

Economic Research Centre

Strengthening Municipalities in Azerbaijan

Concept Paper

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INTRODUCTION

Democratic political system, creation of effective public management and eradication of socio-economic recession are the major challenges facing most of the world countries. The analysis of experience across highly developed countries reveals that the road to democratic and economic prosperity is quite clear. The matter has more to deal with the rejection of authoritarian type of management both in political and economic realms, establishment of market oriented relations and liberal economic environment. Liberal political and economic system in the country first and foremost presupposes deeper decentralization along with the autonomous strong municipal institutions from the perspectives of administration and financial capacity. However, a number of transition countries do not have any precise policy or concept for decentralization. They seem to be conservative towards any other external efforts or initiatives with that respect. The situation is even more complicated by a higher level of corruption in public administration and high-rank public officials preponderantly pursuing their own interests, which is a hindrance on the way towards the reforming of political and economic system. It is possible to observe the same traits in the case of Azerbaijan too.

Though there have been a few steps taken towards the improvement of both political and economic fields in Azerbaijan over the last ten years (such as, introduction of municipalities, deregulation reforms of economy etc), it is difficult to say that all these are in compliance with the development demands of the open society and empower the citizenry to participate in public affairs.

Firstly, Azerbaijan ratified the European Charter of Local Self-Government (Strasbourg, 1985) in 2001 and this document stipulates that the right of citizens to participate in the conduct of public affairs is one of the democratic principles shared by all member states of the Council of Europe and this right can be most directly exercised at the local level. The first municipal elections took place in the country in 1999 and consequently 2735 local self-governments were created. The next elections were in 2004 and the number of municipalities grew due to the formation of new ones reaching 2800 in total. During this period, 30 normative and legal acts have been adopted by the government to regulate the operation of local self-governments. In general, their operation is regulated by about 300 normative documents related in this or another way, which suggests that it is possible to argue the existence of compliance with the Charter requirements. Yet the Charter also includes that “only the existence of local authorities with real responsibilities can provide an administration which is both effective and close to the citizen and this entails the existence of local authorities endowed with democratically constituted decision-

making bodies and possessing a wide degree of autonomy with regard to their responsibilities”.¹ That said, from the perspective of these clauses, the establishment of Azerbaijan municipalities do not meet these requirements even formally- municipalities have been created but they possess extremely limited responsibilities. Currently, it is impossible to refer to any significant responsibility of local authorities in addressing people’s socio-economic problems. Under paragraph 3 of Article 4 of the Charter, “public responsibilities shall generally be exercised, in preference, by those authorities which are closest to the citizen”. Moreover, the low financial capacity of municipalities does not allow them to perform even their limited responsibilities. It is only enough to mention that the per capita income of an average municipal budget is 2.8 AZN manats. To exclude fiscal transfers to municipalities, this figure is even lower than their own revenue generating capacity, whereas section 1 of Article 9 of the Charter reads that “local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers”. The current share of total municipal income amounts for less than 0.5 percent in the consolidated state budget, while this number was 15-20% in transition economies, such as Bulgaria, the Czech Republic and Poland in the late twentieth century and 20-45 percent in developed countries such as Denmark, Netherlands and Great Britain.² Such being the case, there is an urgent need for the formation of local authorities with crucial impact tools and levers in public affairs, which the citizen can trust as an official body. This requires, above all, the reinforcement of decentralization process in the country as being one of the priorities of the state’s political and economic reforms in the short-run. Thus, it has become an inevitable necessity to identify priorities justified on the ground of scientific and practical perspectives so as to enforce municipalities. In this respect, civil society institutions engaged in local self-governance issues have some serious tasks too to move the matters forward. These entities can even be more contributive through their possible involvement in learning international experience, discovering advanced initiatives with this regard and putting them at the disposal of concerned state authorities in the form of a package of recommendations and formulating public opinion of the would-be local self-governance reforms. With this in mind, the Economic Research Centre (hereinafter referred to as ERC) made an announcement of the creation of Public Advocacy Group (PAG) with a mission to strengthen municipalities in September of 2006 under the project “the Role of Local self-governments in poverty reduction in Azerbaijan”, which was co-financed by Oxfam, GB and ICCO, Netherlands. The major task of the expert group competent in municipal issues was to make public current concerns of municipalities, establish necessary relations with the relevant government agencies in addressing these concerns and eventually

¹ Preamble of *European Charter of Local Self-Government*: Strasbourg. 15.10.1985.

² *Развитие бюджетного федерализма: международный опыт и российская практика. Мизгара Де Сильва, Галина Курляндская. Москва, 2006.*

design and submit a conceptual framework on strengthened municipalities to official bodies. The PAG contemplates a series of awareness campaigns in order to popularize and implement the ideas contained in the framework concerning administrative and fiscal decentralization. The framework contains several conceptual approaches for the enhanced municipal responsibilities and financial capacity. The document provides an analysis of the current situation being followed by relevant messages and recommendations targeted for the future.

REVIEW OF PROBLEMS IN THE ORGANIZATION AND OPERATION OF MUNICIPAL INSTITUTES IN AZERBAIJAN

There is a one-tier municipal system in Azerbaijan, which means that there is no hierarchy among municipalities irrespective of the status of the administrative-territorial units (villages, towns, districts and cities), their fiscal capacity and number of people living in their territory. All the municipal authorities are equally independent and have been established on the basis of the same principle (having an independent source of income, the same responsibilities and ownership of the right to their properties and order issuance) and countrywide general elections.

Under the requirements of the Election Code³, the number of municipal councillors varies within the following range depending on the number of population living in their territory:

- 5 councillors when there are 500 people;
- 7 councillors when there are 500- 1000 people;
- 9 councillors when there are 1000- 5000 people;
- 11 councillors when there are 5000-10000 people;
- 13 councillors when there are 10000- 20000 people;
- 15 councillors when there are 20000- 50000 people;
- 17 councillors when there are 50000- 100 000 people;
- 19 councillors when there are 100000 people;

The status of municipalities and their assignments are stipulated in the law on “Status of Municipalities”. Article 1 of the law envisages that local self-governments are such a system of arrangement of citizens’ affairs that it enables them to freely exercise their rights to addressing issues of local importance within the framework of the law and performing a few public affairs

³ Election Code of the Azerbaijan Republic

as foreseen in the Constitution (Article 144). However, a wider glance at the role of municipalities in socio-economic development and public service delivery, and especially their scope of competence and dynamics of their financial potential reveals that municipalities have not yet become real authorities in carrying out some of the public affairs. That is, from communal service delivery, renovation activities to the registration of local citizens, social service delivery, improvement of territorial investment, environment and entrepreneurship development, which are commonly accepted as lying in the responsibility of municipalities in the world, are still carried out by various bodies subordinate to the central administration in Azerbaijan. The real responsibility of municipal authorities in Azerbaijan is, at best, related with the maintenance of municipal roads and social assistance delivery to low income people not covered by the state social programs. On the whole, there are basically two factors – *Institutional & economic factors*- that lead to the current problems of municipal authorities thus threatening their development in Azerbaijan. Institutional factors include major challenges that block the evolution of municipalities as being totally local self-governing authorities and impede their operation. Among these obstacles are excessively centralized public administration, very limited municipal responsibilities, incapacity of the current arrangement of public administration to keep pace with the flexible and effective management of administrative territories, and current criteria for the arrangement of municipalities' territories.

The second group of challenges, which are economic, includes inadequacy of real revenue sources vis-à-vis their real expenditure needs, absence of advanced mechanisms in place for the local taxation and regulation of intergovernmental fiscal relations and last but not least, no access to financial markets. Now let's consider each set of obstacles towards the development of municipal institutions separately.

1.1. Institutional Factors Preventing Municipal Development

There are a number of institutional challenges for the development of municipalities in Azerbaijan, such as from the criteria for determining municipal boundaries, public engagement and municipality establishment to the relations between municipalities, central government and local people. Yet this document includes the analysis of such factors that do not prevent only the development of one particular municipality, but also institutionalization of local authorities on the whole. Meantime, the concept paper refers to those factors that their eradication is beyond the capacity of qualifications, knowledge and business opportunities of a given municipality, but possible to achieve via the carefully selected and effective governmental policy with regard to local self-governance. For instance, the experience reveals that bad or good relationships between the citizen and municipalities are contingent upon a particular municipal activity. However, the limited municipal responsibilities result from their exceeding dependence on

Excoms⁴, problems with the legislation or enforcement gaps in the implementation mechanisms of laws.

ERC has built up partnership relations with around 50 municipalities located across various districts of the country over the last three years carrying out extensive projects with a view to improving their budgetary and tax management systems and involving local citizens in budgetary decision-making process. The corresponding studies have been done in these directions, nearly hundred round-tables organized and other public events conducted. Thus, views of municipal representatives and local people have been incorporated into the prioritization of adverse factors on the road to the municipal development,

After all, local self-governance is an area requiring constant improvement and innovative approaches, which will make it inevitable to design such kind of conceptual frameworks and apply different approaches to address problems so as not to fall abreast of ongoing changes and development processes in the society.

The following section will address each of municipal development-averse institutional factors that need to be eradicated in the mid-run (within 3-5 years).

Highly centralized public administration versus limited municipal responsibilities

The public administration is exceedingly centralized in Azerbaijan with, on the one hand, municipalities having a restricted set of responsibilities, and, on the other hand, a number of functions assigned to municipalities being *de facto* owned by various state bodies. Paragraph 8.2.2 of Recommendation 126 of May 21, 2003 by the European Congress of Local and Regional Authorities on “local and regional democracy in Azerbaijan” states that municipalities possess limited responsibilities and in contrast to the requirements of European Charter of Local self-government, a significant majority of public affairs has not been included within these responsibilities. Their responsibilities have been defined in such a way that they either complement responsibilities of local state administration bodies (Excoms) or are effective under their control.⁵ During the last four years when these recommendations were addressed to the government of Azerbaijan, no changes have been made to the currently effective law in terms of reconsideration of municipal responsibilities. Only in the February of 2005, the law on “the Status of Municipalities” was changed to replace the status definition of “Municipalities are non-governmental agencies” with the one that says “Municipalities are a tier of government carrying out public affairs”. Nevertheless, such an accuracy of definition of municipal status was not followed by the necessary re-definition of their responsibilities. Central government and

⁴ Local state administration offices directly subordinate or accountable to the central government

⁵ www.coe.int. Recommendation 126, May 21, 2003 by the European Congress of Local and Regional Authorities on “local and regional democracy in Azerbaijan”

their authorized officials still seem reluctant to carry out local self-government reforms and especially draw a clear-cut line between state and municipal responsibilities regardless of the fact that it is 8 years since the inception of municipalities in Azerbaijan and this period is quite a long time to experiment municipalities and thus giving them no responsibilities. To have a clear idea of to what extent local self-authorities possess limited responsibilities, it is enough to have look at the current division of public affairs between the state bodies and municipalities. While this division was explored, the following normative and legal acts were reviewed as well:

1. The law of the Azerbaijan Republic on “the Status of Municipalities”
2. Regulation on “Local government (Excoms)”
3. Housing Code of the Azerbaijan Republic
4. Law on “Municipal Land Administration”
5. Forestry Code of the Azerbaijan Republic
6. Water Code of the Azerbaijan Republic
7. Law on “Geodesy and Cartography”
8. Law on “Water Supply and Sewage”
9. Law on Transportation
10. Law on “Automobile roads”
11. Law on “Production and garbage”
12. Law on “Postal services”
13. Set of Regulations on “state road-building norms and standards, city, town and village planning and renovating”
14. Land Code
15. Law on “Municipal land leasing”
16. Regulations for “Cleaning settlements, temporary refuse preservation and its regular transportation and harmless rendering in line with the sanitary guidelines, hygienic and environmental normative acts”

Despite the sufficiently greater bulk of legislative documents regulating local self-governments, the above-mentioned normative & legal acts are also major documents defining the lines between the responsibilities of central and local self-governments

Table 1

Sorting out responsibilities for the implementation of various public affairs among central and local self-governments

Public Affairs		Implemented by	
		<i>Central</i>	<i>Local</i>
1	Registration of Citizens' status acts	X	-

2	Sanitation & epidemiology and veterinary control	X	-
3	Standardization & metrology	X	-
4	Geodesy & Cartography	X	-
5	Public order maintenance	X	-
6	Fire protection	X	-
7	Communication (telephone, postal and telegraph) regulation and administration	X	-
8	Public traffic management	X	-
9	Education (primary and secondary)	X	-
10	Health care (polyclinics, hospitals and primary care)	X	-
11	Housing management and regulation	X	-
12	Public utilities (gas, electricity and drinking water) management	X	-
13	Social welfare (social security, maintenance of social care facilities)	X	-
14	Employment	X	-
15	melioration infrastructure management and regulation	X	-
16	Arrangement of Cultural and Art activities and management of related facilities	X	-
17	Roads maintenance	X	X
18	Renovation activities	X	X
19	Maintenance of cemeteries	-	X
20	Environmental protection and implementation of related activities	X	-
21	Allocation of land plots for individual house building	X	X
22	Maintenance of museums	X	-
23	Maintenance of parks and vegetation	X	X

As is seen from Table 1, the municipal scope of competence in the implementation of public affairs is extremely limited and the major public affairs and their implementation or regulation lie in the direct responsibility of state bodies due to the conduct of no substantial public administration reforms during 16 years since Azerbaijan gained its independence. Separate state bodies seem to be trying to undertake logistics functions rather than developing as authorities accountable for state policy generation and strategic functions in various fields. For instance, on the one hand, the Ministry of Transportation designs state transportation policy, while, on the other hand, it deals with road building and infrastructure improvement, gives licence for engagement in public transportation, and regulates intra- and inter-city traffic. Likewise, the Ministries of Education and Health care try to handle all matters from the tiny logistics to strategic problems. How effective can it be that the Ministry of Education and its authorities are both taking care of education and curriculum quality, while engaged in the purchase of chairs, desks and power supply for schools? Similarly, housing maintenance and financing is administered only by Excoms. Such being the case, administrative monopoly emerges not only in the centralization of responsibilities, but also it causes a threat of centralization for funding to carry out these services. In general, the extreme centralization of public affairs, on the one hand, leads to the society being run by a small group of people causing people to fall apart from the

public management, on the other hand, it brings about circumstances where funds for these affairs are spent in an inefficient and non-transparent way.

II. CURRENT ORGANIZATIONAL FORM OF PUBLIC ADMINISTRATION ACROSS ADMINISTRATIVE TERRITORIES VS. FLEXIBLE AND EFFECTIVE MANAGEMENT REQUIREMENTS

There are serious problems resulting from the local administration units established based on the assignments from higher tiers of government having more responsibilities thus possessing a higher status as compared to local self-governments, which have been formed through the public voice. Firstly, it restricts local people's participation in addressing local concerns. Secondly, it serves a reason for the splash of accountability for local problem resolution across the greater number of administration units, which have no practical "public mandate". Finally, the centralization-friendly environment turns out to be a significant obstacle for the decentralization reforms.

The current principle of arrangement of public administration vis-à-vis the administrative territories in Azerbaijan is a legacy from the Soviet time. That is, the soviet model of local administration - "*territorial Soviets*" (village, town or city etc) - has been replaced with "territorial executive representations" (for village, town and city), which were arranged vis-à-vis the then existing administrative territorial units. Under the law of the Azerbaijan Republic on "Territorial Structure and Division of Administrative Territories" of June 13, 2000, the administrative territorial structure of Azerbaijan includes 66 districts, 13 semi-city districts and 7 big cities, which are themselves comprised of 1692 settlements altogether. Even in the smallest administrative territorial units, municipalities operate in parallel with the state representations (local executive bodies), which eventually both slows down the effectiveness of management and creates favourable circumstances for the Excoms to keep municipalities under informal supervision. Over the long years, this problem has been tackled through conceptual approaches about the division of government in the experience of different countries. That is, the term "split of government" does not entail only traditional division of government as "Executive government, Legislature and Judiciary", but also distribution of powers between state and local self-governments. There are currently two principles for such a division: *Vertical and Horizontal distribution*. The vertical dimension covers the arrangement of powers across various levels – settlements, administrative territories (e.g. district, province and county) – and countrywide or at the local scale, while the horizontal dimension divides governmental powers between state and local authorities. Obviously, the two principles should happen simultaneously. Nevertheless, the soviet type of power distribution among administrative territories was a matter of political ideology, which implicates that the state tried to keep people under total control through the division of the country into small and multiple territorial units establishing its power

in each of them. This principle is still dominant nowadays. The state preserves its crew of clerks even in the smallest settlements. Executive committees are not election based, but assignment. Also, the existence of excom representatives in the smallest villages do not allow for the building of public confidence in municipalities. In that case, the current official approach with regard to power distribution seems hard to be explained via the common sense: municipalities established of elected and assigned councillors are not trusted in addressing local issues, while the Excoms local representations of 2 persons can undertake any responsibility. Under the regulation of June 16, 1999 on the “Local executive committees”, representations of Excoms shall be of one representative and his deputy in villages and towns with a total population of about 10 000. Under these circumstances, human and financial resources are inefficiently used. First of all, due to the deficiency of qualified people living particularly in villages it is difficult countrywide to provide both bodies with necessary skilled people. Secondly, according to the regulation on the “Local executive committees”, major function of town and village representations of Excoms is to assist the head Excom with his responsibilities, implement his tasks and do the notary job as provided in the legislation, and issue certificates to people on their personality and family status. How efficient is it that thousands of manats are monthly allocated from the state budget to maintain such representations in the smallest settlements in the presence of municipalities? Let’s have a look at our calculations based on the number of staff units as provided for in the regulation of June 16, 1999 on “Local executive committees” and monthly salaries as defined by presidential decree N. 347 of August 10, 2004 on the “Regulation of salaries of public servants”: the annual salaries fund for the personnel of executive committees in administrative territorial units with a total people of 10 000 was 3200 AZN manats (with local representatives of Excoms getting paid 80 AZN manta, their deputies 75 and accountants 70 AZN manats and drivers 40 AZN manats) in 2006. It is visible from the budget package for 2005-2007 that 20 percent of the total allocated expenses are directed for the procurement of goods and services. Taking it into account, the approximate calculations reveal that annual administrative costs of these bodies have exceeded 4000 manats, whereas the projected yearly income of the budgets of at least 50 percent of municipalities in Azerbaijan does not go beyond 4000 AZN manats.

III. TOO MANY FRAGMENTED MUNICIPALITIES IN AZERBAIJAN

It is still uncertain on the basis of which criteria municipalities are formed in Azerbaijan. For instance, if the municipalities were to be formed according to the administrative territorial units, their number would have been 2000, or if they were to be formed according to settlements, this figure would have been 4600. Nevertheless, the current number of municipalities does not fit with either figure regardless of the fact that to identify the optimum

level of population and territorial boundaries could be a prerequisite in effective management of municipalities while they are formed. The more properly the criteria of population and boundaries are chosen, the more optimum number of municipalities will emerge in the country. The effective legislation does not envisage any limitation for the creation of municipalities through the criteria of population and territory, which results in Azerbaijan going ahead of most of Eastern and Eastern European countries both for its greater number of local self-governments and share of fragmented municipalities among the total sum. This can be easily seen from the table below:

Table 2

Cross-comparison of countries for their number of municipalities vs. Population

States	Total number of Municipalities ⁶	Municipalities clustered vis-à-vis the number of population ⁷						Number of municipalities per 100 000 people
		With less than 1000 people		With 1000-5000 people		With more than 5000 people		
		Number	Share among the total number of municipalities (%)	Number	Share among the total number of municipalities (%)	Number	Share among the total number of municipalities (%)	
Azerbaijan	2750	1275	46%	1279	46,8	195	7,2	34
Lithania	56	-	-	-	-	56	100	1,6
Estonia	254	24	9,4	195	76,8	59	13,8	17,5
Poland	2483	-	-	570	23	1913	77	6,5
Belgium	589	1	0,17	97	16,5	491	83,33	5,6
Bulgaria	255	-	-	22	8,6	233	91,4	3,4
Denmark	275	-	-	18	7	257	93	5
Finland	457	22	4,8	202	44,4	333	50,8	8,7
Holland	647	1	0,2	71	11	575	88,8	4
Sweden	288	-	-	9	3,1	279	96,9	3,2
Italy	8100	1935	23,8	3964	48,9	2201	27,3	13,9
Norway	435	18	4,1	228	52,4	189	43,5	9,7

As is visible from Table 2, Azerbaijan ranks highest among the presented countries for its number of municipalities per 100 000 people. For instance though Poland has 4.5 times as many population as in Azerbaijan, the number of municipalities in this country is approximately 10 percent less than in Azerbaijan. Presently, there are 34 municipalities per 100 000 people in Azerbaijan, while it is 1.6 in Lithuania (21 times as few as in Azerbaijan), 3.4 in Bulgaria (10 times less), 3.2 in Sweden (11 times less), 5 in Denmark (6.8 times less). It is because of the greater number of municipalities in Azerbaijan and also due to the fact that no restrictive norms

⁶ *Dünyada Mahalli İdareler, Türkiye İçişleri Bakanlığı Mahalli İdareler Genel Müdürlüğü, Ankara, 1999*

⁷ *Страны и регионы мира. Москва, 2003*

are stipulated in the legislation for municipality creation that Azerbaijan goes ahead of most of the transition and developed countries for its number of municipalities with a total people of fewer than 1000.

As seen from Table 2, almost half of municipalities in Azerbaijan are in this condition (46 percent, or 1275 municipalities), while it still remains a fact that municipalities can not be established in Lithuania, Poland, Bulgaria and Denmark with a population of under 1000. The share of small size municipalities among the total does not reach even 10 percent in the table-mentioned countries excluding Italy. A significant majority of the municipalities in these countries have been created in administrative territorial units with a total population of 1000 to 5000 people.

What kind of local self-governance problems do the fragmented municipalities pose? First of all, administrative costs rise notably. For instance, there are 698 thousand people living in 1275 village municipalities with a total population of 1000. The number of staff in these municipalities is over 10000 in total, while the figure is two thousand in 4 district municipalities of Baku city – Yasamal, Narimanov, Nasimi and Binagadi – having quite the close number of population (690 thousand). Annually, it is required to have a salary fund of 3 million AZN manats with an average wage in order to cover at least the half of this staff – 5000 servants despite the fact that even if Baku municipalities paid double of the same average wages to its servants, their annual fund of wages would not exceed 250 thousand manats. The difference is obviously more than ten times. Secondly, the overfragmentation of municipalities crushes resources as well. For instance, what infrastructure projects can small municipalities of 30-50 people implement on their own? The budget of such municipalities is not even enough to cover wages of their councillors. Let's have a look at the real situation through examples of a few small municipalities.

Table 3

**Actual budget potential vs. expenditure priorities of small municipalities,
For 2005**

Districts municipalities based in	Name of municipalities	Number of local people	Estiameted annual property and land taxes in AZN Manats	Annual salary fund of municipal servants	difference (+, -) (rp.4 – rp.5)
	2	3	4	5	
Ismayilli	Gulyan	187	300	360	- 60
	Vasha	165	150	362	- 212
	Mudruse	157	117	372	- 255
	Pirabilgasim	157	340	720	- 380
	Gandahar	155	60	720	- 660

	Haftasov	71	113	1080	- 967
	Goydan	70	53	360	- 307
Kurdamir	Gurdbayram	131	600	360	+ 240
Jalilabad	Farajullah	155	1100	360	+740
	Mirtahmazli	134	634	360	+ 274
	Mashadi Huseynli	107	380	360	+ 20
	Agbulag	77	120	360	- 240
Masalli	Isi	186	20	780	- 760
	Yusifli	152	87	840	- 753
	Imanli	156	294	840	- 546
Yardimli	Lazran	137	112	1092	- 980
Лерик	Арта	162	100	792	- 692
	Тябризли	155	60	792	- 732
	Щирамо	154	30	792	- 762
Guba	Rangdar	116	35,20	552	- 516,80
Devechi	Leyti	140	200	840	- 640

Table 3 presents budget estimations of 21 municipalities from 8 districts and it suggests that the estimated proceeds of 17 municipalities from land and property taxes are less than their projected fund of salaries. These are by far the most important sources of revenue for municipalities countrywide. For instance, the total projected tax income of all municipalities in 2005 was 5.5 million AZN manats, 2.1 million or 92 percent of which were due to land and property taxes. This is not the whole list of fragmented municipalities from the perspective of population size. Currently, there are 600 municipalities with a total population of fewer than 500. The smallest municipality (33 people), Guytul, in the country is based in Dashkesen district.

The cross-country studies reveal that the world does not have any particular recipe for municipality establishment with restrictions and the criteria vary across various countries. For instance, although Article 17 of Polish law on “Local Self-governments” does not entail any restriction for gmina (municipality) creation depending on the number of population⁸, the authorities regulate it in such a manner that eventually, there have not been created any municipalities with people fewer than 1000 and the number of municipalities (570) with people of 5000 just comprise 23 percent of the total sum. In other words, 77 percent of gminas have more people than 5000.

On the other hand, the early 2000 subsovereign government reforms in Turkey and Greece led to the modified legal framework of the current system, which reconsidered criteria of population and territory for municipality creation. Ultimately, following the modified normative and legal acts regulating operation of municipalities, it was banned to create municipalities in

⁸ «Сборник некоторых законодательных и международных актов по децентрализация и местному самоуправлению». www.ui.kg/inc/Publication/Rus/lowsbook

administrative units with people less than 2500 and as a core element of reforms, extensive steps were taken to merge fragmented municipalities as opposed to a greater size of 5922 municipalities in the mid 1990s, 4704 of which used to have people less than 1000 and 1021 had 1000-5000. Within a short while, the number of Greek municipalities was reduced by 5 times and there are currently 1033 local self-governments. There are 9.7 municipalities per 100 000 people in Greece, which is 3.5 times less than in Azerbaijan.⁹

Under Article 4 of the Turkish law on “Municipalities” adopted in December, 2004, municipalities shall not be created in territories with less than 5000 people. Moreover, administrative territorial units within a distance of 5000 metres from the municipality regarded as the central point were merged into that municipality.¹⁰ The smaller number of municipalities is not only characteristic of European countries, but also developed countries in other continents. It enables us to say that “bigger municipality” is a universal trend and this is accepted as one of the objectives towards the improvement of municipal authorities. Another example is that of Japan which has 3232 municipalities. There are 2.5 municipalities per 100000, which is 14 times less than in Azerbaijan. Meanwhile, the total population of Japan is 15 times as great as that of Azerbaijan. More often, there is such a misconception that absence of municipalities in small areas brings about restricted exercise of people’ right to local self-governance. This is quite false, firstly, because the point here is not that of non-creation of municipalities in certain areas, but that of consolidation of small settlements with common infrastructure, community needs and adjacent boundaries to each other under a single local self-government. It is clear that the legislation defines representation quota for each settlement in local self-governance and ultimately, each one’s right to local self-governance is exercised. In practice, people’s right to local self-governance is violated when considerably small municipalities, which are too weak, can not satisfy people’ necessary needs and the existence of such bodies is formal. Secondly, there is no practice of municipality creation based on the principle of “one settlement and one municipality” in various world countries. For instance, there are 4555 settlements in Estonia (15 big cities, and semi-city towns and 4460 villages) and 254 municipalities, which implies that on average one local self-government encompasses 18 settlements. Likewise, there are 42697 settlements and 2483 municipalities in Poland. Although of this, 39589 are small villages with population fewer than 1000, the Polish municipalities have each, as mentioned earlier, more people than 1000. Currently, each municipality embraces an average number of 17 settlements in this country. As regards the case in Azerbaijan, there are 4600 settlements and 2800 municipalities in Azerbaijan. That is, there are 1.5 settlements for each municipality, which is 12-13 times bigger than the similar figure in transition countries such as Estonia and Poland.

⁹ «Государственное Управление зарубежных стран». С.В.Пронкин, О.Е.Петрунина. Москва-2004

¹⁰ *Türkiye Cumhuriyeti, «Resmî Gazete»nin 24 dekabr 2004-cü il tarixli 25680-ci sayı*

IV. MUNICIPALITIES' EXCEEDING DEPENDANCE ON LOCAL EXECUTIVE COMMITTEES AND THEIR LIMITED OWNERSHIP OF PROPERTIES

The absence of regulation for intergovernmental relations causes in many cases the violation of the right to local self-governance. This concern is also reflected in section 8.2.3 of recommendation 126 of May 21, 2003 by European Council for Local and Regional Authorities about the local and regional democracy in Azerbaijan. Besides, the constitution and also the legislation of local self-governments state the full independence of municipalities and prohibit any intervention of local Excoms. It remains a reality that the formation of harsh hierarchic system of relations, which is in favour of local Excoms, between these two tiers of government having different status of administration appears to be a formidable challenge on the way of municipal development. The conducted studies reveal the following interventions of local Excoms into municipal affairs:

1. This dependence first of all results from the legislation. That is, both under article 56 of the Land Code and Article 6.5 of the law on "Municipal Land Management", municipalities can sell or rent its municipal lands only with the opinion of local excoms. The authorities try to explain this dependence via the necessity of securing the compliance of lands with their assignments, current technical standards and documents of land composition and urban planning. Nevertheless, these standards are completely precisely regulated in the existing legislation and therefore it seems very hard to explain the necessity of relevant Excom opinion for this purpose through the justified arguments. Firstly, according to Article 7 of the law on "Municipal Land Management", agricultural lands of municipalities can only be rented. On top of that, the boundaries of these lands should be reflected on the map of the territory with differing colour. Secondly, under Article 6.4 of the same law, municipal lands can not be allocated for electricity, communication, and oil and gas lines, sanitary-protection zones of industrial enterprises, multistorey buildings and individual houses. Only lands of perspective development fund can be used for this purpose. The perspective development fund shall be shown on the map in separate. Article 8 of the law on "Municipal Land Management" defines maximum norms for municipal land plots which are given for private ownership. Furthermore, the instructions of "State's urban, town and village planning and building norms and guidelines" adopted by the State Construction and Architecture Committee on October 12 contains necessary norms that municipalities should refer to during independent decision-making. Thirdly, Cabinet of Ministers' decision 93 of April 27, 1998 on "setting normative prices for land areas where privatized state-owned

enterprises and facilities are based”, decision 158 of July 23, 1998 on “Setting normative prices for lands in the Azerbaijan Republic”, and decision 89 of May 17, 2000 on the changes and additions to the “Regulation on the normative price for land areas where privatized state enterprises and facilities are based” which was approved through decision 93 of April 27, 1998 respectively defined normative (minimum) prices for individual house building. The minimum level of rental price of lands is also set in Article 19 of the law on “Municipal Land Management”. Also under 6.7 of the same law, municipalities shall send a copy of their decision on the use, leasing of their land to the Department of Justice Ministry for Work with Municipalities. And if the norms of these decisions are broken, administrative control bodies will prevent it through the court intervention. It should be noted that constitutionally, all owners of properties (state, municipal or private) shall have the rights of ownership, use and disposal to their properties. However, the municipalities’ right to use and disposal of their lands is still not exceptional. This situation is different in village and town administrative territorial units in a sense that due to a greater demand for the lands with an assignment of agricultural use in the villages, representatives of local Excoms hold control of giving out or renting these lands, while there is a greater demand for individual house building in towns and local Excoms exert maximum control over the privatization of lands of this category.

2. Certain features of this dependence are of informal nature. It first includes barriers for municipalities to freely dispose of their budget resources. The effective law envisages the use of budget resources to exceptionally cover needs of people within the municipal territory. Yet the studies by ERC experts uncover that local excoms give unofficial orders to municipalities to use their resources for the renovation activities in the district area on a regular basis, whereas financing of such district or townwide activities is done through the state budget and this happens when municipalities have a myriad of socio-economic problems to address in their own territories.

These interventions have an adverse bearing on limiting the opportunities for municipalities to freely dispose of the state budget subsidies. The studies also show that the allocation of financial assistance is basically decided on the basis of unofficial instructions of local Excoms.

1.2. ECONOMIC FACTORS PREVENTING MUNICIPAL DEVELOPMENT IN AZERBAIJAN

The impact of economic factors on the slowdown of the municipalities' development should not be deemed less as compared to institutional factors. Economic factors can themselves be categorized conditionally as 1) *challenges for the municipal property formation and use* and 2) *limited fiscal capacity of municipalities*. Let's have a look at the current status of financial capacity of municipalities in Azerbaijan by each factor.

I. MAJORITY OF MUNICIPALITIES HAVE NOT BEEN ABLE TO OBTAIN PROPERTY AND OWNERSHIP RIGHT OVER THE PROPERTIES ASSIGNED TO THEM

The provision of municipalities with necessary properties is a precondition for their effective operation. Article 4 of the law of the Azerbaijan Republic on "Relinquishing Properties to Municipal Ownership" enacted in December, 1999 stipulates that state properties or other facilities, which are necessary for the implementation of municipal responsibilities, shall be handed over to municipalities. Within 3 years of the enactment of that law – July 8, 2002- the Cabinet of Ministers made its decision 106 on the "approval of the list of state properties assigned to municipal ownership". Under this decision, 92 properties in the forms of buildings and constructions were officially passed to 62 municipalities out of 2800 throughout the country. The rest of municipalities still have not been able to obtain confirmation certificates of their rights to the assigned properties or their properties, including their administrative buildings from the authorities concerned. For instance, no municipalities in Baku have been granted a confirmatory certificate of ownership of either buildings or lands to date.

II. MUNICIPALITY ASSIGNED TAXES AND CHARGES DO NOT ENABLE THEIR ENHANCED FISCAL POTENTIAL

The effective legislation defines revenue sources of municipalities as being tax and non-tax. Under The Tax Code and law on "the local (municipal) taxes and fees", the following are assigned to municipalities as revenue sources:

1. **Taxes.** This group includes land and property taxes from physical persons, profit taxes of locally owned legal entities and mine taxes from construction materials of local importance.
2. **Non-tax revenues.** includes advertisement (on streets and wall) fees, own revenues from sale and rental of municipal assets, fees from hotels, sanatoriums, resorts and tourism

services, parking charges, in-kind contributions, charges from the whole or retail-sale trade within municipal territory and other services, and finally, fiscal transfers from the state budget.

At first sight, it seems that municipalities have been assigned numerous revenue sources- 4 tax and 7 non-tax sources. However, the studies show that only a few municipalities can benefit from or use all or majority of these income sources in their budget formulation. The table below presents the number of municipalities able to benefit from a few major local taxes and fees.

Table 4

Number of municipalities applying various taxes and fees as stipulated in the law (for 2005)¹¹

Districts and towns*	Local taxes			Local fees		
	Mine	Profit	Property	Advertisement	AutoParking	Sanatoriums, resorts, and inns
Nakhchivan	2		20	1	1	1
Baku	3		15	2	12	3
Ganja			2		2	1
Sumgayit	1		1	1	1	
Ali-Bayramli			1	1		
Yevlakh			4	1	1	
Jlenkoran			5	1	1	1
Mingachevir	1		1	1	1	1
Shaki	1		6	1	2	1
Absheron		1	9			
Agdash		1	5		1	
Agstafa			3			
Agsu			3			
Agjabedi			15			
Astara			1		1	
Balaken	1		4		1	
Beylagan			12		1	
Barda	1		26		1	1
Bilasovar			2		1	
Gazakh	1		6		2	
Gakh	2		8	1		1
Gabala			5	1	2	
Gobustan			1			
Guba	3		14		1	1
Gusar			2			
Dashkesen			2			
Devechi	1		1		2	

¹¹ The table is based on the data of State Statistics Committee and Ministry of Finance.

Zagatala			7		2	1
Zardab			2		1	
Imishli	1		1		1	
Ismayilli			5		1	
Yardimli			2			
Kurdamir			4		1	
Gadabay	1	1	1			
Goranboy			2		1	
Naftalan			1			
Goychay	3		4		1	
Lerik			1			
Masalli	1		2			
Neftchala			1		1	
Oguz			2		1	
Saatli		1	2		1	
Sabirabad			2	1	1	
Salyan	1		2			
Samukh	1		2		1	
Siyazan	3	1	1		1	
Tartar		1	1	1		
Tovuz			4		1	
Ucar			6		1	
Khanlar	2		2		1	
Khazchmaz	5	1	3		1	
Khizi	1		1		1	
Hajigabul	1		1		1	
Jalilabad			3		4	
Shamakhi			3		2	
Shamkir	2		5	1	1	
Total	39	7	244	14	61	12

**Note: this is the number of municipalities applying local taxes and fees by various districts and towns. For instance, under Baku, 49 municipalities have been covered in the capital city.*

Due to the fact that only land tax is applied by almost all municipalities, the table does not contain any data on the number of municipalities collecting this tax. Nevertheless, as is seen from Table 4, with the exception of land taxes from physical persons, municipalities can not benefit as much from the other remaining local taxes and fees. Mine tax can only be levied by 39, profit tax by 7, property tax by 244, advertisement payments by 14, parking charges by 61, and sanatorium-resort-inn duties by 12 municipalities. In other words, 13.5 % (i.e. 377) of all municipalities in the country can benefit from the other local taxes and duties, which are assigned to municipalities under the law, excluding the land tax. It is enough to mention that the budget inflows of municipalities for 2005 accounted for 5% or 1, 2 million manats of their consolidated budget revenues, which is 4 times less than land tax proceeds. Reasons are manifold for the fact that the mentioned taxes and fees can not become sustainable sources for municipalities. Let's review the reasons for such a situation by each tax and fee mentioned:

- 1) **Mine tax from the construction materials of local importance.** Under the Tax Code, municipalities can levy mine tax on three types of construction materials – gravels, brick-tile crays and construction sands. Yet, the application of this tax into the production turnover makes it hard for municipalities to calculate this tax due to the tax law stipulation that municipalities can not conduct an independent audit control over the calculation of this tax in the concerned production facilities. With this regard, municipalities can address to state tax bodies and these bodies will involve municipalities when they perform mobile tax inspection. The tax law does not define any timeframe for the mobile tax inspection by the state tax service in enterprises. However, under the Tax Code, such inspections may cover the operation of enterprises during the last three years including the year of inspection. In such a case, if there is non-compliance of any tax-payer with his tax obligations, the relevant municipality might have to wait for 3 years to do away with such an illegality. According to the Tax Code, 0.5 manats per cubic meter of produced construction materials of local importance shall be calculated and paid to the local buget.

- 2) **Profit taxes form locally owned enterprises.** The situation here is quite clear: the fiscal potential of municipalities in Azerbaijan is limited and they have no access to borrowing. Such being the case, it is merely impossible for local self-governments to establish their own enterprises. This can be proved by the fact that only 7 out of a total number of 2800 municipalities have managed to do so.

- 3) **Property taxes from natural persons.** The situation is more complicated with regard to the property tax, which is more attributable to the current underdeveloped legislation. *Firstly*, under Article 198 of the Tax Code, the taxation of properties of natural persons shall be defined for their inventory value and the inventory value shall be made explicit to the citizens in their certificates of properties. The analysis of the current situation shows that a significant majority of houses in the country appear to have not been privatized and therefore these properties can not be levied taxes due to the absence of property certifications. For instance, State Statistics Committee (SSC) data on housing conditions of people say there are 1.1 million houses in the country with a total area of 90 million square meters, while it is also obvious from SSC data that 680 thousand apartments with a total area of 20.3 million square meters were privatized within the period of 1990-2006 years. That is, 40% of people's properties still have not been privatized. *Secondly*, in many cases, people manage to have no price of properties shown in their certifications of property by various means in order to evade taxes. In this case, municipalities have no legal basis to calculate property taxes from natural persons. At last, houses with an inventory value of up to 5000 manats are not subject to taxation, which brings about possibilities

of value indications below this level in the certificates of property. Due to these causes, currently a total of 244 municipalities or 8.7 percent of a total number can levy property taxes in their territories. It should be noted as well that 0.1 percent of the inventory value of a property over 5000 manats should legally be calculated and paid to the municipal budgets. The taxation of properties of natural persons is governed by Cabinet of Ministers' decision 110 of June 28, 1999 on "the approval of calculation guidelines for inventory values of buildings in the possession of natural persons".

- 4) **Advertisement charges.** Despite the considerably small portion of this fee, the reason why it is an income source for 14 municipalities is clear. *Firstly*, the development of advertisement sector is dependent on the development of entrepreneurship and business-friendly environment. It is now clear to what extent entrepreneurship is underdeveloped in districts, which cover 98% of the whole country area. It is enough to say that according to different estimations, 90% of tax revenues of the state budget and 85% of GDP are generated in Baku. The fact that 81% or 28 thousand manats out of the revenues of 34.5 thousand manats of the consolidated municipal budget is attributable to Baku and Sumgayit municipalities can affirm it. Secondly, under the effective law, municipalities are only entitled to those advertisement charges which are based on their property. As was mentioned earlier, municipalities currently can obtain neither the properties that should be assigned to them nor the certification of the ones they have already been assigned. The rate of advertisement duty is defined by the agreement between the owner of the advertisement publication and the municipality.

In line with the presidential decree of May 8, 2001, the Cabinet of Ministers was tasked to define rules for the calculation of minimum rates for advertisement posting and broadcast on the lands, buildings and other facilities, which have municipal ownership and also for the charges to be paid vis-à-vis commercial tariffs. Although it is 6 years since the enactment of the decree, the government has not put forward any document.

- 5) **Parking Fees.** This is natural that there is no need for parking spaces in village municipalities, which make up 85% (2350) of the entire total. There is a demand for paid parking lots only in district centres or big cities. As is seen from Table 4, the number of municipalities (61) that levy this fee coincides with that of cities and district centres. Nevertheless, it is a real challenge for these municipalities to arrange for some parking space in their territories or get the fees from the already operation parking lots. Because, district excoms themselves organize these spaces and the collected fees are assigned to the city (or district) budgets as the proceeds from the extra-budgetary activities of those bodies. For instance, in

Baku although there are considerable paid parking places of the Executive Power of Baku city with a working staff equipped with a special uniform, the role of municipalities in doing so is negligible.

- 6) **Fees for sanatorium-resorts, inns and tourism services.** According to the effective legislation, municipalities shall charge payment no more than one equivalent to percent of conditional monetary unit (i.e. 1.1 manats) from the facilities in the municipal territory delivering resort, sanatorium, inn and touristic services to people. However, the statistical reviews show that a total of only 12 municipalities could generate revenues from this source in 2005. The proceeds were not as much -94 thousand manats. 87.6 thousand Manats or 93.2% of this sum was attributable to Baku municipalities whereas SSC data show that the number of inns, motels and other overnight facilities reached 270, only 48 of which operated in Baku and Absheron economic zones. It is clear from SSC presented data that customers paid 1.1 million manats for overnights at inns in 2005. As is seen, if the mentioned service facilities had paid the sum of one percent of the conditional monetary unit, municipalities would have received 12 times (1.2 million manats) as great as their actual proceeds. Further, the official statistical data say there are over 100 sanatoriums, resort and rest facilities with a total of 25 thousand beds, 27 tourism bases with 2500 beds. The fact that such a sphere with an extremely big turnover can not turn into an income source for local budgets is blamed on the imperfect performance mechanisms in the legislation for the proper calculation and assignment of the duties. That is, under the Tax Code, municipalities can not conduct an independent tax inspection at the mentioned facilities. They can refer to local tax bodies and be involved into this process when these tax bodies carry out inspection. The tax law does not define any timeframe for the mobile tax inspection by the state tax service in enterprises. However, under the Tax Code, such inspections may cover the operation of enterprises during the last three years including the year of inspection, which means that in case of non-compliance by inns or tourism facilities with their tax obligations vis-à-vis local budgets, municipalities might have to wait for 3 years to do away with such an illegality. Thus, due to the mentioned problems with the calculation and assignment of local taxes and duties to local budgets, municipalities in Azerbaijan possess an extremely weak financial potential. The real situation can be clearly seen by looking at the structure and size of municipal incomes for 2005 in the following table:

Table 5

Structure of municipal revenues in Azerbaijan (actual inflows for 2005)

Income sources	Size of proceeds, <i>In thousand manats</i>	Inflows as Percentage of total budget incomes
Land taxes from natural persons	4964	20,4
Property taxes from natural persons	566,5	2,3
Mine taxes	226	0,9
Locally owned enterprise profit taxes	2,4	0,009
Advertisement payments	34,5	0,14
Fees for Sanatorium-resort-inn and tourstic services	94	0,39
Parking lot fees	310	1,3
State budget fiscal transfers	1900	7,8
Proceeds form sale and rental of municipal assets	13470	55,3
Other revenues	2759,6	11,46
Total	24327	100

As is seen from Tabel 5, all these financial sources amounted to a total of 24 million manats of the consolidated municipal budget, which is 2.8 manats per capita. During the specified period, 55.4 percent or 13.47 million manats of the municipal budget proceeds was attributable to the sale or rental of municipal assets and about 8 percent or 2 million manats to state budget transfers. That is, with the exclusion of these two sources, the proceeds from the rest tax and non-tax revenue sources of 9 were 8.8 million manats in total, which makes up 1 manat per capita. To make it clearer, the tax proceeds accounted for 25.6 percent (or 6.3 million manats) of the total budget revenues in 2005. 79 percent (or 4.95 million manats) of the aggregate tax revenues were derived from land tax. The property taxes to local budgets from natural persons were 566,5 thousand manats in total.

The share of municipal budget revenues in the general state budget was less than 1 percent during 2004-2005 in Azerbaijan, whereas this indicator is deemed as an important tool to judge the level of fiscal decentralization in the world countries and varies within 10-25 percent in transition economies. For comparison, it is necessary to note that Lithuania, having 2.3 times less people than in Azerbaijan (3.7 million), had a total municipal budget revenues of 961,6 million dollars in 2006, 39.5 times as great as that of Azerbaijan. As regards per capita municipal budget resources, Lithuania had an indicator of 260 dollars. 73% or 704 million dollars of total budget of municipalities in this country are generated from income tax, 10.8 percent or 103 million dollars from property taxes and the rest from use of municipal assets,

state grants and other miscellaneous sources. The ratio of municipal budget revenues to state budget inflows comprised 15.3% in Lithuania in 2006.¹² Take Poland for instance; the total municipal budget revenues made up 8.5 billion dollars or 235 dollars per capita in 2004, with the ratio of state vs. municipal budget reaching up to 20 percent. For this time period, 52% or 4.7 billion dollars of municipal budget resources were attributable to miscellaneous local taxes, and 34% or 3.1 billion dollars to property taxes.¹³

Among the local taxes and fees, land taxes from natural persons is the only source of revenues in Azerbaijan that the municipalities can freely calculate and make it subject to the local budgets without the presence of any other mechanisms or outsider bodies, as a result of which land taxes can be levied unexceptionally by all municipalities. That is, the Cabinet of Ministers' decision 230 of December 29, 2000 on the "conditional points specified through the consideration of assignment, geographic location and quality of agricultural lands based in cadastral price districts and surrounding administrative territories" defines conditional points for the calculation of taxes for agricultural lands across the whole country. Under the number of conditional points, these lands are classified into 4 quality groups. The first group is the best, while the fourth is the worst quality. Depending on the quality level, the tax amount for agricultural lands may go up and down. Taxes for non-agricultural lands and also courtyard areas are directly specified in the Tax Code. The tax load is also differentiated for non-agricultural lands by districts. For instance, lands with industrial, construction and commercial use are subject to tax in the amount of 10 manats in Baku, 4 manats in district centers and 2 manats per 100 square meters in villages. Also housing buildings and courtyards are subject to taxation by the amount of 0.6 manats in Baku, 0.3 manats in district centers and 0.1 manats per 100 square meters in villages.

By the way, the existence of precise mechanisms for land tax calculation is an indication of the fact that due to the absence of advanced mechanisms for calculation and assignment of other tax types and duties, the other sources of tax and duties haven't become a real income source for municipalities. Nevertheless, land tax should not be regarded as a significant revenue source for local finance. As mentioned earlier, the tax proceeds of natural persons from all categories of land in 2005 was 4.96 million manats in total or 1770 manats per municipality. This is, first of all, due to the less size of lands of physical person ownership. Currently, the total size of these lands is around 2 million hectares, with 1.5 million hectares comprising agricultural lands and the rest 0.5 million hectares non-agricultural. The second important cause is that of low tax rates for lands. For instance, the highest tax rate for agricultural land is 12 manats per hectare (1st group of lands in Shaki-Zagatala cadastral price district) and the lowest rate is 0.3 manat (4th

¹² Source: www.finmin.lt

¹³ Source: www.pprc.kz, www.tpprf.ru

group of lands in Gusar-Gonagkend cadastral price district) in Azerbaijan. A greater majority of lands under private ownership in Azerbaijan belongs to lower quality groups, which is why lands with a low rate of tax have a greater weight among the whole lands subject to taxation. For instance, only in six districts of the country – Balakan, Gakh, Zagatala, Shaki, Oguz and Gabala- the land tax is various within the range of 5-12 manats per hectare depending on the quality group they belong to. Next come Mil-Garabagh and Lenkoran-Astara cadastral price districts containing almost half of the territory and population of the country with the highest tax rate of 7.5 manats, Autonomous Republic of Nakhchivan with 3 manats and Mugan-Salyan and Aran-Shirvan cadastral price districts encompassing 10 districts of the country with a land tax rate of 5 manats.

III. SMALL STATE BUDGET GRANTS WITH IMPERFECT MECHANISMS OF DISTRIBUTION AMONG MUNICIPALITIES AND NO REAL MECHANISMS FOR THE ALLOCATION OF CONDITIONAL TRANSFERS

One of the crucial income sources in the effective legislation to assure proper performance of municipalities is state budget transfers. Under the law on “Budgetary System”, unconditional transfers – grants, along with conditional ones- subsidies and subventions can be allocated from the state budget to municipalities. *Grants* are unconditionally allocated from the state budget to the budgets of Autonomous Republic of Nakhchivan and municipalities to close the mismatch between their expenditures and revenues. The portion of expenditures that municipalities can not cover at the expense of their revenues can be financed through state budget grants. The budgets of Autonomous Republic of Nakhchivan and municipalities can also benefit from *subventions*, a conditional transfer supposed to be returned in case of nonuse for its assignment or within the timeframe specified. *Subsidies* are unconditional transfers to the budgets of Autonomous Republic of Nakhchivan and municipalities, as well as, legal entities. Article 32.2.2 of the law on “Budgetary System” provides that in the event of incapability of financing local socio-economic development programs through local budget resources, state budget allocates subsidies and subventions.

Nevertheless, within the past period of 8 years since the inception of municipalities in Azerbaijan, municipalities have not received any conditional transfers, subventions, which is firstly ascribed to the absence of clear legislative definition of principles and criteria for the allocation and secondly, to non-specified directions or assignments for these transfers, while it was supposed, by this time, to assure conditional transfers to municipalities for the maintenance of municipality owned roads. Regarding the grant, the problems are quite unique with the financial assistances under this category. Firstly, the amount of grant is too small and on top of

that, it has been consecutively cut down over the last five years without any official rationale being provided and additional revenue sources given to municipalities. The total amount of grants made up 4.8 million manats in 2002, while it was reduced to 2 million manats in 2006, by 2.4 times. The same amount can be expressed in terms of 714 manats per municipality or 0.20 manats per capita in the municipal territories. Besides, the distribution mechanisms for conditional transfers across municipalities are far from perfect and various local self-governments are unclear on what criteria are applied with regard to conditional transfer allocation and how their needs for additional financial resources are assessed. That is, under the law on the “Budgetary system”, the amount of grants is set through the principle of population number in a municipal territory. However, looking at the sum of grants for various districts in 2005, it can be noticed that this principle is not followed at all. The table below presents the real situation with regard to the distribution of grants by districts:

Table 6

№	Cities/districts	Amount of state budget grants	
		In AZN Manats	Per capita (in AZN Manats)
1	Autonomous Republic of Nakhchivan	118,6	0,32
2	Baku	208,7	0,11
3	Alibayramli	9,7	0,13
4	Ganja	46,7	0,15
5	Mingachevir	16,0	0,17
6	Sumgayit	63,8	0,22
7	Absheron	14,8	0,16
8	Agdam	24,9	0,15
9	Agdash	29,2	0,31
10	Agjabadi	28,1	0,25
11	Agstafa	15,7	0,20
12	Agsu	30,8	0,46
13	Astara	27,7	0,30

14	Balaken	18,5	0,21
15	Beylagan	26,0	0,32
16	Barda	55,4	0,41
17	Bilasuvar	17,7	0,22
18	Jalilabad	64,9	0,36
19	Dashkesen	13,4	0,42
20	Devechi	20,0	0,41
21	Fuzuli	10,4	0,07
22	Gadabay	21,2	0,24
23	Goranboy	33,4	0,37
24	Goychay	27,0	0,26
25	Hajigabul	14,8	0,24
26	Khachmaz	42,8	0,28
27	Khanlar	17,7	0,32
28	Khizi	5,8	0,42
29	Imishli	26,1	0,24
30	Ismayilli	35,2	0,46
31	Kurdamir	37,1	0,38
32	Gakh	24,5	0,46
33	Gazakh	12,8	0,15
34	Gabala	29,0	0,33
35	Gobustan	13,6	0,36
36	Guba	55,5	0,39
37	Gusar	36,3	0,42
38	Lerik	46,5	0,67
39	Lenkoran	45,5	0,23
40	Masalli	61,4	0,33
41	Neftchala	17,9	0,24
42	Oguz	17,0	0,43
43	Saatli	24,6	0,28
44	Sabirabad	42,2	0,29
45	Salyan	30,0	0,25
46	Samux	19,3	0,37
47	Siyazan	9,3	0,25
48	Shamakhi	29,8	0,34

49	Shaki	46,6	0,28
50	Shamkir	41,7	0,22
51	Tartar	23,6	0,24
52	Tovuz	39,9	0,26
53	Ujar	19,1	0,25
54	Yardimli	30,0	0,55
55	Yevlakh	24,7	0,21
56	Zagatala	24,2	0,22
57	Zardab	21,7	0,44

As is seen from Table 6, the per capita sum of grants oftentimes differs by 3 times across various districts. At last, the studies show that there are no criteria for the identification of the actual fiscal capacity and level of resource mobilization of municipalities during the calculation and assignment of grants for municipalities.

IV. INFLEXIBLE GOVERNMENT POLICY OF LAND PRICE REGULATION AND GREAT LOSSES FOR MUNICIPAL BUDGETS DUE TO THE LOW RATE OF EXISTING NORMATIVE PRICES

This is even more common with the prices of courtyard lands. The normative prices for lands of this category are based on the following decisions of Cabinet of Ministers. Under the effective law, the most expensive courtyard lands in the country are in Baku. Baku is itself divided into 12 zones for the sale price of courtyard lands. The current normative price in the 1st zone of the capital is 608 manats and 80 manats in 12th zone. Sumgayit and Ganja cities are split into 6 zones. The normative price per sot in the 1st zones of these cities is 250 Manats, and 50 manats in 6th zones. The highest normative price for other cities and districts is 116 manats and 35 manats for villages. According to the existing law, municipalities can not sell lands for individual house building below the normative price. Nevertheless, there is no restriction for them to sell lands for higher tariffs depending on the demand in their territories. Yet the practice shows that due to a large discrepancy between market and normative prices, municipalities find it profitable to sell lands with market prices and then officialize them with normative prices. The profit is even greater in settlements where market prices of lands are too high. It is clear that there are lands in various parts of Baku which cost a fortune. However, as is seen from the above-shown data, the highest price is 608 manats in the capital city. Under such circumstances of increasingly growing market prices of lands, it is not that hard to imagine the scale of local budget losses: the difference between normative and market prices of lands can be thought of as being a mathematic expression of these losses. The last time that the government heard

normative prices of lands was in 2000, in spite of the fact that prices of lands, especially, those of courtyards, houses and cottages have gone up several times until now. Thus, all these can be perceived as negative implications of the normative-price based evaluation of lands of both state and municipal ownership and non-application of market prices.

II. MAJOR REFORM DIRECTIONS FOR ENHANCED MUNICIPAL REPOSNSIBILITIES AND FINANCIAL CAPACITY IN AZERBAIJAN

Over the short perspective, strengthening municipalities in Azerbaijan presupposes reforms both in administrative and fiscal decentralization.

Administrative decentralization- entails the distribution of responsibilities among the tiers of government for administrative functions in various spheres of public life and their implementation. The idea of assignment of public administration powers to lower levels of government is in line with the subsidiarity principle as incorporated in Article 4.3 of European Charter of Local Self-Governments.

The essence of this principle is «that, to the greatest extent practicable, affairs must be managed as closely to the citizens as possible». But it is equally important for the local self-governments to have enough financial resources in order to implement their functions.

Fiscal Decentralization – means distribution of revenue and expenditure responsibilities among different governmental tiers to execute local self-governance.

We ought to accept the reality which has been forming in developed countries for long years: state bodies should engage in countrywide strategic activities, while totally relinquishing the accountability for addressing local socio-economic problems to the local self-governments. There are a number of perfect approaches with regard to the decentralization trend. For instance, World Bank experts think it would be possible via decentralization to better arrange public service delivery to meet local people's needs. Their argument is that local self-governments are in a privileged position to be aware of local citizens' needs and local specificities. Meanwhile, this trend reduces the number of instances responsible for important decision-making and leads to more accountability of local governments vis-à-vis their citizenry.¹⁴

Thus by taking these arguments into account and summarizing findings achieved via the analysis of existing problems in the fields of administrative arrangement and fiscal capacity of municipalities, we propose the following priorities for municipalities to eventually become

¹⁴ Развитие бюджетного федерализма: международный опыт и российская практика. Мигара Де Сильва, Галина Курляндская. Москва, 2006.

strengthened. Conceptual approaches regarding local self-government reforms are grouped into two blocs:

- 1. Reform proposals for administrative decentralization and strengthened financial potential of municipalities;**
- 2. Reform proposals for strengthened financial potential of municipalities.**

Reform approaches for *Administrative decentralization* and administrative capacity building of municipalities can be introduced under three major dimensions:

- a) Exceptional municipal responsibilities.** Responsibilities of local self-governments need to be full and incorporated in the law.
- б) Expanded municipal competence.** This, above all, calls for the clear definition of *boundaries of the issues of local importance*. In line with the subsidiarity principle, the government has to relinquish issues of local importance to municipalities.
- ж) Enhanced Municipal organization capacity.** A few conditions need to exist to facilitate this initiative. Firstly, the law must determine optimum criteria for the organization of municipalities by the administrative territories. For instance, the greater number of small size municipalities with few people impedes the development of local self-governments as mature administrative bodies. The practice shows that small municipalities have weaker financial potential, which renders the opportunities for better public service delivery limited. Secondly, severe and clear mechanisms need to be introduced to ensure the growing autonomy of municipalities and also prevent external interventions of state bodies into municipal affairs. Finally, having ownership of necessary properties is another prerequisite for their enhanced organizational capacity.

As for the reforms towards the strengthened financial potential of municipalities, two dimensions can be classified here:

- a) Enhanced economic bases of municipalities – includes municipal access to borrowing, especially, loans and creation of necessary mechanisms to manage this process.**
- б) Increased Municipal Fiscal potential – entails more income generating opportunities while enhancing the scope of application of some very special revenue sources (like local taxes and duties) and establishment of an advanced system for interbudgetary relations.**

The particular proposals for reforms are the following for each dimensions presented, both administrative and fiscal decentralization:

I. ALTERING THE ORGANIZATIONAL PRINCIPLES OF LOCAL EXECUTIVE COMMITTEES ACCORDING TO ADMINISTRATIVE TERRITORIES

The recommended option. The centerpiece of decentralization reforms should incorporate the preservation of only local (district or city) executive committees and their boies as structures carrying out the president’s tasks locally. This means municipalities as being the only tier in territorial units such as villages and settlements. Such steps will intensify the process of administrative decentralization. At the expense of the elimination of Excoms’ village representations, responsibilities like statistical registration of citizens, issuance of certificates on their family status and composition, and also renovation of the territory, effective management of educational and health settings in the area will be assigned to municipalities. Besides, such an organization of local self-governance is also economically efficient. Firstly, in this case, local people become directly responsible for the resolution of local problems and identification of local needs. Secondly, the elimination of about 1700 structures will save the government 7 million manats, which are allocated from the state budget (as discussed earlier in the analysis section, the preservation of one village or town representation of the Excom annually requires 4000 manats on average). This is three times more than the funding allocated from the 2006 year state budget for the municipalities and comprises 25% of the total municipal budget revenues. Thirdly, there can emerge a chance for the provision of the public control over the expenditures allocated from the state budget for the purposes of local problem settlement and territorial renovation.

II. PROVISION OF EXCEPTIONAL RESPONSIBILITIES FOR LOCAL SELF-GOVERNMENTS

Municipal responsibilities are not exceptional in Azerbaijan. Under the term of exceptionality, the law regulating responsibilities and status of local self-governments must define three major components – *functions, responsibilities and obligations*, and provide for the clear-cut division of responsibilities among various tiers of government to carry them out.

Functions– indicate the scope of competence of municipalities as defined by the law in addressing issues of local importance.

Responsibilities– are the exclusive tasks to be carried out by municipalities within the capacity of their competence

Obligations– entail municipal rights and privileges to the implementation of their responsibilities within their scope of competence.

If the responsibilities for municipalities had not be defined by the law in this format of scheme, it would be hardly possible to say anything about the exclusiveness of local self-government responsibilities.

The law of the Azerbaijan Republic on the “Status of Municipalities” provides for the *functions*, i.e. spheres within their competence. Under Articles 4, 5, and 6, respectively, of that law, functional orientation of municipalities in the country is confined to three spheres:

- 1) Local social protection & social development;**
- 2) Local economic development;**
- 3) Local environmental issues;**

In general, there are no clear cut norms in the law on “Status of Municipalities” with regard to municipal responsibilities, though there are few defined according to certain functions. That is, in spite of a few responsibilities specified regarding the local social protection & social development (such as water and sewerage farming management, construction and maintenance of local roads etc.), no responsibility is envisaged in terms of municipal intervention in local economic development. Yet it is simply stated that municipalities have interventions into agrarian, industrial, transport and other fields. As for the environmental issues, it is possible to see some clear-cut responsibilities for municipalities: planting of greenery and renovation activities in the municipal territory, refuse transportation, disposal and processing, protection of land, air and water against any pollution. The formidable problem is that no separation of tasks and obligations between state bodies and municipalities has been made with regard to certain responsibilities. Nor are there any legal mechanisms for municipalities to carry out responsibilities they are assigned to. Let’s go through each of these responsibilities one by one:

- 1. maintenance of pre-school education, health and cultural buildings;***
- 2. organization and maintenance of Sanitaria entities, and refuse collection, transportation and processing;***
- 3. House building;***
- 4. Water supply and sewage system organization;***
- 5. Maintenance of historic and cultural monuments;***
- 6. social assistance delivery to the solitary, disabled and elderly in addition to the state programs;***
- 7. Construction and maintenance of local roads;***
- 8. Assistance with people’s employment;***
- 9. Planting of greenery and renovation of municipal territory;***
- 10. Organization of funeral services and maintenance of cemeteries;***
- 11. Assistance with the physical exercise and sports development;***
- 12. Water, air and land protection against any pollution;***

From amongst these, only the responsibility of “construction & maintenance of local roads” has been incorporated in the municipal legislation as being assigned to the municipalities in a sense that state and municipal bodies are labeled in Article 1 of the law of December 22, 1999 on “Automobile roads” as being authorities for road management. Roads are classified as state, municipal and private roads in line with their property status. Article 7 of the document provides that municipal roads are those which are based within towns, settlements and other types of settlements together with streets, crossings and public transportation lines and road devices. Municipal roads ensure automobile and other transportation services within the territorial boundaries of municipalities. According to Article 43 of the law, all road owners, including municipalities must have the roads to which they are entitled registered as immovable properties and get a passport for the very properties in order to formalize their property rights. The responsible agency for the registration is the State Register Service for Immoveable Properties. Apparently, quite a big amount of legal clear cutting has been laid down for municipalities to perform this responsibility. It would be, therefore, interesting to have a look at a sample scheme of the division of responsibilities between state and municipal authorities based on the principle of “functions-tasks-obligations” in the light of existing responsibilities for the maintenance of automobile roads:

Table 7

Municipal responsibilities for Automobile roads operation

<i>Funtions</i>	<i>Tasks</i>	<i>Obligations</i>
Ensure the operation of automobile roads	Construction and maintenance of local roads	Building of local roads
		Restoration of loca roads
		Maintenance of local roads
		Repair of local roads
		Registration and formalizing of local roads
		Tracking of affairs with regard to construction, restoration and repair of local roads based on the operation acts
		Mapping of local roads

It is true that problems related to the maintenance of local roads have not been completely resolved. The full implementation of this responsibility is beyond the current financial capacity

of municipalities. This will be discussed in more details under the section of recommendations for the enhanced financial potential of municipalities.

Let's also have a look at other uncertainties with regard to other responsibilities on the basis of above shown sample scheme. No precise municipal responsibilities and obligations have been provided for in the related legislation sources concerning the maintenance of pre-school education, health and cultural settings and municipal responsibilities for the organization and maintenance of sanitary entities, refuse collection, transportation and processing are laid down in two normative acts: the law of October 26, 1998 on the *“production and daily wastes”* and the law on *“regulations for the cleaning of settlements in line with sanitary, hygienic and environmental rules, temporary refuse preservation, regular transportation and disposal”* approved by decision 74 of the Cabinet of Ministers on April 21, 2005. Article 12 of the law generally provides for the regular refuse collection in and cleaning of the settlement territories, while on the other hand no responsible body is specified for this service. Article 6 of the regulations stipulates that refuse transportation must be performed with isolated trucks and applies this service to the bodies of communal services, which are subordinate to local executive committees. Natural or legal persons interested in refuse transportation and processing can do this only under the condition of signing an agreement with the bodies of communal services.

The similar problem arises in relation to the water and sewage network as well. The 100 percent of equities of this field belong to the state owned “Azersu” Open Stock Company in Baku, while they are at the full disposal of bodies of communal services, which are under the direct supervision of local excoms. The law on “Water Supply and sewage waters” enacted on October 28, 1999 regulates water supply (both for the purpose of drinking and production) and sewage water management. Article 1 of the document specifies local excoms and municipalities as being responsible entities for these systems. Nevertheless, there is no provision of any clear-cut municipal responsibilities, within certain territorial boundaries, with respect to water supply, sewage water management, supply of water to settlements and enterprise for the drinking, industrial, technological, production and other purposes. All sections of the document speak about water supply and sewage entities in an abstract way. Sometimes, it is said that the legislation does not contain any restriction to communal infrastructure building (such as water supply and refuse transportation) by municipalities. The simple provision is that wherever the infrastructures are, they belong to local excoms and municipalities must, on their own, create these in other settlements. Of course, this is a totally false approach. Firstly, if there is any division of responsibilities in a certain field, the boundaries need to be clear cut: should the drinking water supply, or refuse transportation be assigned to the municipalities, it will be municipalities who will exceptionally be responsible for these functions in the settlements regardless of their types. If the government applies a differential approach here, the status of

town and village municipalities needs to be differentiated in the law as well. Secondly, the current financial sources of municipalities do not enable them to create their own communal infrastructure.

The recommended option: So due to the same nature of problems with each of responsibilities shown above, there is no need for further interpretation of the effective municipal legislation. Therefore, by summarizing the mentioned problems, it is recommended that the following steps be taken to secure exceptional local self-government responsibilities:

- 1) Clear-cut definition of municipal rights and obligations to each of the responsibilities as provided for in the legislation based on the earlier presented scheme;**
- 2) Careful assessment of municipal financial needs to facilitate their regular implementation of responsibilities; based on such assessments, municipalities can fulfill their responsibilities either at the cost of their own income sources or state budget allocations.**

The recent Russian local self-government reforms introduced a special scheme for the split of expenditure responsibilities between municipal and state bodies. Based on this scheme, there are 119 functions defined across all levels of public administration, 55 of which are exceptionally federal, 9 for regional government bodies and 12 for the municipalities. The rest 23 are functions that all three tiers are co-responsible in a coordinated way.¹⁵

III. GREATER SCOPE FOR MUNICIPAL COMPETENCE

Along with the provision of exceptional responsibilities for municipalities, there is also a need for the expanded scope of municipal competence or intervention. The question “which responsibilities should be relinquished to municipalities” has been asked more frequently recently. One of the answers to this question is that non-countrywide issues (and also issues that are common for the region) that are bounded with municipal territories should be assigned to municipalities due to the very aim of municipal establishment that people can freely and flexibly address problems that are bounded within their territory and prevent the development. If people have to wait long for the final output of outside decision-making in terms of the repair of the out-of-order power transformer, reinstallation of intra-farming irrigation canals and setting

¹⁵ «Развитие бюджетного федерализма: международный опыт и российская практика. Мигара Де Сильва, Галина Курляндская. Москва, 2006.

artesian for drinking water supply, which are quite of local importance, then the essence of municipalities is distorted as independent institutes.

Recommended Option: the optimal option is to launch legislative reforms to clarify these uncertainties. The scope of exceptional municipal responsibilities and those that are relinquished to municipalities from upper levels of government need to be precisely specified in the legislation of municipal status and responsibilities.

The municipal scope of competence can be expanded via the following:

- Statistical track record and registration of people in the municipal area;
- *Maintenance and management of kindergartens and other pre-school settings;*
- *Provision of public order in the municipal territory;*
- *Organization of refuse transportation and territorial renovation;*
- *Issuance and registration of citizens' status;*
- *Issuance addresses for houses and apartments and giving numbers;*
- *Planting of greenery in the municipal area and maintenance of existing vegetation and parks;*
- *Regulation and licencing of public transportation;*
- *Local amelioration and irrigation systems management;*
- *Lightening streets;*
- *Issuance and giving various certificates to people about their family and property status;*
- *Organization of military recruitment of local youths;*
- *Assistance with the state policy on employment, migration and demographic issues locally;*
- *Organization of utilities;*
- *Organization and maintenance of primary and secondary education and health care premises;*
- *Spotting of low-income people and aid with the state social assistance delivery;*
- Preparation and submission of periodical statistical reports about the socio-economic state of the territory to the state statistics bodies.

Among them are responsibilities, such as refuse transportation, renovation, utilities management and local irrigation systems that need to be exceptional for municipalities. Along with these, the responsibilities for the statistical registration of local citizens, maintenance and operation of

kindergardens and pre-school establishments, military recruitment of local youths should be assigned to the municipalities, which is also a tier of governance. This division must be reflected in the law on “Status of Municipalities”.

In light of the processes mentioned above, the assignment of responsibilities to municipalities can be justified on the grounds of four both theoretical and practical reasons:

- 1.1. Subsidiarity:** Public responsibilities should preferably be exercised by those authorities that are closest to the citizen and the higher authority is to assist the lower level authority in fulfilling its tasks.

- 1.2. Transparency:** These powers are currently split across various higher level state authorities, which require tens of millions of state budget manats for them to fulfill their tasks, whereas the public is quite unaware of the criteria for the distribution of these funds, how much funding needs to be allocated for a given municipality and if these funds are actually incurred for the assignments that they were intended to be. ERC did a mini-survey among the various classes of people living within the municipalities that ERC partnered with under projects. The surveys uncovered that even the so-called community activists were not cognizant of the funding amounts allocated for the purposes of renovation, maintenance of village schools and health facilities. Only three instances – local Excom representative, school headmaster and head doctor of the health care point- have the information about exact sums of this funding.

- 1.3. Formation of Public accountability:** if the public noticed that higher level authorities of government assign the decision-making power in terms of local issues and support them through the possible state budget funding to carry them out, then the sense of collective accountability would be higher. Even in case of limited funding for resolving various problems, people would be tempted to do away with them at their own expense.

- 1.4. Allocative effect:** a number of scholars draw the major attention to the *allocative effect* arising from the decentralization, which advocates for the use of limited resources to first address the primary needs of people. If the affairs are managed as closely to the citizens as possible and their management is handled at a low cost, then the allocative

effect happens. Experts assume that allocative effect is only possible at the highest levels of administrative decentralization, because it is the authorities that are closest to people which can best assess need of local people.¹⁶

Let's review the situation in the light of some responsibilities assigned to municipalities: For instance, administration of pre-school, primary and secondary education systems are under the full control of state bodies. It is in the competence scope of state authorities in the world to define the strategy of and organizational structure for the education system, identify minimum normatives for education financing, carry out control over the overall implementation of state education policy and decide upon curricula and manuals. Nevertheless, the breakdown of the system into maintenance problems of pre-school and secondary education issues comes in contrast with the principle of decentralized governance. Obviously, no space has been left for the locally elected bodies to administer the lowest tier of education, which ultimately causes limited access of the citizenry to education, one of the basic social services, because these services are not implemented vis-à-vis the objective needs of community people, who are consumers of these services, but on the basis of subjective decision-making of individual state bodies. Why should not communities come together to discuss and define on their own the amount of funding necessary for the repair of the school building, and provision of communal services and be able to decide upon public control mechanisms over this funding? The current situation is that the Ministry of Finance allocates appropriations for schools to districts through the local treasury system and based on the approval of local executive committees, these appropriations go to the disposal of regional education departments, which, in their turn, distributes them among schools. The consequence is obvious: millions of manats annually go from the state budget to cover technical and communal needs of schools, while parents across the country are also charged for some under the name of creation of so called "voluntary schooling funds". Having cooperated with various municipalities, ERC experts revealed that there are a number of cases where both local budgets and people are charged for the repair and heating of secondary schools in winter times. Here the noteworthy fact is that state budget resources for these purposes are kept in full secret and in more cases it turns out that these resources have been subject to the corruption at the top level financial canals. Let's have a look at the volume of state budget funding resources directed towards the repair and other communal services over the recent years:

¹⁶ Муниципальные финансы. Хорст Циммерманн. Москва 2003.

Table 8**State budget funds and their dynamics across years for pre-school, primary and secondary schools (in AZN manats)**

Expenditure assignments	2005	2006	2007	Increased by % in 2005 relative to 2007
Heating (fuel) costs	1968	2483	3714	89
Repair and construction costs	3621	4349	5389	49
Total	5589	6832	9103	63

As is seen from the table, the volume of spending for heating and repair of pre-school, primary and secondary education premises has gone up by 63% over the last three years. This might seem insufficient for covering actual expenses. Given total number of 5000 of pre-school, primary and secondary education settings in Azerbaijan, this makes up 1850 manats per setting. It is undoubtful to say that if there is public supervision over the use of these funds, to deviate them from their core assignment and would be less possible and people can mobilize their financial resources, if necessary, towards this purpose.

The recommended option: it is necessary to separate the education process from the administrative management of schooling and the education process (e.g. set up and implement the education policy, control the quality of education, conduct attestation of teachers, methodical management of the work of educational settings, teachers' salaries, publication of manuals etc.) should be under the direct management of the Ministry of Education and its local departments. The administrative management (e.g. repair, maintenance and communal services of the education buildings and other related properties, supply of pre-school settings with subsistence and organize mass events on historic days and during holidays etc.) of the education should be relinquished to the local self-governments. It first presupposes the clear-cut definition of minimal administrative expenditure normative per student (currently, it is based on a different set of minimal normatives) through the criteria of provision level of educational settings with communal infrastructure (power, gas, water, and sewage), number of classrooms and technical condition of the building. In that case, the government should allocate funds to municipal budgets in the form of conditional transfers depending on the number of pupils at schools.

The current situation that there is no public control over the state budget expenditures and services are poorly delivered to the people applies to other spheres where responsibilities are proposed to be assigned to municipalities. These spheres may include several public affairs that are within the competence of local excoms, such as communal services, renovation, refuse collection, street lighting, lift & stairs services in multi-storey buildings, maintenance and repair of houses that are under the authority of the State Housing Fund, last but not least, the maintenance and repair of roads in municipal territories. Let's have a look at the amounts of recent year state budget funds for the above mentioned dimensions:

Table 9

State Budget expenditures to Local Executive Committees for the maintenance of housing and communal infrastructure (Million of AZN Manat)

Year	2004	2005	2006	2007
Subsidies for the maintenance of Housing fund	2,2	1,9	6,0	6,2
Substantial repair of housing fund	1,7	2,1	2,3	2,9
Substantial road repair	29,2	15,0	24,1	41,8
Territorial renovation, Refuse collection & disposal	22,4	25,4	36,1	70,3
Street lighting	1,8	-	2,7	4,6
Total	57,3	44,4	71,2	125,8

As the table suggests, the total volume of spending for the local executive committees to fulfill some of their tasks with regard to the housing / communal sector has increased twice over the last four years, which is three times greater than the total projected municipal budget revenues and 4.5 times than their actual revenues. Nevertheless, the way these funds are distributed across various districts of the country is something that even research experts in the budgeting issues have no awareness of because the budget envelope that the government reports to the public contains this information in a general way. As per decision 40 of the Cabinet of Ministers of March 10th, 2000, on “the fees of houses of state housing fund and approval of tariffs for communal services”, local executive committees shall charge these fees to the people. These fees are termed as service payments for the use of houses of state housing fund (i.e. *house rental*) and maintenance of house properties privatized, refuse transportation and use of lifts. Under this decision, monthly fees to be charged from owners of privatized houses shall be 0, 05 manats per square meter with the fees for refuse transportation being 0.04 manats per capita. The lift fees shall be on a monthly basis with 0.20 manats per person. However, state's statistical

records contain hardly any information about the collection rate from these sources and their expenditure direction. Combined with the amounts that are allocated from the state budget, this is quite a big money turnover. For comparison, it should be noted that this amount is approximately bigger by 50% (90 million AZN manats) than that allocated from the state budget for the purposes of cultural and art development of.

The survey conducted by ERC experts in various municipalities across both Baku and Sumgayit cities that in many cases, municipalities seem to be more proactive in terms of repairing lifts, stairs and roofs of housing buildings than the local executive committees. It should be mentioned that local excoms carry out their tasks related to the communal services basically through the housing and communal services agency.

The recommended option: the first stage of local self-governance reforms in Azerbaijan should start with agencies of housing and communal services taking specific actions towards the elimination of these agencies and assignment of their responsibilities to municipalities. This embodies the adoption of a new Housing Code of the Azerbaijan Republic to replace the Soviet type one that has been effective since 1982. Agencies of housing and communal services are currently governed by this soviet period housing code. The introduction of a new housing code is vitally important from the perspectives of bringing the rights of house owners in line with the new system of relations and changing management principles in this sector. Notwithstanding the fact that most individual apartments in various housing buildings are under the private ownership, the ground areas, where buildings are based, lift, stairs and roofs are public properties. How could it be economically efficient to spend tens of millions of manats to maintain housing and communal service agencies in order to manage these properties? And it happens in the absence of any public control over the use of these expenditures. Be it in developed or transition countries, this problem is conveniently tackled via the privatization of public housing fund. Condominiums are created or unions of house owners are established for this purpose and their activities are subject to the special law. Similar to a corporate property, “*Condominium*” - (a Latin word with «con» meaning joint, and «dominium» *ownership*) –is a form of ownership of land area with the building over it. Once these bodies are established, owners of apartments in the building hold shares and only lose their right to shares when they sell their apartments. Such a type of collective ownership entails decision-making of problems by people living in the building based on simple majority voting. Condominiums sign agreements with various agencies to provide the building with utility services (such as gas, warm and cold water, electricity, lift and sewage) of which people are common consumers. The budget is formulated through shareholders’ payments, grants and in-kind contributions and

shareholders have an independent right to dispose of the budget. This all ultimately results in the formation of collective responsibility. To facilitate the full operation of condominiums, they are granted a certificate by a relevant state body about the status of the building as a collective property. In various countries of the world, municipalities are assigned a wide range of powers to control the operation of condominiums (e.g. if the decisions are based on collegial principle) and the use of expenditures as assigned. If they detect any case of incompliance with the law and regulations, local self-governments address it via the courts. Apparently, the reforms of housing and communal services may lead to the assignment of local decision-making authority in terms of communal issues to municipalities and efficient use of public resources thus relieving the public administration of the unnecessary functions.

Finally, it is worth to review the current status of management of local amelioration and irrigation systems, which is characterized with the lack of funding for the repair and restoration of irrigation canals, acute lack of artesian wells in the areas with no artificial irrigation network, growing land salinization due to the deteriorated drainage canals system. “National Program for the environmentally sustainable socio-economic development of the Azerbaijan Republic”, which was approved by Presidential decree 1152 of February 18, 2003, emphasizes a big concern of gradual deterioration of agriculture-friendly lands of 4.1 million hectares (which comprise 47.7% of the total country area). Of this, 3.6 million hectares have fully eroded, while 1.3 million hectares are slightly, 1.16 million hectares mid and 1.14 million highly eroded. Land salinization poses another challenging concern. Over 1.5 million hectares of land are salinity. There is an urgent need for a more efficient use of funds allocated to develop amelioration and irrigation systems, more flexible management and enhanced activity of municipalities, which, over the recent years, have been successful with getting grants of big amounts from international organizations to renovate irrigation networks in various areas.

The recommended option: under Article 7 of the law of June 5, 1996 on “*Amelioration and Irrigation*”, municipal properties of amelioration and irrigation include irrigation and amelioration systems which are owned by the state, natural and legal persons, but not under the property of the Union of Water User within their territories. Moreover, according to the law of June 21, 2001 on “Municipal Water Farming”, municipalities can set up their own amelioration and irrigation systems. Yet it is clear to everyone that though deteriorated, this system has existed in villages and other settlements of the country since the soviet times. In this case, how logical would it be to propose establishment of alternative irrigation systems by municipalities? Besides, it is beyond the current financial capacity of municipalities to set up amelioration and irrigation systems in areas with no such systems and lead an independent management of these

systems. In fact, there is not an urgent need for the creation by the Amelioration and Water Farming Open Stock Company of Water Users Union, which is simply very strange in the presence of municipalities. It is worthwhile adding that under the contract concluded with this Open Stock Company, these unions will retain 25% of the payments that they charge to the people for the use of irrigation water as service fees. It would seem a reasonable decision under the current circumstances to assign municipalities the responsibilities to manage amelioration and irrigation systems, distribute water among land users and collect water fees from the people given the fact that they are anyway part of the implementation of amelioration and irrigation activities at the request of people and they have expertise in it. Let's have a look at the implemented amelioration activities by those municipalities ERC partnered with:

Table 10

Amelioration and Irrigation activities started and managed by Municipal Initiatives

District	Municipality name	Activity type	Budget	Funding source		
				Donor	Municipality	People
Barda	Muganli	2 artesian wells drilling, installment of a 600 meter water pipe	22550\$	1840\$	1000\$	3510\$
Barda	Khanarab	5 artesian wells drilling	56300\$	45040\$	2500\$	8760\$
Barda	Soganverdiler	3 artesian wells drilling	25000\$	20000\$	2000\$	3000\$
Barda	Mustafagali	1 artesian wells drilling	10000\$	8000\$	1500\$	500\$
Barda	Alachadirli	1 artesian well drilling, cleaning of water ditches	10900\$	8000\$	1000\$	1900\$
Barda	Gazigurdali	1 artesian well drilling	12700\$	7000\$	3000\$	2700\$
Agjabedi	Galabadin	cleaning of water ditches	4000\$	3000\$	1000\$	-
Barda	Garadamirchi	artesian well repair	2000\$	-	2000\$	-
Tar-tar	Ismayilbayli	Water system repair	2500\$	2000\$	500\$	With Labour
Agjabedi	Ranjbarlar	1 artesian well drilling	12000\$	10000\$	1500\$	500\$

In case of the existence of municipal responsibilities in this regard, it would be easier and less costly to collect water fees from people along with the taxes. The point here is that of assignment of state owned amelioration and irrigation systems to the management by municipalities, but not to be municipal property. Given the yearly greater portions of state budget funding for amelioration and irrigation systems, the municipal involvement in this sphere would help to ensure public control mechanisms of these resources. Moreover, the conducted studies reveal a deficiency of information about the amounts of collected water fees and use of state budget resources. People are hardly aware of this information across the areas where the survey was conducted. The table below reflects the state budget funding across several years:

State Budget Expenditures for Amelioration and Irrigation Activities (in Million Manats)

Year	2004	2005	2006	2007
Financing of Amelioration and irrigation activities	39,4	48,6	66,3	114,2
<i>As well as</i>				
Operational costs	31,8	39,4	52,3	75,4
Capital costs	4,7	6,1	8,9	9,3
Procurement of machinery and equipments	2,9	3,1	5,1	29,5

It is undoubtful that if the government comes to imposing this responsibility on the municipalities and they get a real authority on that, it can actively mobilize both local people and international organizations to address any problems with amelioration and irrigation networks. In more cases, both citizens and humanitarian agencies avoid giving any in-kind contributions on the grounds of this sphere being under the authority of state and non-transparent and inefficient use of funds allocated for these purposes. Article 3 of the law on “Municipal Water Farming” provides that state owned water farming facilities can be relinquished to the municipalities on conditions that there a legal basis created with that regard. Amelioration and Water Farm Open Stock Company can outsource its properties with relevant funding to municipalities under specific conditions. For instance, as one of the preconditions of this partnership, the bilateral agreement between the two agencies might contain municipality’s commitment to put aside a certain portion of its budget expenditures for the purpose of improved water farming.

IV. INTRODUCTION OF NEW CRITERIA FOR MUNICIPAL ESTBALISHMENT

This presupposes the elimination of small size municipalities. Nearly 45% or 1257 of all municipalities in Azerbaijan have fewer than 1000 people. Such fragmented municipalities with a small territory and population cause both sparse distribution of both resources (in particular, human & financial) and local self-governance system.

The recommended option: a set of restrictive criteria should be incorporated in the law to create establishment of municipalities in various areas.

1) *Number of Population*: municipalities should not have fewer people than 2000. There are currently 2057 municipalities (74%) in the country with a population of fewer than 2000. It makes up 1.8 million people in total or 880 people per average municipality. According to the estimations, if the requirement of 2000 people per municipality were introduced, each municipality would have an increased number of the population of at least 2200-2300 (due to the fact that new municipalities will appear as a result of the mergence of several municipalities, which presently have over 2500-3000 people). Thus, the ultimate number is 800 out of the original 2057 municipalities. Combined with the current 700 municipalities having more than 2000 people, it would be 1500, which is 1200 municipalities fewer than the current number. According to rough calculations, the proposed way of mergence of municipalities would save the budget 3-4 million manats per year and they can be directed to address social problems of communities.

After these changes, municipalities can be permitted to demerge on condition that they still people no fewer than 2000. there will be no restriction to mergence.

2) *Size of Territory*. Municipalities should have no less than 1500 hectares of land that is under private ownership and could be subject to taxation given the fact that the land is the most stable tax source. The studies show that even if the other tax sources are weak, the current level of land taxes can provide for the operation of municipalities, weak notwithstanding.

3) *Infrastructure*. There should necessarily be facilities or entities that deliver basic social services within the municipal territory as such:

- *Secondary schools;*
- *Health care points;*
- *Communal service delivery entities;*

Once the minimum limit has been applied and municipalities merged, the settlement, which has the most population along with the conditions (such as, administrative building) for a better activity of municipalities, is selected as a central point. To facilitate equal representation of all settlements, merged under a single municipality, in local self-governance, a quota system is introduced for the number of municipal councilors depending on the number of settlements. For instance, individual municipalities will each have one municipal councilor per 100 people. Other incentives can also be utilized to achieve a bigger mergence of municipalities, such as state grants within the following 5 years of re-mergence for those municipalities that reached their population up to 10000 via the mergence and that had had each 4000 people by the time of re-

mergence to implement social projects and also long-term non-interest loans to create municipal enterprises.

V. ASSESSMENT OF ACTUAL MARKET VALUES OF IMMOVABLE PROPERTIES OF PHYSICAL PERSONS AND MECHANISMS FOR THEIR TAXATION

Most of the world countries have immovable property taxes as their main source of income. In some of them, for instance, in the Great Britain, Austria and Australia, this tax holds over a 90% share of the total local budget revenues.¹⁷ The official statistics say that, on the whole, per capita revenues from the property taxes of municipalities in Azerbaijan comprise 0.6 manats. The inflows from properties had a slightly more weight than 2% among the total pool of municipal budget revenues. As mentioned in the analysis part of the document, the major reason for this is that municipalities levy taxes on properties of physical persons based on their inventory prices rather than market prices. The official statistics also point out that the total private properties currently make up 90 million square meters, which indicates that this source has quite a significant potential for taxation. In the event of mechanisms for real taxation, municipalities will have a chance to generate substantial revenues from the properties of physical persons alone. For instance, under the present circumstances, average taxation of 0.01 manat per square meter implies revenues of 9 million manats for municipal budgets, 17 times bigger than the current figure. Calculated based on the current taxation mechanisms, 0.02 manats needs to be charged per square meter of a property with an inventory price of 6000 manats and total area of 50 square meters ($6000 - 5000 = 1000 \times 0,1\% = 1 \text{ manat} / 50 \text{ sq.meter} = 0.02 \text{ manats}$).

The market of properties is considerably dynamic and size of taxation is definitely affected by the market fluctuations, while the inventory price never reflects any market changes in terms of price variation.

The recommended option: a mechanism should be set out to determine market prices of immovable properties and subject them to taxation. Over the recent years in the world, individual pricing mechanisms have been quit and replaced by massive pricing so as to ease the whole process of pricing. The advantage of such a mechanism is that all the properties in the country can be massively priced through the features that have been unified at the lowest cost. Namely, the data stored in a single computer database can help to mass price of immovable

¹⁷ **Налоговая реформа в России: проблемы и решения (Том II).** *Институт Экономики Переходного Периода. Москва, 2003 стр.*

properties. The following is the proposed real mechanism to facilitate pricing as mentioned above:

- 1) **A commission comprised of representatives of State Registry Service of Immovable Properties, Ministries of Taxes, Finance, Justice and Municipal Associations is established to determine prices for properties based on the relevant studies and observations of no more than three years. On top of the decision-making body of that commission, a group of experts is formed consistent of economists, specialists in economic modeling, construction and property issues given several factors in the market affecting property prices.**
- 2) **The single prices per sq.meter of buildings, lands established by the assessment commission are posted and announced via the internet, free questionnaires and municipalities or other administrative bodies in the area.**
- 3) **The assessment commission obtains data from public notaries, bodies of State Registry Service of Immovable Properties and other real estate entities located across various areas. The collected data are fed into the computer database on a regular basis. Moreover, these entities should be legally obliged to constantly report to the assessment commission about the status of property market.**

The key point with regard to price setting is the careful selection of parameters or factors that may have an impact on the prices. These are the proposed set of variables:

- *Number of rooms;*
- *Total area of rooms;*
- *Living area;*
- *Size of kitchen;*
- *Floors of apartments;*
- *Roofs in case of individual houses;*
- *Year of Construction;*
- *Number of floors;*
- *Materials of walls;*
- *Balconies;*
- *Telephones;*
- *Distance from the city centre;*
- *Access to Transportation means (Metro, Railways, automobile road);*
- *Location (city, district centre, town, village);*
- *Year of Pricing;*

It would not be that difficult to create an electronic database and calculation base via the consideration of these variables. For instance, the database may entail classification codes by districts and property types for setting market prices of properties. Each district per se can be sub-classified as center, town and village and separate pricing can be done for each point via the aforementioned variables. It would make much more sense for Baku to have a range of classifications of buildings (such as architectural buildings of the 1920s, soviet time “Stalinka”, “Krushovka”, “Leningrad” and “Kiev”, newly constructions, houses).

As for the price determination for lands, the current classification principle of districts can be regarded as satisfactory, which provides for the classification of Baku and other big cities as one group for their normative prices and attractiveness of lands and other villages and towns as being classified through another set of parameters.

The recent world trend for market price setting is based on the last purchase price of properties, the system that can not function as properly under the circumstances of non-transparent notary affairs. For the rate of property taxes, a differentiating approach is preferential:

- 1) Tax rate of 0.1% in case of constructions with a market price of up to 50000 AZN manats;*
- 2) Tax rate of 0.2% in case of more than 50 000 AZN manats;*

The method applied in Nijni Novgorod city of Russia is interesting from the point of view of assessment of properties based on massive pricing and Azerbaijan can benefit from this experience. There is a characteristic of the immovable properties established in Nijni Novgorod, which contains a full list of properties, both included (with the certified property right) and not included into the register for 8 types of properties (land plots, living houses, garage, constructions about to be finalized, private houses, non-living buildings, garden houses and other properties not in line with this characteristic). Municipalities are fully aware of the number of all properties in their territory, portion of non-privatized ones. For instance, the 2003 year register revealed that there were 278 821 immovable properties in this city and 75% of them or 50 271 had not been privatized. Municipalities draft special schedules for the inclusion of non-privatized properties into the register so that it is clear in advance how many properties will be privatized each month of the year. Based on the comparative sale pricing, mass pricing is done. The essence of the comparative sale pricing is that it takes account of the bargaining or offered price of similar property while establishing its final price based on the data provided by agencies specialized in real-estate issues. Three models are used to set the massive price: pricing of

multistory building houses, individual houses, and land plots, and pricing of commercial and industrial oriented properties. For instance, over the three years, 1500 data sets have been obtained from agencies and in addition to that an expert assessment has been conducted in parallel with the price monitoring by local administrations of immovable properties, the results of which are eventually published in the local media.¹⁸

VI. DISTRIBUTION MECHANISMS FOR INTERGOVERNMENTAL TRANSFERS

As noted in the analysis section of the document, the budget law provides for the distribution of state budget grants to municipalities based on one principle – number of population. These grants are for equalization transfers. There are a number of criteria and correcting coefficients applied in various world countries for the distribution of transfers across municipalities (such as infrastructure, demographic situation, size of area etc). As the official statistics suggest, the legislative requirements are not followed during the distribution of transfer funds in a sense that the size of transfers oftentimes varies twice for municipalities with the same number of population, which denotes the absence of transparency and subjective decision-making in the distribution process.

The recommended option: if the municipalities are under the legal obligation to provide any public services to people, there should first be sufficient financial resources for them to carry out their tasks as properly. **When municipalities can not generate enough revenues from local taxes and duties to cover their expenses related with service delivery in various world countries, the state gives transfers to municipalities. Transfers can be both conditional and unconditional. Unconditional transfers are generally of equalization purposes, which are basically calculated based on 3 formulas:** 1) equalization transfers in case of the mismatch between existing tax base and rates and municipal responsibilities 2) **transfers in case of government decision-making having an impact on the decrease of municipal revenues and increase of their expenditures;** 3) transfers to avoid any increase of expenditures over local revenues. Nevertheless, the calculation of transfer amounts should be based on a particular formula. Which set of criteria can be applied to determine the variation in revenues and expenditure needs? The fair and transparent distribution of unconditional transfers requires a system or formula design with an accurate set of indicators.

Conditional transfers are given with a special purpose attached (i.e. targeting particular needs) and distributed for the delivery of particular services (e.g. road construction, and substantial

¹⁸ **Налоговая реформа в России: проблемы и решения (Том II). Институт Экономики Переходного Периода.** Москва – 2003 стр.

amelioration measures etc). Fiscal transfers undoubtedly continue to constitute one of the dominant shares of local budgets in most developing and transition countries. For instance, this is more than 15% in the Czech Republic, Poland and Estonia¹⁹, while it comprises 20-60% in developed countries, like in France and Denmark being 25%, in Spain 40% and in Great Britain 60%.²⁰ A number of minimum norms have been put in place to identify amounts of transfers in many countries. For instance, at least 4% of total Armenian state budget shall be allocated as unconditional transfers. The equalization transfers in this country are given through a special budget fund. In some other countries, such as in Croatia, an attractive scheme is applied for transfers to municipalities in a sense that individual ministries give conditional transfers to the municipalities to get their problems solved, which is stipulated under a special budget article. Meanwhile, municipalities can get conditional transfers from the Regional Development Funds to improve local infrastructure.²¹ In the case of Azerbaijan, the law envisages the following provisions for the application of transfers:

1) Unconditional Transfers. Equalization transfers are allocated through the consideration of the indicator of “tax effort per capita” in international experience. In this case, per capita amount of tax inflows for individual municipalities is determined and an average indicator is calculated across the whole country. Transfers are then given to those municipalities, which perform lower than this level, to cover the discrepancy between their revenues and expenditures on condition that this discrepancy is caused by a lower tax base. Therefore, the “per capita tax effort” is not determined based on the actual tax inflows, but on estimated (projected) tax revenues. Under the current circumstances, agricultural lands can be taken as a base for the calculation of “per capita tax effort” in Azerbaijan due to the fact that currently the highest amount of tax per hectare of highest quality agricultural lands is 12 AZN manats (Shaki-Zagatal cadastral price region, 1st quality group), while the lowest tax is 1.5 AZN manats per hectare (Gusar-Gonagkend cadastral price region, 1st quality group). As is seen, the difference is around 8 times with regard to one tax alone, which is quite external to municipalities or outside their influence. Besides, the land tax appears to be the only one that is able to be levied by all municipalities across the country. Interbudgetary transfers and inflows from sale of municipal properties exclusive, 60% of the total budget inflows of municipal budgets were due to the land taxes in 2005. The calculation of

¹⁹ «Развитие бюджетного федерализма: международный опыт и российская практика. Мигара Де Сильва, Галина Курляндская. Москва, 2006.

²⁰ «Финансовая самостоятельность и контроль в местном самоуправлении: актуальный опыт». С.В. Вобленко. Москва 2002.

²¹ «Децентрализация фискальной политики в условиях экономики переходного периода, кейс-стади (анализ конкретных примеров) стран Балканского и Кавказского регионов». Братислава 2005.
www.undp.org/europeandcis.

transfers based on per capita tax effort of municipalities can be realized through the following formula:

Formula for Unconditional Transfers based on the calculation of per capita tax effort of municipalities from agriculture oriented lands (arable lands)

$a_i \Rightarrow i$ Total land taxes per cadastral district $i = [1, 19]$

$t_z \Rightarrow$ Size of lands by quality groups $z = [1, 4]$

$v_{iz} \Rightarrow i$ Tax ratio by quality groups of lands per cadastral district

$$a_i = \sum_{z=1}^4 t_z \times v_{iz}$$

$$\left\{ \begin{array}{l} a_1 = t_1 \times v_{11} + t_2 \times v_{12} + t_3 \times v_{13} + t_4 \times v_{14} \\ a_2 = t_1 \times v_{21} + t_2 \times v_{22} + t_3 \times v_{23} + t_4 \times v_{24} \\ a_3 = t_1 \times v_{31} + t_2 \times v_{32} + t_3 \times v_{33} + t_4 \times v_{34} \\ \cdot \\ \cdot \\ \cdot \\ a_{19} = t_1 \times v_{191} + t_2 \times v_{192} + t_3 \times v_{193} + t_4 \times v_{194} \end{array} \right.$$

$$\sum_{i=1}^{19} a_i = \sum_{i=1}^{19} \sum_{z=1}^4 t_z \times v_{iz} \rightarrow \text{Total Land Taxes across the Azerbaijan Republic}$$

$b_i \Rightarrow i$ Per capita land tax in a cadastral district

$p_i \Rightarrow i$ number of population in a cadastral district

$$b_i = a_i / p_i$$

$$\sum_{i=1}^{19} a_i / \sum_{i=1}^{19} b_i = c \rightarrow \text{Per capita land tax across the Azerbaijan Republic}$$

$$T = [c - b_i] \times p_i \quad (\text{total size of transfers per municipality})$$

The formula can be explained in the following way:

a) The “per capita tax effort” of each of 19 cadastral price regions is calculated based on potential land tax inflows from each of 4 quality groups and through the consideration of the tax rate in each of the regions.

б) based on indicators from all the cadastral regions, an average country indicator for “per capita tax effort” is established.

ж) Municipalities with a lower indicator of “per capita tax effort” than the average level are given equalization transfers in proportion to the mismatch between their tax potential and expenditures. The difference between the average level and per capita tax effort indicator of each municipality is determined in order to later calculate transfers per municipality. Once the difference is determined, it is multiplied by the number of population within the territory of a municipality that claims for transfers.

On the other hand, a simple formula can be applied in the case of Baku and other big cities given the absence of agricultural lands: equalization transfers for city municipalities can be calculated based on the indicator of the cadastral price region with the lowest difference from the average level of “per capita tax effort”. According to the results of 2006, per capita tax effort from the lands is 1.5 AZN manats on average across the country, while it is 0.37 manats in Nakhchivan, 0.55 in Absheron, 1.15 in Yevlakh, 0.54 in Astara, 0.53 in Dashkesen, 1.0 in Shamkir, 1.25 in Jalilabad, 2.1 in Balakan, and 2.5 in Barda.

Various types of “per capita tax effort” indicator are used both in developed and transition economies. For instance, gminas in Poland with an indicator of per capita tax inflows lower by 92% than the average level are given unconditional transfers. Transfers are divided into 12 equal portions and given to municipalities within 15th of each month²². Sweden has a more similar approach giving local self-governments (communas and landstings) transfers in case of the discrepancy by 90% in comparison with the average country level. “Per capita tax effort” is based upon the income taxes from physical persons, because it is the only tax which is locally levied.²³

The drawback of the recommended formula: Due to the calculation of formula only based on the land tax, it could be an inevitable practice that financial capacity of individual municipalities will be distorted. For instance, one municipality may have fewer revenues from land taxes, while it has more from other revenue sources. Such being the case, a wealthier municipality may be earmarked transfers, while the other municipality with a smaller revenue base may remain outside the transfers. A certain set of restrictive norms can be used as a way out of this unpleasant situation. For instance, only those municipalities with 50% of total budget revenues that were due to the land taxes in the previous year may be entitled to transfers based on this

²² Польский путь децентрализации. Местное самоуправление в 1990-2004 годах. Болеховице- 2004.

²³ Международный опыт формирования межбюджетных отношений. О.В. Воронцова. www.fpcenter.ru

formula. State budget subsidies, grants and inflows from the sale of municipal properties are not factored into the calculation of total local budget revenues.

Two more alternative approaches can be used to define the indicator of “per capita tax effort” in an easier way. First: three cadastral price regions are selected and an average indicator is calculated for the whole country based on them. The selection of regions is done in the following manner: Cadastral regions with the highest, middle and lowest levels of land tax for the 1st quality group. Under the current circumstances, it is hardly possible to give equalization transfers based on expenditure needs, because the law of the Azerbaijan Republic does not currently have any necessary mechanisms to identify an indicator for “minimum local budget needs”, which should be set on a per capita basis. The essence of this indicator is all the local self-governments regardless of their scale of revenue base have an obligation to deliver public services to people as defined by the law, especially with regard to those services that are under the exceptional responsibility of municipalities.

Second option is that separate formulas are designed for village and city municipalities. In this case, the formula will cover 10 city and 20 village municipalities with the highest tax rate and budget, half of which is constituted by local taxes and duties as stipulated in the law. Amounts of transfers are then defined based on distinctive coefficients calculated through the consideration of per capita tax potential for village and city municipalities.

To avoid any negative incentives arising from unconditional transfers for municipalities, the budget performance can be factored into the calculation of transfers. For instance, if the performance for the previous year taxes was lower than 50%, 75% or 90%, the amount of transfers can be reduced by 30%, 20% and 10% respectively.

2) Conditional Transfers: these transfers are generally with a special target and related with the fulfillment of particular responsibilities assigned by the government to the municipalities. In the case of municipal responsibilities in the fields of health care and social services, per capita needs minimum can be used as a factor for the distribution of conditional transfers. Under the current circumstances, conditional transfers can be allocated vis-à-vis the roads that are at the disposal of municipalities for the common use. Roads of common use are those that are in the central part of municipalities and also that connect adjacent municipalities, but not at the disposal of state bodies. The following approach is suggested for the management of municipal roads via conditional transfers:

a) A separate set of expenditure needs normatives should be in place for the municipal roads. It should be noted that such normatives already exist with regard to the roads that are of republic and local importance and at the disposal of state bodies. Under the “temporary need normatives

for the exploitation of roads of local and republic importance that are in common use in the Azerbaijan Republic” approved by Cabinet of Ministers’ Decision 12 of January 17th, 2006, these roads are classified into 5 ranks and road use needs are differentiated depending on the ranks. According to the decision, the annual exploitation cost of one kilometer of 1st rank roads is 39.86 AZN manats, while it is 7.1 AZN manats for the 5th rank roads. Let’s have a deeper look: the decision characterizes gravel paved roads as being the lowest rank with an annual required cost of over 7 000 AZN manats for use, whereas most municipalities currently have roads in the central parts that are relatively of higher ranks (i.e. covered with asphalt or concrete) and require a lot more costs for maintenance. The total budgets of 70-75% of municipalities in Azerbaijan are inadequate even for the maintenance of one kilometer of the lowest rank roads.

б) 4 types of need normatives are identified for each kilometer of the roads: operational, capital, restoration and maintenance costs.

ж) the periods of operational and capital repairs, as well as, the duration of exploitation for the newly paved roads are shaped into norms. For instance, roads with a capital repair can be used at least for 5 years without any further repair or operational repairs can not be launched within two years of the capital repair.

д) Severe control mechanisms need to be in place to turn over the newly paved or repaired roads so as to avoid any deviation of funds from their original assignments and assure a good quality job. тящвил-тяслими цццн сярт нязарят механизмляри формалашдырылып.

е) a stocktaking of municipal roads with an orientation of common use should be carried out and their full number is obtained for across the country. Municipalities are then granted by the State Register Service of Properties with a certificate of ownership right to municipal roads. Conditional Budget Fund for “Automobile roads” can step in to provide funding for these transfers.

The major objective of this fund established under the Presidential decree of October 12, 2006 is maintain and develop road farming in the country. The main financial sources of the fund are road taxes, excise taxes on imported vehicles and customs duties, and fees from annual technical checkups of cars.

One of the transition economies, Macedonia, applies this practice. There is a Road Fund here, which gives transfers to municipalities via the consideration of 5 factors (number of vehicles, fuel consumption, and density of road networks, size and population of municipalities).

3) Tax-sharing transfers. The review of the world experience shows that tax-sharing appears one of the popular forms of intergovernmental transfers. Under the tax-sharing system, subnational governments receive fixed fractions of revenues from particular national taxes in

line with the normatives as stipulated in the law. For instance, 6.71% revenues of income tax in Poland, 10% in Croatia, 56% in Estonia, 15% in Germany are shared across municipalities. 70% of Income Tax revenues collected from big cities of the Czech Republic, such as Prague, Ostrava, Brno and Plezen are accrued to the budgets of those cities, with the rest 30% being shared with the municipalities in other areas. A number of countries use Corporate Income Tax and Value Added Tax as the basic sources of income to share with municipalities.

In the case of Azerbaijan, Personal income tax (PIT) can be applied for the intergovernmental sharing system in Azerbaijan. The accrual of 10% of PIT revenues to municipalities with the rest 90% going to the state budget can be regarded as a relatively good option. Given the current level of state budget revenues of 550 million manats from the PIT, the municipalities would receive additional 50 AZN million manats in case of the application of proposed tax-sharing normative, which is twice bigger than the total municipal budget revenues in the country.

Mechanisms to implement the recommended proposal: the normatives of tax-sharing should be reflected both in the tax and budget laws and tax sharing should be on the registration basis of persons, which means that the calculated PIT is accrued to the municipality where persons are registered. It is state tax bodies that should levy and transfer taxes to the local budgets. A simple mechanism needs to be applied for sharing taxes: total pool of tax-sharing revenues can be distributed across municipalities according to their role in the formulation of the total pool of municipal shares in the consolidated state budget. To get this system more efficient, it is necessary that there is a regularly updated register for physical persons and that all municipalities have a free access to that register without any obstacles, because of the privileged position of municipalities to check with that register and find out the actual size of work force without any job agreement and report it to the state tax bodies. The major advantage of this system is that municipalities can more easily track activities of persons, who are within their territory. It means that if municipalities were entitled to the shared tax revenues, they would play a crucial role in the legitimization of hidden work force, one of the serious concerns for Azerbaijan as mentioned in reports of various international organizations about the level of hidden economy. The last figure as was announced by the World Bank was beyond 50%, which is of course an assumption and only one fact can be cited to prove its existence: Municipalities possess very limited budget resources and have no other alternative but take maximum benefit from the opportunities they have.

VII. MUNICIPALITIES' ACCESS TO LOANS

The other challenge municipalities face on the way to their development is that they do not legally have any access to borrowing sources. It is enough to say that during 8 years of the inception of municipalities, none of them have taken up a loan. Borrowing is particularly important with regard to the development of local infrastructure and enhanced business potential of municipalities. On the other hand, loans will stimulate municipalities to develop their capacity to work through financial instruments making them create a necessary pool of qualified personnel and intensifying Public-Private Partnership linkages, one of the rationales in various world states to decentralize borrowing powers (across tiers of government) as a step forward in the local self-governance reforms.

The widespread administrative decentralization and assignment of several state powers for engineering, communal and social infrastructure down to local tiers of governance increase municipalities' fiscal needs. Infrastructure projects are generally so costly that can not be covered either from particular revenue sources or transfers. In this case, there emerges a need for long-term fiscal instruments, loans. Even the countries with the same degree of development as Azerbaijan have been successful with designing municipal borrowing mechanisms. The neighbouring Georgia's experience is of interest in a sense that there has been founded Municipal Development Bank (MDB) with the assistance of World Bank.²⁴ The fund gives loans and grants to municipal authorities. The major expenditure priorities of MDB are local investment projects, such as restoration of local sewage, water supply infrastructures, local roads, and renewal of existing communal infrastructures and equipment. The financing mechanisms of the fund vis-a-vis particular projects are as follows: 40% of funding is given as a loan, 40% as a grant, with the rest 20% left to be covered by a municipality submitting the proposal. Yet grants are not given all the time and their allocation depends on conditions (e.g. scope of project, potential of the proposal submitting municipality etc). Municipalities can even apply for loans from the central government with a guarantee of both fund and multiple people. The borrowing from MDB is done under the following terms:

- a)** Immediate coverage of 20% cost-share contribution by municipalities;
- б)** With an annula interest rate of 15%;
- ж)** Repayment of credit within 10 years;
- д)** No repayment of loan within the 1st year;
- ы)** the actual financial capacity of municipalities is reviewed and based on their creditworthiness, the amount of loans is defined;

²⁴ Fondun internet saytı: www.mdf.org.ge

e) There is a ceiling for the borrowing to avoid much wealthier municipalities claiming for loans and unfair distribution of credit resources.

Armenian approach requires initial approval from the relevant ministry in charge of regional administration and municipal issues to apply for loans. These loans are for short-term and intended to timely cover the expenditure responsibilities. They need to be repaid back by the end of fiscal year. If the municipality is planned to fill the next year budget deficit with loans, it has to hand out a clear program about the implementation of its obligation for the loans. Based on that program, the authorized state body keeps constant control over the budget performance of the very municipality. Armenian municipalities can also apply for long-term loans to implement their infrastructure projects. Nevertheless, their amounts shall not be more than 30% of the total budget revenues excluding previous year loans. Municipal properties can not be used as collateral. However, loans do not have a big role in the management of municipalities in this country.

Azerbaijan has large fiscal resources and municipal borrowing can not pose such a big concern in Azerbaijan. True, there is no legal restriction for the municipal borrowing. However, the fact that no municipality has addressed to this funding source over the past 8 years indicates the existence of some problems in this field, which means that authorities should enforce necessary mechanisms to accelerate the process.

What steps can be taken towards the facilitation of municipal borrowing in Azerbaijan?

Firstly, the unavailability of borrowing funds for municipalities in Azerbaijan is attributable to their low fiscal capacity. They are not able to repay the loans both due to the fact that their resources are not even adequate for their operational costs and that financial institutions are not interested in granting loans to municipalities with such a low financial potential. Therefore, the government should urgently address improvement of intergovernmental transfers system and local taxation mechanisms. Municipalities will eventually become institutions that financial bodies will gradually bear trust in, which will relieve the state's fiscal burden in the mid-term and future (during the upcoming 5-10 years).

Secondly, municipalities are not commercial entities and can not get loans under the commercial terms. Given the public purpose orientation of these loans, the government can put forward the following mechanisms for the municipalities to get loan funding under the auspicious conditions: *a) Municipal Bank is established with the capital money based on the state funding sources to regulate the finance-credit relations of municipalities. All the municipalities will have their accounts in this bank and the bank will be fully managed by municipalities. They will all be shareholders of the bank, which will have a Board of Directors of 15 municipal councilars voted*

and selected by municipalities. The board will be selected for a term of two years and rotate for other municipalities to get a chance to be selected. Municipalities with more than 20000 people will have a real vote right to formulate the Board of Directors, while those with less than 20000 will have a nominal vote right meaning that they can come together to vote for the candidate nominated by a municipality with the real vote right. This person is given an authority right via the notary office. In case of such a bank, municipalities will not have problem with getting loans, because the best guarantee for the repayment of loans will be their accounts in the bank: if the repayment is due, it will be immediately charged to the money transferred to the account. The ceiling for the loan rate will be annually set by the National Bank; б) the budget law should envisage the highest limit for municipal borrowing, which could be up to the amount which is equivalent to 25% of total municipal budget revenues excluding state budget transfers. Loans can be for short/ mid and long-terms depending on the priorities of the borrowing; ж) municipal borrowing should exceptionally be investment oriented, and investment priorities should be legally defined (such as, restoration of water infrastructure).

It should be stressed that the establishment of Municipal Bank will also facilitate municipal bonds. Under the current situation very few people will be willing to purchase municipal bonds. The reason is simple: apart from the interest that the bond might yield, there should be guarantee for the repayment of the bond loan. This guarantee can be the very Municipal Bank.

VIII. CHANGES TO LOCAL TAXATION MECHANISMS, AND CREATION OF ELECTRONIC INFORMATION BANK FOR LOCAL TAXATION

Improved local taxation mechanisms. This first and foremost spans fees for local advertisement and parking lots. The legislation should provide for the accrual of fees to municipal budgets from advertisements not only from those that are posted on municipal properties, but also from across the whole municipal territory. As with the parking lots, the local executive committees and other state bodies engaged in transportation should be banned to do this job and this should be the exceptional responsibility of municipalities to both organize and regulate parking lots. There is another challenge with the collection of fees for sanatorium, resort, hotel and other tourism services due to the absence of professional tax service for determining the actual turnovers in these facilities and accurate calculation of the fees, absence of municipal rights to conduct auditing and apply any chronometry. In this case the collection can be done by state tax bodies and revenues accrued to municipal budgets based on the derivation principle.

Electronic information bank for the local taxation. This is very important both for the assessment of municipal transfer needs and financial potential. The bank should be structured as follows:

- 1) Total size of lands of private ownership that can be taxed in each municipality, as well as agricultural lands (by hectares), courtyard lands, privately owned gardens and garages, industrial and commercial land areas (by square meters);*
- 2) Size of private properties (by square meters), and final estimated market price for each square meter of house buildings of various types in the municipal territory;*
- 3) Number of municipal enterprises and their profile of activity;*
- 4) Information about the payers of mine taxes (information about construction materials of local importance that they produce);**
- 5) Size of municipal lands in the stock fund and those rented;*
- 6) Number of car parks;***

* Along with the inclusion of information provided by the municipality about the payers of mine taxes, the information from the state tax bodies needs to be fed into the bank because municipalities oftentimes can not collect mine taxes either because of their vested interests or their incompetence. Therefore an inventory of local taxes and duties should be conducted by the local agencies of the Ministry of Taxes. This information will make municipalities that do not subject tax sources to the budget accountable vis-à-vis both the authority that carries out administrative control over their performance and Accounting Chamber. This is truly paradoxical that a municipality that can not make a good use of its tax resources legally relinquished to it requests state budget transfers.

** the aforementioned proposal regarding the stocktaking of tax bases and inclusion of collected data into the information bank should refer to the car park fees as well.

CONCLUDING REMARKS

The decentralization reforms are inevitable for Azerbaijan. Otherwise, it would be impossible to speak about any political or socio-economic implications of the changes brought about by the best socio-economic programs.

The expert group working out this paper suggest that the best practices of administration occurring in world countries over the last 50 years be brought to Azerbaijan, but of course not doing it blindfold. The reforms should take account of real situation in the country. Therefore

the ideas with regard to reform directions presented herein have been seriously analyzed by considering current realities and possibilities for their implementation. We maintain that if there is enough effort displayed, each of the ideas in this paper can be realistically implemented. Undoubtedly, it presupposes one thing, which is moving up the idea of strengthened municipal institutions in the coming perspective onto the list of strategic priorities of the government. The practice shows that any initiatives of civil society organizations that are not politically backed by the government remain merely unfulfilled.

The co-authors of the proposal firmly believe that decentralization reforms will sooner be launched towards the ends of strong municipal institutions. The reform ideas contained herein may then be very useful and give great contribution to this process.