table 6: Comparing monthly wages of village municipalities and the regional averages, AZN, 2011-2012.

Municipality	Monthly wage per employee, AZN, 2011	Average monthly wage in the region, AZN, 2012
Nadirkand	261.8	210.1
Garabork	255	223.5
Boluslu	171.6	210.1
Aran	141.7	209.0
Deller Ceyir	116.9	239.8
Khatinli	54.7	223.1
Garakhanli	47.3	223.1
Deller Dashbulag	43.7	239.8

Source: EPF Municipal Performance Management System, 2010-2011

The two budget items mentioned above only comprise a portion of municipalities' overhead costs. When one includes other relevant expenses (e.g. the maintenance of the office, or membership fees), the administrative costs become even higher. For instance, Boluslu spends the remainder of its budget (18.2 percent) on office costs, printing, membership fees, donations to the army, and banking fees. Likewise, Deller Ceyir spends 28.8 percent of its budget on membership and administrative costs such as office repairs, subscription and membership fees, the purchase of fuel, and donations to the army. Internal auditing costs and other organizational fees comprise 13.6 percent of Garabork's, 13.4 percent of Khatinli's and 11.1 percent of Garakhanli's budgets. Office-related costs and fees make up 4.4 percent of Nadirkand's budget.

Almost everywhere, included in this sample, the largest non-administrative expenditure item is public works, in particular, the renovation of municipal territories (e.g. roads) and housing-communal spending. Most municipalities have listed their capital costs under the title of public works, or public works and housing-communal expenses. All cities, with

the exception of Mingachevir, spent over three-fourth of their funds on administrative and infrastructure-related costs in 2011.

Table 7: Percentage of city municipalities' spending on administration, infrastructure and communal services in 2011.

Municipality	Administrative costs, 2011	Renovation-housing-communal services, 2011	As a percentage of the total, 2011
Mingachevir	33	20.7	53.7
Siyazan	43	28.9	71.9
Khachmaz	53	24.3	77.3
Salyan	26	56.0	82.0
Gusar	74	13.1	87.1
Lankaran	60	24.5	84.5
Gabala	92	4.7	96.7

Source: EPF Municipal Performance Management System, 2010-2011

As Table 8 indicates, a similar trend exists in the villages. The spending of rural municipalities on the salaries, fees and office related costs and limited infrastructure repairs absorb most of their budgets.

Table 8: Percentage of village municipalities' spending on salaries/SSPF payments, infrastructure and communal services in 2011.

Municipality	Salaries/payments to the SSPF, 2011	Renovation-housing-communal services, 2011	As a percentage of the total, 2011
Garabork	50.7	17.1	67.8
Nadirkand	56.1	29.1	85.2
Aran	7.1	39.6	46.7
Boluslu	57.45	24.3	81.75
Deller Ceyir	35.9	15.8	51.7
Deller Dashbulag	19.2	16.6	35.8
Khatinli	61.6	16	77.6
Garakhanli	56.4	31.1	87.5
Orta Laki	52.8	21.9	74.7

Source: EPF Municipal Performance Management System, 2010-2011

Lack of funding has direct implications for the state of infrastructure in municipal territories. Local roads are an important component of local infrastructure and also a

basic determinant of local development. The Law on Status of Municipalities states that municipalities are responsible for maintaining and managing local roads. It is evident from Table 9 that the local road systems of most municipalities are in need of repair. The table compares the overall length of local roads and the length of roads needing improvement in individual municipalities. The figures suggest that the problem is as significant in cities with relatively high revenues as it is in villages with fewer resources. Among cities, Mingachevir and Khachmaz have the longest unrepaired road systems. The entire road system of 5 of 8 villages, Aran, Deller Dashbulag, Boluslu, Garakhanli, and Garabork, need repairs, too. In 3 municipalities, Siyazan, Salyan and Gusar, roads are not under the municipal authority.

Table 9: Condition of local roads, 2011.

Municipality ⁷⁹	Length of Roads, km	Roads needing repair, km	Municipality	Length of Roads, km	Roads needing repair, km
Mingachevir	570	270	Aran	191	186.5
Siyazan	-	15	Boluslu	26	20
Khachmaz	144	130	Deller Ceyir	40	28
Salyan	-		Deller Dashbulag	22	22
Gusar	-	15	Nadirkand	18	3
Lankaran	12	1	Garabork	11	8
Gabala	28.5	5.1	Garakhanli	20	15
			Khatinli	18	6
			Orta Laki	43	10

Source: EPF Municipal Performance Management System, 2010-2011

The potable water supply systems of some municipalities are in need of improvement, too. Not all municipalities in this sample have provided the data on the water infrastructure within their territories, which is why it is difficult to assess the scale of problem in various municipalities. However, in those municipalities that made the information available, the water pipes are generally in unsatisfactory condition. The

problem is more evident in cities like Mingechevir, Khachmaz and Lankaran. However, as the previous section indicated, the general state of the drinking water systems in the country's rural regions is also inadequate.

Table 10: Condition of drinking water infrastructure in municipalities, 2011.

Municipality	Length of water pipes, km	Pipes needing repair, km	Municipality	Length of water pipes, km	Pipes needing repair, km
Mingechevir	175	150	Aran	191	186.5
Siyazan	35	0.9	Boluslu	-	-
Khachmaz	130	120	Deller Ceyir	-	-
Salyan	50	n/a	Deller Dashbulag	15	4
Gusar	73	n/a	Nadirkand	10	4
Lankaran	116	96	Garabork	-	-
Gabala	18.3	3.5	Garakhanli	-	-
			Khatinli	-	-
			Orta Laki	-	-

Source: EPF Municipal Performance Management System, 2010-2011

Revenue Sources

Own-Revenues

The data is also informative about the current state of revenue sources, on which municipalities depend. A major problem in most municipalities is that a significant percentage of their population does not pay their taxes on time. Approximately 30 percent of the population in the cities has not paid off their local taxes. The situation is worse in rural municipalities, where about 40 percent of the residents have tax debt to municipalities. As the decentralization literature indicates, in developing countries the tax base of local government is generally weak. In Azerbaijan, this is particularly visible, because the oil-related businesses, which are the driver of the country's economy, are concentrated in and around Baku, the capital. As will be discussed later, the socio-

economic reforms of the recent years have not significantly increased the economic opportunities outside of Baku, particularly, in the rural regions of Azerbaijan.

The sale and lease of municipal lands are the predominant source of revenue in many municipalities. Almost the entire budgets of Siyazan and Gusar were financed through the sale or lease of their lands in 2010-2011. Land sales and leases account for approximately 30-60 percent of revenues in cities of Salyan, Mingachevir, Lankaran, and Gabala. The only exception to the rule is Khachmaz, which saw a sharp decline in its revenues from this non-tax revenue source in 2011. Interestingly, all cities, excluding Khachmaz and Lankaran saw a slight increase in the share of this revenue source in their total budgets. The dependence of most municipalities on land sale puts them in a very vulnerable position, due to unsustainability of this revenue source. Most village municipalities, too, saw an increase of revenues from sale and lease of lands in their budgets from 2010 to 2011. Municipalities that have larger budgets such as Garabork and Aran are also more dependent on this revenue source. A notable exception in this respect is Nadirkand which has the third largest budget, but sales and leases account for slightly over 13 percent of its revenues. The villages of Khatinli and Garakhanli both have the smallest budgets and the least share of receipts from land sale and lease in their revenues.

Table 11: Revenues from sale and lease of municipal lands, 2010-2011.

Municipality	Revenues, in thousand AZN, 2011	Sale and Lease of Municipal Lands, in thousand AZN (%)	Revenues, in thousand AZN, 2010	Sale and Lease of Municipal Lands, in thousand AZN (%)
Cities				
Mingechevir	369.9	120.885 (32.7)	344.0	101.343 (29.5)
Siyazan	199.5	172.8 (86.6)	121.4	92.5 (76.2)
Khachmaz	166.5	11.6 (7)	96.3	56.9 (59.1)
Salyan	98.2	57.3 (58.4)	125.7	48.3 (38.4)
Gusar	68.8	59.5 (86.5)	56.0	47.4 (84.6)
Lankaran	65.4	23.9 (36.5)	65.6	27.9 (42.5)
Gabala	31.7	9.4 (29.7)	29.1	4.6 (15.8)
Villages				
Garabork	28,200	20,200 (71.63)	16,700	5,600 (33.53)
Nadirkand	13,911	1,838 (13.21)	18,537	0,700 (3.77)
Aran	11,400	9,000 (78.95)	22,400	12,600 (56.25)
Boluslu	8,859	1,734 (19.57)	9,806	0,809 (8.25)
Deller Ceyir	8,500	1,700 (20)	11,200	1,370 (12.23)
Deller Dashbulag	3,950	1,313 (33.24)	5,001	0,867 (17.34)
Khatinli	3,550	28 (0.79)	3,034	0,028 (0.92)
Garakhanli	3,094	0,0 (0)	3,554	0,468 (13.17)
Orta Laki	16,926	3,781 (22.34)	15,381	2,228 (14.49)

Source: EPF Municipal Performance Management System, 2010-2011

Both city and village municipalities derive a larger portion of their tax revenues from taxes on private lands. 5 of 7 city municipalities and 8 of 9 village municipalities receive the biggest share of their tax revenues in the form of land tax. The budgets of rural municipalities are more dependent on this type of tax, due to the fact that most of them cannot levy property tax.

The findings of this research indicate that municipalities, in general, are unable to tap into the potential of personal property tax. Property tax is considered the most appropriate source of local government revenue; however, mostly for reasons beyond municipal control, their share in municipal budgets is low. For instance, houses and apartments often lack an inventory valuation certificate, without which municipalities cannot levy the

property tax. One estimate puts the number of unregistered houses in the suburbs of Baku, the capital city, at 450 thousand.⁸⁰ There are also cases when owners illicitly register the value of their property as below AZN 5000, because properties that are priced under this amount are exempt from personal property tax under the Tax Code.⁸¹

In 4 of 7 cities, municipalities collect practically no personal property tax. The municipality of Khachmaz is a noticeable exception in that over 22 percent of its revenues flow from personal property tax. Khachmaz had experienced a sharp decline of its revenues from the sale and lease of lands between 2010 and 2011, but an increased property tax collection compensated for some of the financial loss in 2011 fiscal year. Unlike many other municipalities, Khachmaz has apparently substituted the older, inefficient method of taxation on the inventory value of property for the taxation mechanism based on the market value of property. The municipality has registered the properties in its territories and established a new accounting system to increase the efficiency of tax collection.⁸² There is limited information available on the method employed in the city, that's why further investigation of the subject could provide valuable insight for the majority of municipalities in Azerbaijan. A mining tax is an important source of revenue only in two municipalities, namely Mingachevir and Garabork. Understandably, it is not a reliable tax source for many municipalities that do not produce construction materials.

Table 12: Revenues of municipalities from three sources: land tax on private individuals, property tax on private individuals, and mining tax on construction materials, 2011.

Municipality	Revenues, in thousand AZN, 2011	Land tax on private individuals, in thousand AZN (%)	Property tax on private individuals, in thousand AZN (%)	Mining tax ⁸³ , in thousand AZN (%)
Cities				
Mingachevir	369.9	3.258 (0.9)	0 (0)	22.950 (6.2)
Siyazan	199.5	16.6 (8.3)	1.6 (0.8)	0.4 (0.2)
Khachmaz	166.5	9.7 (5.8)	36.9 (22.2)	0 (0)
Salyan	98.2	15.2 (15.5)	12.9 (13.1)	6.2 (6.3)
Gusar	68.8	3.7 (5.4)	0.6 (0.9)	0 (0)
Lankaran	65.4	14.7 (22.5)	10.0 (15.3)	0.2 (0.3)
Gabala	31.7	9.8 (30.9)	0 (0)	0 (0)
Villages				
Garabork	28,200	3,500 (12.4)	1,200 (4.26)	0
Nadirkand	13,911	2,669 (19.2)	-	8,404 (60.4)
Aran	11,400	600 (5.3)	-	-
Boluslu	8,859	5,750 (64.9)	180 (2.03)	-
Deller Ceyir	8,500	3,700 (43.5)	1,000 (11.77)	0
Deller Dashbulag	3,950	748 (18.9)	-	-
Khatinli	3,550	2,355 (66.3)	-	-
Garakhanli	3,094	1,779 (57.5)	-	-
Orta Laki	16,926	7,831 (46.3)	3,529 (20.85)	-

Source: EPF Municipal Performance Management System, 2010-2011

Intergovernmental Transfers

Although the share of intergovernmental transfers seems significant in some municipalities relative to other revenue sources, in absolute terms, they are inconsequential. To put these numbers in perspective, the monthly minimum wage in Azerbaijan is AZN 116 (2013), in other words, the state allocations to most village municipalities do not even allow them to hire a person at a minimum wage, let alone help them cover their expenditure needs. The situation is not better in most cities, either. The only cities that received partially sufficient grants were Mingachevir and Khachmaz. When one compares these numbers to the annual allocations made to the LEAs, it becomes obvious that these figures are really low. For instance, the LEA of Mingachevir

received AZN 18 million from the state budget in addition to its own revenues at AZN 9.2 million in 2012.⁸⁴ Lankaran's city administration had total revenue of AZN 30 million, of which over 17 million was transfers from the state budget.⁸⁵ In other words, Mingachevir's municipality received 130 times less money than its LEA from the state, while Lankaran's 2100 times.

Also the criteria, on the basis of which the amount of allocations to each municipality is decided is unclear. For instance, Lankaran, the major city of the southern region, receives approximately four times less money than Khachmaz, which has fewer inhabitants. The same can be said of rural municipalities, all of which are assigned approximately the same amount of money, despite their differences of population.

Table 13: Comparing the state grants and total municipal revenues, 2011.

Municipality	Grants-in-aid, thousand AZN (%)	Total Municipal Revenues, AZN	Population
Mingachevir	140 (37.9)	369.9	99,126
Siyazan	4.1 (2.1)	199.5	16,902
Khachmaz	36.0 (21.6)	166.5	39,594
Salyan	6.6 (6.7)	98.2	38,457
Gusar	4.0 (5.8)	68.8	23,990
Lankaran	8.1 (12.4)	65.4	53,321
Gabala	3 (9.5)	31.7	14,110
Median	9.5%		
Mean	13.7%		
Villages			
Garabork	1.3 (4.6)	28,200	3,506
Nadirkend	1.0 (7.2)	13,911	1,530
Aran	1.8 (15.8)	11,400	7,099
Boluslu	1.2 (13.6)	8,859	2,985
Deller Ceyir	1.8 (21.2)	8,500	5,530
Deller Dashbulag	1.0 (25.3)	3,950	2,253
Khatinli	1.2 (33.8)	3,550	3,186
Garakhanli	1.3 (42.0)	3,094	3,251
Orta Laki	1.8 (10.6)	16,926	6,302
Median	15.8%		
Mean	19.3%		

Source: EPF Municipal Performance Management System, 2010-2011

Summary

The findings of this section indicated that Azerbaijan's municipalities operate on an extremely tight budget and the volatility of some of their main revenue sources makes their financial situation even more precarious.

The dynamic of municipal revenues shows that municipalities did not benefit from the economic and public sector growth in Azerbaijan over the last decade. Despite a decline in municipal revenues after 2007, the central government did not provide additional funds

to bridge the fiscal gap. In fact, the share of intergovernmental grants in the state budget went down significantly during the same period.

Most municipalities lack development programs, which diminishes their role in local governance. The actual revenues of municipalities are usually much lower than the forecasted ones, which can be attributed to their weak administrative capacity in tax collection, tax debt of many citizens and other factors (e.g. lack of properties' inventoried value). The single major expenditure item is the operational expenses of municipal authority. Even so, municipalities provide low salaries to their employees, which almost surely affect the quality of workforce.

Municipalities have serious infrastructure needs, which they have to finance through their budget expenditures. More infrastructure spending leads to less service spending. In normal circumstances, municipalities should be able to borrow in order to finance their long-term investments. This option is not feasible in the case of Azerbaijan's weak municipal system.

Municipalities primarily rely on their own revenue sources, due to limitedness of the intergovernmental grants. However, the examination of municipal funding options reveals that they are of limited importance and unsustainable. Sale and lease of lands account for an important portion of municipal revenues. One-off revenues from sale of lands are clearly unreliable. Two sustainable sources of revenue, land and property taxes have a relatively small share in municipal budgets. Especially, the untapped potential of property tax can significantly improve the fiscal capacity of municipalities, if the problems pertaining to property appraisal are resolved.

4. Discussion

The findings of the previous two sections indicated that Azerbaijan's municipalities suffer from chronic deficit of powers and revenues. The current state of municipal authority, therefore, is not conducive to effective local governance. Despite the fact that these problems hinder institutionalization of local self-government, the central government has not come up with a clear strategy to tackle them. In view of the importance of successful decentralization to good governance, the persistent shortcomings of municipal powers and resources raise three questions:

- Why has the central government failed to address these problems?
- What factors can induce the government to reform the local self-government?
- What changes are necessary to improve municipal powers and funding?

Obstacles to Good Decentralization Policy

Although Azerbaijan's last two governments (the father and son Aliyevs) accepted the general rationale for political decentralization by granting municipalities a constitutional status and signing the European Charter of Local Self-Government, a number of factors appear to have slowed the formulation of an adequate decentralization strategy. As Section 1 indicated, the main benefits of decentralization that motivate governments to devolve powers are its potential political (e.g. legitimacy), economic (e.g. efficiency), and democratic (e.g. participation, accountability) gains. To better understand the current state of weak local self-government, one, therefore, should ask whether these benefits provide enough incentives for the government of Azerbaijan to commit to empowering local self-government.

Until recently, the answer of this question was more “no” than “yes”. The government put the subject of democratic decentralization on the back burner amid favorable economic and political conditions of the mid-2000s. Political incentives for democratic decentralization were weak, because the challenges to semi-authoritarian rule of the incumbent president Ilham Aliyev were minimal. The key to his stable presidency was the oil-driven, rapid economic growth in the second half of the 2000s. In fact, most observers share the view that the economic rise came at the expense of Azerbaijan’s nascent democratic institutions. Azerbaijan’s oil windfall also reduced economic incentives for decentralization. The increased revenues from oil production boosted the public spending, slowed the pace of public sector reform, and adversely impacted the efficiency of public expenditures.

However, the government may have to revisit its policy of non-engagement with local self-government due to the changing realities in the country. The large and inefficient public sector is becoming a liability in light of the projected decline in oil revenues, on which the state budget heavily depends. There is also growing public discontent about the quality of government policies at the local level. The recent unrest in Azerbaijan’s two regions, Guba and Ismayilli, demonstrates that the dissatisfaction with local authorities may easily transform into a much greater challenge to the country’s political stability. In addition to economic and democratic factors, political considerations may also incline the government to modify its policy towards democratic decentralization. Calls to reform the political system of Azerbaijan may become costlier to ignore altogether, as the president seeks third term, the legality of which is disputed by the opposition parties and international organizations.

Rising Cost of the Status Quo

“Bloated” Public Sector

Azerbaijan’s large public sector will become difficult to sustain as revenues from oil, the main revenue source of the state budget, are expected to decline in the coming years. Azerbaijan’s oil production, by most estimates, peaked in 2010 and is set to reduce significantly in the foreseeable future. As the share of oil revenues in the state budget shrinks, the costs of maintaining a big government become more burdensome. The reform of local self-government and gradual transfer of some state responsibilities to the lower level may reduce some of the adverse implications of this economic change looming in the horizon.

Azerbaijan has traditionally had a larger government employment compared to its neighbors Armenia and Georgia. In the last two decades, the share of public employment in the economy declined, but still remains very high. The percentage of the workforce employed in the state sector hovered above 30 percent since 1999 and stood at 36 percent in 2008. Unlike Armenia and Georgia, where economic problems led to the cutback on the public sector, Azerbaijan experienced a reverse trend since 2003. Azerbaijan’s public employment increased hand in hand with the country’s growing oil exports.

Table 14: Share of public sector employment in total employment in Armenia, Azerbaijan and Georgia, expressed as a percentage, 1995-2008.

Years	Armenia	Azerbaijan	Georgia
1995	49.8	56.1	42.4
1996	38.9	51	30.1
1997	37.1	46.5	28.7
1998	30.3	46.2	34.6
1999	27.4	36.2	31.3
2000	26.5	33.6	25.1
2001	24.8	33.4	n/a
2002	25.8	32.0	23.5
2003	23.3	31.5	24
2004	21.1	31.7	22.8
2005	19.8	31.9	23
2006	19.6	32.0	20.6
2007	19.3	36.3	n/a
2008	18.8	36.4	n/a

Source: LABORSTA Databasa, Public Sector Employment Statistics, International Labor Organization, quoted in Guliyev, Farid. "Chapter 9: Political Elites in Azerbaijan." In *Challenges of the Caspian Resource Boom. Domestic Elites and Policy-Making*, edited by, Andreas Heinrich and Heiko Pleines, 117-130.

As the country's oil production went up over time, the state budget became increasingly dependent on the direct transfers from the State Oil Fund of Azerbaijan, the country's sovereign oil-wealth fund. The share of oil transfers in the state revenues of 2012 was slightly over 60 percent, and is forecasted to remain the same in 2013.⁸⁶ In addition to the funds from the SOFAZ, 41 percent of the state tax revenues are projected to come from the oil and gas sector in 2013.⁸⁷ There is already a downward trend in Azerbaijan's oil production, which has made the budget's resource dependency particularly precarious. In 2011, oil output fell by 10.3 percent to 45.6 million tonnes.⁸⁸ Due to shrinking oil and gas production, the country's economic growth slowed to 0.1 percent after years of rapid economic expansion.⁸⁹ Although the economy rebounded in 2012 thanks to the

stabilization of the production level, the data from the first quarter of 2013 indicates a decline of oil exports compared to the previous year.⁹⁰

By reforming the institutional capacity of municipalities, the central government could optimize efficiency of public services, thereby reducing the public expenditures. Research also indicates that decentralization can moderate the effects of “resource curse” in rentier economies.⁹¹ Therefore, the reform of the local government system is a long term investment, which can facilitate the country’s sustainable development.

Poor Public Service Delivery

The public perception of the government’s resource allocation and program implementation in the regions is generally negative. The top-down management of public services and investment programs leads to inefficient and ineffective spending and undermine the public trust in the state institutions. A survey conducted by the Center for Regional Development in Azerbaijan (CRDA) and the Association for Civil Society Development in Azerbaijan (ACSDA) to evaluate the results of the State Program on Social-Economic Development of Regions for the Years of 2004-2008 is informative about how the citizens see the outcome of the government’s development programs outside of the capital city. Approximately 1,500 citizens participated in the survey, which was held among the residents of 7 economic regions of Azerbaijan in 2008-2009. The survey results suggest a general skepticism about the outcome of the state’s socio-economic development programs between 2004 and 2008. Asked if the economic reforms of the recent years satisfied them, more residents responded negatively than positively. One third of the citizens found the reforms ineffective, whereas nearly 17 percent were

content with their impact. A large portion of the interviewees, almost half of them did not express any opinion on the subject. Interestingly, over half of the respondents of the villages of Absheron, a region surrounding the capital city of Baku did not think the economic reforms changed their life for the better. The percentage of the population dissatisfied with the quality of reforms was around or over the 30 percent threshold in all regions where the survey was conducted.

Table 15: Are you satisfied with the economic reforms in your region? (%)

Region	Yes	No	Difficult to answer
Absheron	7	51	42
Shaki-Zagatala	10	39	51
Ganja-Gazakh	26	30	44
Lankaran-Astara	38	33	28
Daglig-Shirvan	18	33	49
Aran	11	23	66
Guba-Khachmaz	8	29	63
Mean	16.86	34	49
Median	11	33	49

Source: CRDA and ACSDA survey, 2008-2009

Particularly interesting for the purpose of this study is that three in four Azerbaijanis (the median) thought that the LEAs performed poorly or very poorly in their region. The number of the unsatisfied citizens was particularly high in the economic regions of Shaki-Zagatala, Daglig-Shirvan, Absheron, and Guba-Khachmaz. The only region where the number of people favorably disposed towards the LEAs was more than those who thought unfavorably of them was Aran. Only 3 percent of the respondents expressed a favorable opinion about the way the LEAs carried out their responsibilities.

Table 16: How would you evaluate the performance of the local executive authority? (%)

Region	Good	Average	Poor/Very Poor
Absheron	3	20	77
Shaki-Zagatala	1	11	88
Ganja-Gazakh	4	55	41
Lankaran-Astara	16	49	35
Daglig-Shirvan	3	18	79
Aran	21	62	17
Guba-Khachmaz	3	21	76
Median	3	21	76
Mean	7.29	33.71	59

Source: CRDA and ACSDA survey, 2008-2009

In most regions, citizens are not satisfied with the municipal performance, either, although municipalities are rated more favorably compared to the LEAs. 13 percent of the population viewed municipalities positively as opposed to 3 percent who had a high opinion of the LEAs. In the regions of Guba-Khachmaz, Daglig-Shirvan and Aran, a significant portion of the residents was favorably disposed towards municipal administration. On the other hand, in Absheron and Shaki-Zagatala, over half of the population was critical of local self-government. One of the reasons for lack of trust in the institution of local self-government may be its minimal role in addressing the problems of communities. As the discussion indicated, municipalities lack administrative and political powers to make a meaningful contribution to local development in Azerbaijan. Another cause of the general skepticism about municipalities could be the general perception of municipalities as the subordinates of the LEAs. Currently, the latter does not only interfere in the decision-making and intra-organizational matters of municipalities, but also frequently influences the outcomes of the municipal elections in the country. The reports of local and international election observers testify to LEAs' systematic violation of election laws.⁹²

Table 17: Are you satisfied with the performance of your municipality? (%)

Region	Yes	No	Difficult to Answer
Absheron	12	63	25
Shaki-Zagatala	8	51	41
Ganja-Gazakh	13	49	38
Lankaran-Astara	8	37	55
Daglig-Shirvan	31	27	42
Aran	25	34	41
Guba-Khachmaz	44	25	31
Median	13	37	41
Mean	20.14	40.86	39

Source: CRDA and ACSDA survey, 2008-2009

When asked to rank in order of importance the problematic factors to the regional development (7 in total: unemployment, healthcare, education, the local executive authority, municipality, corruption, energy and water supply), the residents of all regions included the LEA in the top three, along with unemployment and corruption. One fifth of all respondents mentioned the LEAs as a barrier to their region's development. However, a significant portion of the population also considers municipalities as an obstacle to local development. Taking into account that corruption is also closely associated with the public institutions of the country then it becomes obvious that the public perception of the current system of local governance is highly negative.

Table 18: Rank the obstacles to local development in order of importance. (%)

Region	1 st	2 nd	3 rd	4 th
Absheron	Corruption (36)	Unemployment (29)	LEA (19)	Municipality (11)
Shaki-Zagatala	Unemployment (31)	Corruption (21)	LEA (18)	Healthcare (10)
Ganja-Gazakh	Unemployment (29)	Energy and Water Provision (25)	LEA (17)	Corruption (13)
Lankaran-Astara	Unemployment (38)	LEA (21)	Corruption (19)	Municipality (10)
Daglig-Shirvan	Corruption (36)	LEA (27)	Unemployment (18)	Municipality (9)
Aran	Corruption (30)	Unemployment (26)	LEA (24)	Municipality (11)
Guba-Khachmaz	Unemployment (24)	LEA (20)	Municipality (19)	Corruption (15)

Source: CRDA and ACSDA survey, 2008-2009

Strong local institutions may positively influence the quality of the service delivery by improving downward accountability of local decision-makers (e.g. via elections), and transparency of and citizen engagement in local governance.

Threat of Political Instability

The recent protests against the abuses of power by the LEAs in two regions of Azerbaijan shattered the illusion of stability under the deconcentrated system of governance. Accountability and transparency deficit in local government was the major reason for the unrest in Guba and Ismayilli. In May 2012, the residents of Guba, the country's largest city in the northern region, took to the streets demanding the resignation of the head of the region's local executive authority, after the governor supposedly made offensive comments about the region's population.⁹³ In January 2013, in a similar development, riots and protests hit another town of Azerbaijan, Ismayilli, against the local governor.⁹⁴ The government sent troops to restore order in both cities, but the president also relieved both governors of their jobs.

Many researchers attribute the unrest to corruption and limitless powers of local executives.⁹⁵ In the current political order, which is based on patron-client relations, the governors have an important function. Accountable only to the president, they are tasked with overseeing local development and ensuring political stability. Article 3.1 of the Regulations stipulates that the head of the local executive authority is “personally responsible before President” for performing his duties. Thus, the legislation holds the individual holding the position responsible, rather than the institutional capacity, in which he acts, for the implementation of the state policies. As a quid pro quo, the governors have wide decision-making authority in matter concerning their districts, which they often abuse. Municipalities, which represent local communities, have no influence over the LEA decisions. Quite the contrary, as the latest CoE report quoted one mayor, “local governments cannot take a breath without the approval of the executive body.”⁹⁶

Empowering municipalities, as legitimate representatives of the citizens, would provide additional safeguards against the misuse of power by bureaucrats in the LEAs. Effective local self-government opens more channels for public participation in local decision-making and ensures more transparency in how local funds are spent.

Challenges to Government’s Legitimacy

The incumbent president is likely to run for a third term in office in the upcoming October election after the controversial 2009 amendments to the constitution removed the presidential term limit. As the government enters the uncharted territory of third term, it may become more receptive to democratic reforms at the bottom of the political system to boost its legitimacy. In legal terms, the current president is not eligible for another consecutive tenure in office, because the amendments were made after he was elected a

president.⁹⁷ The decision to seek re-election would have implications for the government both domestically and internationally. Domestically, it would intensify social and political tensions, if the continued presidency of Aliyev is perceived as the maintenance of the status quo. As the preceding discussion suggested the public perception of the government policies in the regions outside of the capital is unsatisfactory. Internationally, it would undermine the political reputation and democratic legitimacy of the current government, especially, among the European partners. The only other head of state in the Continent, who altered the constitution to remain in power in the Continent, is Alexander Lukashenko of Belarus, who is often referred to as “Europe’s last dictator”. As the costs of limiting democracy and resisting reforms both at the national and local levels increases, the government may opt to improve local self-government as a quid pro quo for maintaining the status quo in the center. The evidence from a number of authoritarian countries indicates that the ruling regimes may tolerate democracy at the local level, because they often see it as less threatening to their powers.⁹⁸ The examples include Brazil and Mexico in the 1980s and Morocco today.

The Way Forward

The study indicated that weak municipal powers and revenues have persisted due to a combination of wrong policies and lack of political interest in democratic decentralization. The government will have to modify its policy approach to local self-government, if it wants to address these problems. A major shortcoming of the government’s decentralization policy is that it does not define the central government’s role in the strengthening of municipalities. The government has considered its job almost done after it created the structures of local self-government. But political decentralization

is a long term policy process, which requires a political commitment. The central government should not remain a passive observer of local self-government evolution. The government's active political and administrative support to municipalities is central to the development of their institutional capacity.

The reform of Azerbaijan's local self-government should start by defining the role of municipalities within the country's political system and its local development. The government needs to develop a comprehensive decentralization strategy that can coherently reflect the mission of this nascent institution and the objectives it will serve to achieve. The addressing of the problems studied in this paper should be done in the context of a broader decentralization policy aimed at building functioning local authorities in Azerbaijan and should be based on the conceptual and practical principles of political decentralization, some of which were discussed at the beginning of this study.

One of these principles can be summarized as "finance follows function," which denotes that a clear framework of local government expenditure responsibilities must precede the assignment of revenues and the amount of revenue must be adequate for each task assigned to local self-government. The current distribution of functions and revenues does not seem to take into account this rule, as neither the municipal responsibilities are clear, nor the revenue sources adequate.

The functions, over which authority is transferred to municipalities, should be chosen according to three considerations. First, only services that can be efficiently done by municipalities (relative to the LEAs) should be transferred to them (e.g. street lightening, garbage removal, etc.). Second, new responsibilities must not overwhelm the weaker

administrative capacity of municipalities. Third, politically “less controversial” tasks should be reserved to them in the early stage of the reform to reduce the intensity of bureaucratic resistance to the change. It is important to add that the purpose of decentralization is not to delegate numerous responsibilities to local elected authorities. Rather, the rationale is to improve the management of public services, as it is stated in the European Charter of Local Self-Government.

When municipalities are granted functions, they should be provided with sufficient discretion to perform them. The review of the drinking water-related problems in rural municipalities showed that even though the municipal role in the provision of water to households in villages is formally recognized, the legislative and bureaucratic impediments to the exercise of this prerogative have not been eliminated.

Municipal revenues should be adequate to their competencies. The current level of financial resources available to them is so low that it does not cover a limited range of tasks they do. Municipalities currently underutilize their own-tax revenues, mostly for reasons beyond municipal control. For instance, obstacles to property tax collection are mostly legal-bureaucratic and can be relatively easily addressed, if the central government desires so. The weaker administrative capacity of municipalities also undermines their revenue-raising ability.

When a service is delegated to municipalities, they should be able to rely on a stable and predictable source of revenue. The higher the share of local taxes in their revenue sources, the more effectively they can operate. The central government has a key role in addressing the bureaucratic challenges to municipalities’ taxing authority and in

improving their tax-raising potential. The government also needs to assign other local taxes to municipalities, which pertain to their competencies. For instance, municipalities are responsible for the maintenance of local roads, but they have not been assigned vehicle tax, a relevant source of road infrastructure funding.

There are limits to local taxes, which almost always necessitate additional funding. Municipalities receive a limited amount of grants from the center and have no access to credit. The provision of intergovernmental grants to local authorities without the latter's adequate use of the full potential of its tax base can be damaging to the purpose of decentralization. The *fiscal equivalency* principle states that communities should pay for the services they consume. This may partly account for the government's reluctance to increase the amount of grants to municipalities. However, the government has failed to address the problems that hinder municipalities' effective use of their local revenue sources.

However, an effective structuring of intergovernmental financing is essential to the long term success of local self-government. Equally, access to credit is crucial to Azerbaijan's local development. To minimize the danger of moral hazard arising from the central funding options, the government also should have in place effective regulatory framework.

Municipalities' partnership with the private sector and their establishment of their own businesses are also important in terms of raising their economic role in local development. Lifting the restriction on their commercial activities is necessary to unleash municipalities' potential for innovation.

The problems this study has found in the design of Azerbaijan's local self-government are serious, but also fixable, if there is enough political will to address them. Until now, there has been limited interest on the part of the government to fix them, as incentives of the reform have not been strong enough. The changing political and economic situation in the country may compel the government to reconsider the benefits of strong and accountable local authorities. The earlier this decision is made, the better the outcome of the reform would be. As Smoke puts it, “Offloading functions to local governments in times of central government crisis is far from a guarantee of better performance.”⁹⁹ However, under a gloomy scenario, the government may do just that; delay the implementation of the reform until it becomes a political necessity. Much depends on how the government perceives the strengthening of municipal authority, a threat to its powers or a trade-off, in which “more subtle and substantial gains will accrue to” it.¹⁰⁰

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APPENDIX

Municipal functions and competencies under the Law on Status of Municipalities

Social protection and social development

Preschool education, education, healthcare, and culture; the maintenance and use of residential and nonresidential buildings; the organization of sanitation enterprises; the construction of apartments; the use of water resources of local importance, the operation, maintenance and development of water supply and sewerage system; the fuel supply and its sale; the construction and maintenance of local roads; the organization of funeral services and maintenance of cemeteries; the management of local transportation and communication services; the setting up of conditions needed for establishing catering and consumer services; the facilitation of the development of cultural institutions, the maintenance of historic and cultural structures; the management of information services, and creating the conditions for mass media activities; the provision of assistance, in addition to the state-provided help, to orphans, sick, elderly, poor, gifted and talented children; the support of physical education and sports; the stimulation of employment opportunities, the provision of social and legal protection of youth; other areas of local infrastructure.

Economic development

Issues of local importance in the areas of agriculture, industry, communications, transportation, etc.

Environment

The preservation of the ecological balance in the community; the improvement and renovation of municipal territories; refuse collection and disposal; the prevention of water, soil and air pollution; joint programs with neighboring municipalities, etc.
