MODELLING AZERBAIJAN'S FISCAL DECENTRALIZATION: EXAMING TRENDS AND EXPLORING OPPORTUNITES

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Abstract

Finding a proper way of financing in the process of fiscal decentralization is a challenging task facing many countries across the globe. This is also a critical issue in the Republic of Azerbaijan. That is, significant deficiencies observed in local governance financing present one of the challenging problems at present. This research identifies that the key problem hindering the effective functioning of municipalities is closely related to the present form of financing. Through examining available sources of municipal financing in the Azerbaijani context, it is concluded that that there should be more focus on a grant type of intergovernmental transfers with an emphasis on county-specific corrections. The thesis is based on a content analysis of documents, laws and background research, as well as an evaluation of semi-structured (e-mail) interviews conducted with twelve fieldworkers who have been closely involved in work with local governments in Azerbaijan.

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Introduction

The issue of fiscal decentralization presents one of the topical discourses in public policy at present. Decentralizing the economic and political power of the state is currently perceived as a main vehicle to fight the most challenging problems of the present time, e.g., poverty (Tibaijuka, 2007) and local development (Swinburn, 2007), which may be dependent upon many factors. In this respect, finding a proper way of financing is priority number one. In other words, "there is no decentralization without adequate funding" (Marcou, 2005, p., 38). Exploring opportunities for local government financing and choosing a proper model are, therefore, an important issue in many countries' policy objectives.

This worldwide trend is also a critical issue in the Republic of Azerbaijan, which is to say that decentralizing the central state administrations has been one of the important reforms initiated in the country since it gained its independence in 1991[1]. Furthermore, the constitution of Azerbaijan provides the primary legal framework for the decentralization of the state authority and gives special attention to standards on local-self governance. In 1999, the country held its first local elections and, in 2002 ratified the European Charter of Local Self-Government. All in all, the country has established its municipal system and some progress has been made up till now.

However, reports released by country representations of international organizations (e.g., OXFAM, UNDP and Council of Europe) and research conducted by national organizations (e.g., Economic Research Center) demonstrate that there are significant deficiencies hindering the

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[1]There was a conference, "Modeling Azerbaijan's Future: Examining Trends and Exploring Opportunities", in Baku in 2005, dedicated to the most challenging issues facing Azerbaijan, which inspired me to choose this research's title in this way.

effective functioning of local governments in Azerbaijan. Furthermore, the power of municipalities in local service provision is very limited, and majority of local public affairs fall on the responsibilities of the central state's representations, implying that the process of decentralizing the country is very slow. The situation becomes even more pressing when it comes to the issue of subnational government financing. That is, lack of own source revenues and ill-designed intergovernmental transfer mechanisms are the main obstacles challenging the fiscal decentralization process. To be more specific, an analysis of the prevailing trends in the country illustrates that local governments face significant problems, and this tendency is increasingly growing. For instance[2], share of local taxes[3] as overall municipal revenues has been constantly reducing, e.g., from 38.8 percent in 2002 to 18 percent in 2007, which means the most autonomous way of local financing, i.e., local taxes, presents only a tiny proportion of revenues. Another critical situation observed in subnational financing is related to the central government allocations, which constitutes a small share of the central budget expenditure, e.g., 0.05 percent of the whole budget spending in 2006. Moreover, grant allocations to municipalities have been continuously decreasing, and as a consequence of this increasing trend, the central budget allocations to municipalities have become "less prioritized" share compared to other sides of inter-budgetary allocations, e.g., from 4.7 percent in 2004 to 1.8 percent in 2008. Under such circumstances, municipalities are hindered in fulfilling even their basic mandatory functions. Some municipalities are not even capable of paying the salaries of their staff. In sum, this short description shows that the situation is critical and requires carefully examined solutions.

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[2] The figures presented here are taken from data provided by State Statistics Committee and Economic Research Center, to be analyzed in-depth in the Second Chapter.

[3] In Azerbaijan, the law on municipal finance defines that the rates and bases of the locally assigned taxes fall on municipal responsibilities, and collected by municipalities.

There have been few attempts to analyze the problem facing the local government system in Azerbaijan from various viewpoints. For example, Agayev *et al* (2007), through identifying the key issues present in the country, offer a package of solution with the purpose of reforming the entire fiscal decentralization system. Or Mikaylov (2007) examines financing problems and emphasizes the application of tax sharing as a solution.

This research can be considered an important source in examining essential problems and issues in the municipal system of Azerbaijan. However, less practicality and applicability of the solutions they offer are the main drawbacks of their methodologies. In other words, the drawbacks appearing in the background research are that they focus on changes of the overall system and offer application of concepts, e.g., tax sharing, which are not feasible in the present situation existing in the country.

This research intends to evaluate the existing problems in the country by exploring not only the current status of local government system but also fiscal architecture of Azerbaijan, with the purpose of learning its characteristics and identifying key problems and options for designing a better system of municipal finance, with an emphasis on the grant allocation system. More specifically, the research focuses on financial aspect of problems, and offers more practical and applicable model of municipal finance fitting Azerbaijani context at the current situation.

The thesis argues that in Azerbaijan where significant share of natural resources, industry, ninety percent of tax revenues of the central state budget and eighty five percent of GDP are concentrated in the capital, the main source of local government financing should be central budget grants. Furthermore, under this circumstance, the reform with a focus on financial side is less challenging task than the reform of the overall system, and it may seem more attractive to the central government at the present time.

To achieve this purpose, existing international definitions and classifications will be the main tools and indicators to assess and identify the root of the problems on subnational financing. These classifications (e.g., LGI publications) are invaluable sources of indicators and tools for assessing the challenges facing the local government financing and formulating a comparative approach, based on other countries' experiences, for a better design of Azerbaijan's subnational financing. In examining Azerbaijani context, this thesis will be based on a content analysis of documents, laws, background researches and reports on the local government system in Azerbaijan. These existing materials can not be a sufficient enough in examining a "real" situation because of two reasons. First, they lack valuable information about realities in place in the country. Secondly, they have already been explored in previous researches. For this reason, additionally, semi-structured interviews (e-mail) have been conducted with twelve fieldworkers who are closely involved in work with local governments in the country. More specifically, this list includes interviewees who have experience in project implementations of national and international organizations with municipalities, as well as who have been a part of teams in preparing reports and researches on various aspects of local governance system in Azerbaijan.

Based on the above-described methodology, the thesis will be comprised of three chapters. The first chapter of the thesis is devoted to examining the issue in general by exploring the existing literature on local government financing. The second chapter will firstly evaluate Azerbaijan's fiscal architecture and the general situation on the present status of local government system. Secondly, challenges facing the system of subnational financing, current trends, and overall findings of the research will be summarized in this chapter. The third chapter will combine the first and the second parts with the purpose of identifying more appropriate form of subnational financing in Azerbaijan. More significantly, through examining unexplored

opportunities modelling a proper intergovernmental grant system fitting into Azerbaijani context will be developed here.

Chapter 1: Financing Local Government: Theory and Practice

1.1 Financing Local Government (FLG): Brief Overview

The issue of financing local governments is a central question facing many countries around the world (Bahl, 1995). Designing an effective fiscal decentralization model is greatly dependent upon finding a proper form of financing, which, in turn, may include a wide range of dimensions, e.g., own source revenues, subnational borrowing and intergovernmental transfers.

Of these, *own source revenues* are considered a priority in ensuring local autonomy and, as Ebel argues (2007), it is essential to a system of local self-government. Furthermore, the presence of a well-developed own source revenue system would constitute an ideal form of fiscal decentralization. This can be observed in countries that have locally developed business activities and properly designed intergovernmental relations, e.g., Scandinavia (Davey and Peteri, 2004), which is not always the case across the globe.

The traditional theory of fiscal decentralization, referring to the importance of own source revenues, stipulates certain standards for local revenues (e.g., less administrative efforts and less distortionary effects if dealt with locally, and levied on local residents), which are not too many in practice (Martines-Vazquez and Boex, 2005). Under these rules, the taxes that fall on local governments' discretionary control may include property taxes, some excise taxes, betterment levies, some users fees, taxes on vehicles, etc. (Bird *et al*, 1995). This implies that even though they are a key foundation for fiscal autonomy, they can not be sufficient enough to provide effective municipal financing, which, in turn, urge countries to seek other forms of financing.

While *subnational borrowing* constitutes one of those forms to complimentarily support municipal financing (Bobcheva, 2007), there are many constraints for this. In general, subnational borrowing can take two forms, i.e., borrowing for capital investment and borrowing for service delivery. It should be stressed that classic fiscal federalism theory suggests that borrowing should be used only for the capital investments[4], and "using it for current expenditure needs is acceptable only in specific cases, e.g., for short period of time, to cover deficits from uneven cash flows within a budgetary year, etc. (Swianiewicz, 2004a, p., 7). While borrowing for capital investment is a common trend observed across the globe, in some countries the law does not limit the purpose of borrowing (e.g., the Czech Republic, Hungary and Poland), which is to say that subnational borrowing can be used for operational purposes when local revenues are not enough to support service delivery (Swianiewicz, 2004b). However, giving more space to subnational borrowing may substantially cause macroeconomic stability, e.g., decreasing the central government's control on macroeconomic management. The experience of transition economies suggests that using more subnational borrowing can be more risky in their cases, as they lack sound macroeconomic stability. Given this nature of local borrowing, it can be concluded that this form of FLG is hard to be widely employed in many countries, particularly in transition economies.

As this analysis shows, the constraints in intergovernmental fiscal relations leave a great need for *intergovernmental transfers*. To put it differently, intergovernmental transfers are an important policy tool to address fiscal imbalances that are inherent in any system of fiscal decentralization (Ebel *et al*, 2007). This is a major form of FLG even in highly decentralized countries, e.g., Great Britain (Davey and Peteri, 2004). While the lessons learned from

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[4] Musgrave (1959) defines it as a "golden rule", and argues that it should be strictly observed. For further analysis, see Swianiewicz, 2004 a.

decentralization trends across the globe show that there is no best transfer model that would fit every case, there are general guidelines and principles to be considered in designing transfers systems. This chapter will look at how the theory explains the characteristics of intergovernmental transfers, as well as draw some lessons from different countries' experiences.

1.2 Intergovernmental Transfers: Theoretical Background

The chief goal of intergovernmental transfers is to bridge the gap between the expenditure and revenue assignments of local governments (Ebel *et al*, 2007), and to ensure local fiscal autonomy (Peteri, 2008). This implies that intergovernmental transfers are of great importance in the discussion of fiscal decentralization.

More significantly, a variety of factors associated with demographic, economic and institutional trends (hereinafter: fiscal architecture) prevailing in any county are the main features generating a great demand for intergovernmental transfers[5]. To expand it a bit more, Ebel and Wallace (2007) argue that demographic characteristic (e.g., household composition, population growth, etc.), the structure of the economy (e.g., variations in sectoral developments, distribution of natural resources, etc.) and institutional trends (e.g., existing social system, quality of tax administrations, etc.[6]) vary largely within a country. The variations affected by fiscal architecture may occur in two forms: vertical and horizontal (Bird and Talasov, 2002). While vertical imbalance refers to a gap existing between central and subnational governments,

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[5] Demographic, economic and institutional factors are the main pillars defining "fiscal architecture", for further analysis see Ebel and Wallace, 2007.

[6] In general, intitutions can be divided into formal and informal ones. The former includes, for example, quality of service delivery administrations, social systems and the latter implies local culture, traditions, etc. For further analysis on institutions see Timothy J. Yeager, 1999.

horizontal imbalance implies the differences among similar levels of governments (Martines-Vazquez and Boex, 2005). Besides these "natural" conditions, some practical concerns are also among those factors that generate imbalances. For example, on the basis of the classical theory (The Theory of Public Finance) of Musgrave (1959), McLure and Martinez-Vazquez (1999) argue that two main functions (macroeconomic stabilization and income redistribution) of governments will achieve desired objectives if assigned to central government. That is, the center as the main body controlling the two main functions of the government regulates many issues with respect to revenue assignments in its boundaries. In other words, while the central government has control on the country's most productive tax bases, more expenditure responsibilities fall on local governments, and this is because the existence of vertical imbalance is almost always the case around the world (Ebel and Peteri, 2007). Another area of practical concern is related to horizontal imbalances, which has mainly to do with policy considerations (e.g., more nation-wide focus on agricultural development may favour one region more than another, generating more revenue for the SNG located in that region) that cause differences among similar tiers of governments. The above-discussed aspects of fiscal decentralization illustrate that both fiscal architecture and some practical concerns create inevitable space for intergovernmental transfers. Intergovernmental transfer is, therefore, a predominant form of FLG in many countries, e.g., 65 percent in Italy, 60 percent in Spain, 88 percent in Lithuania and 81 Estonia (Peteri, 2008; Dexia, 2003, see Appendix 1).

In theory, intergovernmental transfers may take a wide range of forms such as shared revenues, grants, subsides and subventions (Bahl, 2000), the main purpose of which is to bridge imbalances and increase financial capacity of local governments. Of these, *revenue sharing* is considered a more efficient way of subnational financing, as it gives more ground for revenue

stability and budgetary predictability for SNGs (Bahl, 2000). The term implies that tax collected by one government is shared with the subnational governments, chiefly based on the geographic origin of the revenues (Bird *et al*, 1995). Moreover, in tax sharing local governments lack a discretionary power on both tax rate and base. This, however, is considered the most decentralizing way of revenue sharing because of the opportunities it offers for local governments (Bird *et al*, 2002), e.g., broader access to local revenues (Beesley, 2008), certain level of local control on taxes collected locally by favoring/disfavoring some local policies (Dunn and Wetzel, 1998), etc. Therefore, tax sharing is common in some successfully decentralized countries. For example, the proportion of shared taxes as the percentage of local revenues constitutes 78 percent in Lithuania, 43 percent in Estonia and 42 percent Slovenia (Peteri, 2008; Dexia, 2003, see Appendix 1).

What, however, should be highlighted is that tax sharing may undermine the central government's flexibility in some cases, as it has fixed rules for a certain period of time, and the center may be become less sensitive with respect to periodic tax enforcements, as it may be less interested in further tax efforts, since a fixed share of the taxes constantly goes to SNG (Bahl, 2004). Besides, there are some more practical considerations that can undermine applicability of tax sharing, which are discussed in the forthcoming sub-section.

1.2.1 Practical Considerations Undermining the Efficiency of Tax Sharing

As described, tax sharing is based on a system where tax originates[7], more reliance on which is hardly feasible in some cases. For example, the lessons drawn from CEE countries' experience suggest that the application of tax sharing is the least policy option to be employed when a country has a high concentration of the economy only in certain regions. In this case, as Fox puts it (2004, p., 150), "revenues from shared taxes are concentrated in highest income (or other tax base) areas, because less affluent places have less capacity to meet their responsibilities". In Hungary, for example, where PIT sharing has a derivation-based system, per capita allocations of share differ largely, e.g., in 1995, while the average local government received less than HUF 4,300, Budapest collected HUF 18,300 per capita from PIT shared revenues (Fox, 2004). To put it differently, when in some regions local governments can not derive revenues because the majority of the residents earn incomes that fall below the taxable income, e.g., the case of Hungary (Bird *et al*, 1995), or the majority of the residents is involved in the informal economy, e.g., the case of Azerbaijan[8], implying that they do not pay taxes, the application of derivation-based tax sharing is not feasible. Besides, more weight on formula-based sharing may panelise richer regions, in which the growth potential is greatest, e.g., in Russia fast growing areas may simply reject the revenue sharing system if a great portion of the resources are taken from them (Bird *et al*, 1995). While a surcharging system may cover the weaknesses that the above-noted options contain, e.g., a good example is Scandinavia (Bird *et al*, 1995), however, it seems less applicable in some transition countries, where assigning SNG to have a discretionary power on

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[7] Tax sharing takes three chief forms: a derivation basis (taxes are retained by SNG in which they are collected, a formula basis (based on per-capita income, population, etc. factors) and a surcharging system (also called "piggybacking" referring to levy local surcharges on national taxes). For further analysis see Richard M. Bird *et al*, 1994.

[8] It is based on the analysis of the interviews, to be broadened in the second chapter.

the tax rate may cause macroeconomic instability (Kandeva, 2001), and increase regional disparity. All these considerations imply that under some circumstances tax sharing may not be an efficient form of FLG, which is to say that the system may make wealthy wealthier and poor poorer.

In sum, evaluations examined in sections 1.1 and 1.2, conclude that own source revenues apparently can not be considered a sufficient foundation for subnational governments to fulfil the locally assigned service provision, which requires a great need for intergovernmental transfers. More importantly, while different forms (especially revenue sharing) of intergovernmental transfers are of great importance, intergovernmental grants deserve special attention, particularly in countries in which the application of revenue sharing is less feasible. The following sections of this chapter will focus on the essential aspects of grant type of intergovernmental transfers in both theory and practice.

1.3 Rationale for Grant Allocation

The above-discussed nature of fiscal decentralization demonstrates that along with other forms of local financing, a grant design system is an essential factor particularly in countries in which other sources of revenues face significant challenges. For example, in fragmental municipal systems (e.g., the Czech Republic and Hungary), the existence of many small local governments, which lack a sound tax base, urges a need for greater grant allocation (Peteri, 2008). Or if there are specific regional development programs within a country, then special attention should be given to grant distribution, e.g., in Sudan different regions receive different

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amount of grants, depending on the development priority of the center (Bell, 2005), which equalizes infrastructure needs of the target areas.

It should be underlined that in some cases a grant system may become complicated hindering effective functioning of the system, e.g., the cases of Indonesia, Australia and Hungary. Extreme care should be taken in organizing the allocation system, e.g., in Serbia the grant distribution system's success is attributable to sound administrative arrangements. That is, it is extremely important to have simple and predictable allocation system.

Furthermore, a grant design system, independent of its case-specific nature should, as Ahmad *et al* (2002) put, be supplementary to own source revenues and harmonize less developed areas. To put it in another way, there are three fundamental principles involved in grant distribution systems: motivation for efficient local spending, guarantee for managing local services and support for regional equalization (Ebel and Peteri, 2007). This, in turn, implies that a grant design system plays a significant role in FLG. As a case in point, central government grants constitute a substantial share of the local revenue in some successfully fiscally decentralized countries, e.g. 59% in Poland, 44% in Hungary and 38% in Estonia (see Appendix1). All in all, the above-discussed nature of grant allocations demonstrates that this is an important tool to correct imbalances and to ensure fiscal autonomy of SNG, all of which increase the process of fiscal decentralization further.

1.4 Forms and Types of Grants

To achieve the desired objectives, a grant distribution may take a wide variety of forms depending on its target areas and its case-specific characteristics. Generally, channelling grants to local governments can be structured in tied (giving control to the center on how to spend the allocation) and untied (giving a discretionary power to SNG on the usage of grants) manners (Searle, 2000). This implies that in the discussion of grant design systems a central question to identify is that whether it is based on conditionality or unconditionality. Furthermore, unconditional grants (also called "general purpose" grants) allocated on an annual basis chiefly intend to achieve equalization purposes by leaving the spending priority to the discretionary power of the SNG. Conditional grants (also called matching/specific purpose grants) are a specific contribution by the central government to provide SNG with the purpose of meeting the center's priorities[9]. To put it in another way, general purpose or unconditional grants aim to reduce horizontal imbalances, and special purpose or conditional grants intend to focus on national priorities (Ahmad and Searle, 2005).

Before moving on to focus on specific grant types, it is worthwhile to briefly touch upon some considerations about the above-specified forms of grant allocation. That is, several practical considerations suggest that some conditionality in grant allocation may provide better outcomes, as the central governments have a legitimate interest in having a certain degree of control in spending the earmarked shares (Bird *et al*, 1994). The issue of transparency on spending grants and challenges associated with administrative capacity of SNG to effectively use the allocated amount are among those practical considerations urging the center to pose some

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[9] For further analysis see Martinez -Vazquez and Jameson Boex, 2005.

conditionality in any grant design system. This is especially important in some transition countries in which, for instance, local institutions are too weak to independently administer the allocated grants. For instance, the more weight given to unconditional grants in case of Hungary, Romania, Russia and Ukraine demonstrates that the system has not been effective in producing better outcomes (Bird *et al*, 1995).

On the contrary, a general tendency observed around the world is that there is a gradual shift from conditional to unconditional grant systems particularly in highly decentralized countries, e.g., Australia, Canada and Indonesia (Searle, 2000). That is, unconditional grants may work more effectively in countries that have achieved a well-designed intergovernmental financing, e.g., the existence of strong local institutions. This, in turn, implies that giving more space to conditional grants is important in early years of decentralization.

Speaking of specific grant types, there are several models for grant allocation with varying country-specific corrections, which deserve special attention to be further specified. Ebel and Peteri (2007) classify three main models: *gap-filling model, hard budget constraints model and fiscal capacity based method.*

In the gap-filling model, the share is equal to the variations between the estimated degree of expenditure and the local revenues (E-R=G). Though its centralizing nature, the experience of some transition countries demonstrates that this model may work well through the incorporation of some modifications, e.g., Bulgaria and Slovenia.

In the hard budget constraint model, the transfer equals the sum of the locally generated revenues and grants made available for the local governments (R+G=E). Based on formulae (e.g., population size, number of users of municipal services, etc.) and unconditionality, this model is used in Hungary, the Czech Republic and Poland.

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In the fiscal capacity based method, a formula-based grant is distributed to SNG on the basis of estimated difference existing between the nationally determined expenditure assignments and the SNG's capacity to mobilize own source revenues based on nationally identified revenue bases ($E_{\text{estimated needs}} - R_{\text{potential}} = G_{\text{calculated}}$) (see Appendix 2). The Advantages of this model is its focus on potential local revenues in addition to calculating local expenditure, implying that SNG with high revenue potential will receive less grant, which in turn serves more for the purpose of equalizations, leaving less place for abuse, e.g., there have been some trends in Hungary and Poland in this direction with the purpose of standardizing the revenue aspect of formulae in grant allocation.

Speaking of the characteristics of the above-specified models, it should be emphasized that the first model may undermine local accountability and lead to constant dependence on transfers. What, however, should be highlighted is that, as above noted, this model, based on some improved techniques (e.g., paying special attention to the issue of transparency) may provide an effective outcome. In Slovenia, for example, grant allocation based on this model (21.5 percent of local revenues in 1998) works in transparent and objective manners (Setnikar-Canka *et al*, 2000). Or in Macedonia the application of this model through simple formulas (the local government that has primary schools receives a certain amount per municipality, plus an additional amount calculated on a per pupil basis, weighted by the population coefficient density) has produced some achievements (Peteri, 2008). While the *gap filing model* leaves less space for conditionality, its simplicity in terms of both the calculation and the allocation of grants is the advantage that can be utilized by some countries through country-specific modifications.

The second model's unconditional nature and its incentive for motivating local governments to be constantly interested in generating own-source revenues is the advantages it

has. For example, in Hungary a wide range of normative grants based on this are used by municipalities for any purpose (Fox, 2004). There is, however, the issue of complexity in this model. In Hungary, distribution mechanisms for local governments are determined on the basis of 90 sophisticated indicators, each of which gives various weights, resulting in high complexity (Peteri, 2008). What, in general, should be highlighted is that this model increases local autonomy by giving a discretion power to SNG to independently use the earmarked grant and local tax effort by considering many factors, e.g., revenue side, nationally set standards, etc.

The third model, *fiscal capacity based method* emphases on expenditure needs and own source revenue capacity, which, in turn, is the most advantages part of this model, as it considers wider factors, and give less space for abuse. Moreover, since this model focuses on the calculation of revenue potential and expenditure needs, this can be considered a better option in terms of both the revenue efforts it gives to local government and equalization purposes it intends to achieve. This is because it is one of the frequently observed models in highly decentralized countries, e.g., Canada, Indonesia, etc. Even tough, this model requires a well-developed mechanism for standardized estimates of expenditure needs, which can be hardly achieved in newly decentralizing countries, it is the best option to be employed in countries where the issue of regional equalization is extremely important.

All in all, the above-discussed nature of the models demonstrates that choosing a model is greatly dependent on characteristics a country has. Moreover, they can provide an effective outcome if adapted well to country-specific characteristics.

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1.5 Key Issues and Options in a Grant Design System

Besides the specific models discussed above, it is worth briefly exploring some general issues and options for an intergovernmental grant design system. In this regard, an initial step to be taken is to define the issue of standardization based on which grant allocation mechanism works. That is, independent of the size of a grant pool aiming to achieve equalization, some standards should be developed, whether it is minimum, national average or nominal standards, e.g., equalization in Australia based on national average, regional minimum standards in Canada (Searle, 2000). To put it differently, defining measures with the purpose of narrowing down economic disparities among regions is a key issue, e.g., the measurement of fiscal capacity and fiscal needs. Careful consideration of both factors is an important aspect of a proper grant design system, which is to say that in some cases fiscal capacity (which refers to potential revenue capacity based on an average level of effort) can not be a good representative of disparities, and there is a need to consider other factors, such as fiscal needs (it implies that variations among regions can be affected by geographic, demographic, etc. factors, e.g., a region with higher poverty rate allocates more money for social services) (Martinez-Vazquez and Boex, 2005). This, in turn, defines the *fiscal gap* that is a better representative in measuring and defining more needy regions, calculated by the following formula:

Fiscal Gap = Fiscal Needs – Fiscal Capacity – Targeted Transfers[10]

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[10] For more analysis see Martinez -Vazquez and Jameson Boex, 2005

Considering these factors is an essential aspect to ensure the effectiveness of the system in diverse countries. In the USA, for instance, the application of Representative Revenues System (RRS) solves the problem of huge economic disparities among regions[11].

Another key option to consider is the target of the grant mechanisms. That is, in a country that has less variations in service delivery across its regions, *equalization over revenues* would be an effective way (e.g., Canada),   while equalization over need would be effective in a country that has more own-source revenues (e.g., Scandinavia) (Ahmad and Searle 2005). As the discussion, in the sub-section 1.4, on the grant allocation models demonstrates combination of both expenditure and revenue sides in grant distribution can be more appropriate way in countries that have neither enough own-source revenues nor equal level of quality in service delivery among regions, e.g., most transition countries fall on this category.

Another central question is how to ensure the effectiveness of a system in working with many governments. In other words, the larger the number of the governments, the more complexity is observed in the system (Searle, 2000). The lessons learned from many countries' experience illustrates that the issue can be handled in two ways: either through an independent commission or through a proper government agency (Ahmad and Searle, 2005). In case a grant allocation is dealt with by a government agency it can undermine neutrality, transparency, and overall effectiveness of mechanism, it is especially true in transition economies where the issue of governance in general faces challenges. A separate grant commission works effectively if it is provided with wider discretionary powers enabling it to independently judge the situation, e.g., in Great Britain, Australia, etc. (Ahmad and Searle, 2005).

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[11] RRS calculates the amount of revenue that a region can collect when it applies average fiscal effort. The system is comprised of five components: 1) determination of revenue coverage, 2) classification of revenues into sources, 3) definition of standard tax bases, 4) determination of average tax rates, 5) the estimation of fiscal capacity (Martinez - Vazquez and Jameson Boex, 2005).

It also is worthwhile to mention that the legal foundation is a key issue in all these arrangements, the effectiveness of which can be ensured by primary and specific legislations. That is, while important notions such as the bases and targets of grants should be enshrined in primary law, a certain level of flexibility in the amount and allocation mechanisms can be stipulated in secondary laws, e.g., in Indonesia (Searle, 2000). This, in turn, implies that there should be constant modifications in grant systems depending on the developments appearing in a country, which is to say that giving more or less periodic weight to grant allocation and periodic specifications in grant allocation systems may contribute to FLG.

Chapter 2: Examining Opportunities and Trends in Azerbaijan's Local Government System

Before designing any aspect of FLG, it is important to explore problems and trends prevailing in a country in a broader context, as it is a foundation to analyze country-specific realities. Moreover, it is important to have a wider approach to intergovernmental relations (expenditure and revenue assignments, and intergovernmental transfers), as they are closely inter-related (Popa, 2001). This chapter will focus on Azerbaijani context of intergovernmental relations, with an emphasis on evaluation of problems and challenges present in its municipal system.

2.1 Fiscal Architecture of Azerbaijan

An initial step in modelling a proper local government financing form is to examine characteristic nature of fiscal architecture of a country. It is, therefore, necessary to shortly explore Azerbaijan's demographic, economic and institutional realities, which may provide an important vehicle to capture the overall situation with respect to FLG.

To start with, an immediate observation that can be made in the country's demographic situation is that there are some disparities in population growth and movements. That is, urban population grows much faster than rural population (e.g., from 52 percent in 2000 to 64 percent in 2015, USAID - Making Cities Work, 2000) and rural-urban migration has been continuously increasing (World Bank Country Brief, 2007). The implications of such disparities mean that municipalities in rural areas tend to lose their labor force and income sources affected by their

residents' movements. Apart from that, another prevailing situation is related to the fact that some regions are overpopulated by temporarily residing internally displaced people (IDPs). For example, cities such as Sumgayit (44,084 people), Mingachevir (18,004 people) and Ganja (15,359 people) face challenges with newcomers (State Committee on Refugees and IDPs, 2005). What, in theory, this implies is that the municipalities in these regions are obliged, for instance, to spend more on social services.

Regional disparities become more pressing when it comes to the economic characteristic of fiscal architecture. In other words, the distribution of natural resources (exports driven from oil constitute 69.2 percent of GDP) and industrial sectors (59.1 percent of GDP) of the country (State Statistics Committee, 2007) are hugely concentrated in the capital and its surrounding. Besides, during last few years the majority of the newly created jobs have been opened in the capital (57,364 out of 352,405 new jobs created from 2003 to 2006, Statistical Yearbook of Azerbaijan, 2007). More significantly, ninety percent of tax revenues of the state budget and eighty five percent of GDP are raised in the capital (Agayev *et al*, 2007). In principle, these four basic indicators imply that the capital has much wealthier income sources.

Additionally, interviews conducted with the fieldworkers reveal that two important practical considerations deserve special attention[12]. First, majority of population in rural areas are involved in informal economy, e.g., farming and some traditional forms of non-farm economy, which is to say they do not pay taxes, particularly income taxes. Secondly, central government's periodic regional development priorities (e.g., tourism development) overload municipalities' services in respective regions, e.g., a special focus on tourism development in southern part of

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[12] As mentioned earlier, in exploring the Azerbaijani context of municipal finance, this research is also based on the evaluation of the interviews with twelve fieldworkers who have been involved in work with different aspects of municipal system, the results of the interviews are shown in this and the next chapters.

the country, without proper changes to SNGs' revenue assignments. All in all, the above-discussed aspects of the economic structure of the country illustrate that imbalances are high among regions.

The analysis of the last component of fiscal architecture, i.e., institutions, shows that there are two main trends observed in this respect. First, significant institutional challenges (the issue of transparency, corruption and bureaucracy) facing governance at both national and local levels cause enormous obstacles for intergovernmental fiscal relations[13]. Furthermore, highly centralized public administration, limited municipal autonomy and inflexibility observed in the central government's arrangements in work with municipalities are frequently observed institutional factors present in the country (Agayev *et al*, 2007). Another side of this has to do with informal institutions, as the results of the interview reveals. That is, lack of local public participation traditions in decision making creates more space for abuse of the locally assigned revenues in the country.

In sum, the brief analysis of fiscal architecture of Azerbaijan demonstrates that there are huge regional disparities. Moreover, this country-specific analysis demonstrates that it is important to carefully consider the realities of fiscal architecture in designing the country's intergovernmental fiscal relations. The next section assesses the present status of Azerbaijan's municipal system, with the purpose of identifying the key problems and examining how the above-described realties are reflected in the current system.

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[13] According to international organizations' reports, Azerbaijan ranks very low for its local governance, governance, and corruption scores, for further analysis see reports by Freedom House and Transparency International.

2.2 A Brief Overview of Azerbaijan's Fiscal Decentralization

Briefly speaking, the constitution of the Republic of Azerbaijan (Chapter IX), adopted in 1995, provides primary legal framework for the decentralization of state authority and gives special attention to the standards on local-self governance. In 1999, the country held its first local elections, and in 2002 Azerbaijan ratified the European Charter of Local Self-Government. Since then, the government has adopted 30 legal acts to match its fiscal decentralization standards with the norms stipulated in the Charter. Generally, there are 300 normative documents regulating various aspects of intergovernmental relations in the country (Agayev *et al*, 2007). All these arrangements imply that there have been attempts to establish a fiscal decentralization process in the country, which has certain features to be mentioned.

To be more specific, the constitution and other secondary laws (e.g., Law on the Status of Municipalities, Law on Municipal Land Administration and Law on Municipal Land Leasing) entitle municipalities to carry out local social and economic activities. Furthermore, the Law on the Status of Municipalities states that local governments are independent levels of the government and exercise their responsibilities without any restrictions. On the basis of this common principle, Azerbaijan created a one-tier local government system, formed by general and nation-wide elections. There are currently 2800 municipalities in the country, and no hierarchy exits among local governments, independent of their size (e.g., population, fiscal capacity, etc.) (Agayev *et al*, 2007). Moreover, foundation of local government creation is based on own source revenues, the same scale of responsibilities and ownership rights to their properties (Agayev *et al*, 2007). It should be emphasized that the analysis of both background research and interviews show that it is unclear to identify which criteria is applied in Azerbaijan's territorial municipal establishment, which in turn is the chief reason of such a

fragmental system. To get a broader picture of the current status of local governments and the problems facing them, it is worth looking at the important pillars of the system: revenue and expenditure assignments and intergovernmental transfers. It should be outlined that since another pillar of fiscal decentralization, i.e., subnational borrowing, does not exist neither in practice nor in law in Azerbaijan, analysis of this is excluded in Azerbaijani context. The analysis of the interviews reveals that capital investment and infrastructure developments in the regions mostly fall on central state's representatives' (e.g., EXCOMs) responsibilities, which is to say that these services are not handled by municipalities, leaving less space for municipal borrowing in the current situation[14].

2.2.1 Revenue Assignments

Legal foundation existing in the country ensures that local governments should have sufficient revenue sources enabling them to fulfil the assigned service provision. Moreover, the Law on Municipal Finance and Tax Code stipulate two chief sources of revenues: local revenues (tax and non-tax) and central government transfers. More specifically, article 7 of the Law on Municipal Finance specifies four own source tax and seven non-tax revenues.

- Tax revenues: personal land tax, personal property tax, subsoil taxes and income tax from legal persons.

- Non-tax revenues: revenues from privatization and rent of municipal properties, advertisement fees (on public property), hotel fees, as well as aid and assistance from international organizations, etc.

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[14] For further information on results of the interviews see Interview Protocol in Appendix 3.
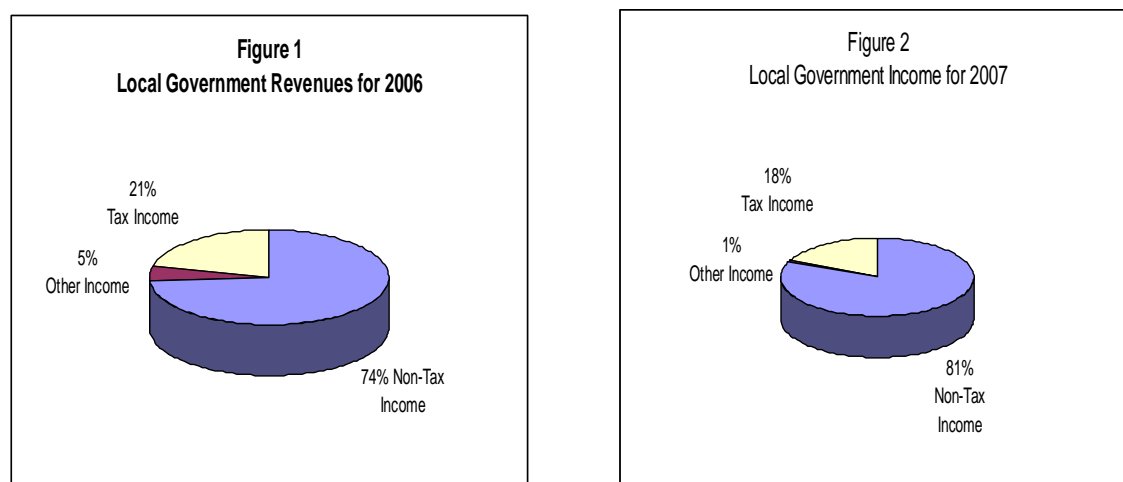
Apart from that, with the purpose of equalizing municipal budgets, the central government allocates subsidies (unconditional grants), subventions (conditional grants), budget loans, and budget funds to local governments (Aslanov, 2003). On the basis of the article 4 of the Law on Local Taxes, municipalities have discretionary power to identify both the rate and base of the locally assigned taxes. Also, article 7 of this law states that municipalities are authorized to collect those revenues that fall on their power.

While the listed sources of revenues and autonomy attached to them may seem attractive in the sense that municipalities are provided with reasonable forms of revenues, study of the real situation demonstrates quite the opposite. One of the pressing problems is related to the fact that the legally assigned revenue sources are not applicable in some regions. For example, a research done by Agayev *el al* (2007) reveals that some municipalities of some regions such as Ali-Bayramli, Agsu and Astara can apply only three of those assigned income sources (see Appendix 4). Moreover, the reasons that many local taxes can not be imposed vary. For example, the examination of the results of interviews show that municipalities in some big cities (e.g., Mingecevir, Ganja, etc.) lack sufficient bases for land taxes as these municipalities have much less territories under their jurisdictions[15], and municipalities in the capital can not make income from their legally assigned revenue sources, e.g., fees on advertisements, simply because the fees are collected Baku City Advertisement Agency, a central body of the city's EXCOM. Or the majority of municipalities in the regions lack opportunities to have income taxes from legal persons, as their residents are mainly involved in informal economy. As these three examples show, locally assigned taxes can not be applied in certain areas.

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[15] As noted earlier, Azerbaijan's municipal system is not based on territorial division, implying that a municipality x with the same amount of population may have much less territory compared to the neighboring y municipality. As a consequence of this fragmental division, for example, Ganja and Mingecevir municipalities can not pose land taxes widely.

Furthermore, to see the actual situation in general, the breakdown of local revenues is pictured in the following figures. To capture general trends in the country, the last two years are selected with the purpose of illustrating the changes from 2006 to 2007.

Figure 1
Local Government Revenues for 2006

21% Tax Income

5% Other Income

74% Non-Tax Income

Figure 2
Local Government Income for 2007

18% Tax Income

1% Other Income

81% Non-Tax Income

Source: Ibadoglu, 2007

As seen from figure 1 and 2, local taxes constitute a tiny proportion of overall local revenues. Another observation that can be made has to do with the decline in tax income, from 21 percent in 2006 to 18 percent to 2007. This observation is true for the previous years as well, which is to say that there has been a constant decline in local tax revenues, e.g., 38.8 percent from 2002 to 25.6 percent in 2005 (see Appendix 5). This, in turn, suggests that majority of local taxes are not stable, and are reducing. As the above-shown figures demonstrate, other sources of income (this includes grants and financial assistance from various sources) are also significantly declining, e.g., from 5 percent in 2006 to 1 percent in 2007.

There is an opposite trend, i.e., increase, in the non-tax income of local revenues, 74 percent in 2006 to 81 percent in 2007, which deserves special attention to be discussed further. The breakdown of non-tax income is analyzed in figure 3 and 4.

Figure 3
Breakdown of Non-Tax Income of Local Revenues for 2006

2%
Income from municipal property

26%
Other Income

9%
Central government's transfer

62%
Income from rent and privatization

1%
Financial aids from other sources

Figure 4
Breakdown of Non-Tax Income of Local Revenues for 2007

19%
Other income

0%
Income from municipal property

7%
Central government transfers

2%
Financial aids from other sources

72%
Income from rent and privatization

Source: Ibadoglu 2007

Figures 3 and 4 illustrate that majority of the non-tax income comes from privatization and rental of municipal property. The reason for the increase in this proportion of income, from 62 percent in 2006 to 72 percent in 2007, can be associated with the fact that privatization of municipal properties has grown, as a consequence of which income from municipal property has shifted from 2 percent in 2006 to 0 percent in 2007. All this indicates that the increase of non-tax income (a significant share of overall local revenues, e.g., 81 percent for 2007, see figure 2) is driven from privatization, which in turn implies that these revenues are temporary and unstable.

To conclude the discussion of the revenue side of fiscal decentralization in the country, it should be underlined that local governments lack enough sources of revenues and the assigned revenues are unstable, all of which constitute a main source of financial problems facing SNGs.

2.2.2 Expenditure Assignments

Speaking of another pillar of fiscal decentralization, i.e., expenditure assignments, it should be noted that local governments are assigned to carry out a number of activities. That is, the Law on the Status of Municipalities outlines that a wide range of local activities such as health services, education, communications, culture, etc. should be assigned to local governments to be delivered at the nationally set standards. Furthermore, the law gives an absolute autonomy to municipalities to independently carry out the listed service provisions. Based on this principle, the central government has already transferred a large amount of housing and communal services to municipalities (Mamedova *et al*, 2001). Currently, local governments enjoy a high degree of independence in dealing with the maintenance of municipal roads and social assistance to low income people (Agayev *et al*, 2007). Moreover, in practice, services such as renovation activities, maintenance of cemeteries, land allocation for individual house building, maintenance of museums and maintenance of parks and vegetation fall on the responsibilities of local governments. Besides, according to article 8 of the Law on Municipal Finance, municipalities have the autonomy to choose the spending priorities of their budget, and to independently use the property and assets that are under their discretionary power.

While the above-described aspects of both legal and practical considerations may seem as progress made by the country, it should be highlighted that the assigned services to

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municipalities in Azerbaijan can not be considered a reasonable share of local service provision, and in most cases municipal responsibilities also fall on discretionary power of local representatives of the central government. This situation is also a main target of criticisms by international organizations. For example, the recommendation made by the Council of Europe in 2003 had mainly to do with limitations observed in municipalities' responsibilities (Mehtiyev, 2007).

Moreover, the analysis of the background research reveals that there are two significant challenges that face municipalities[16]. First, most of the locally assigned services also fall on local representations of central state bodies, e.g., local offices of the Ministry of Education. In this regard, shared responsibilities with Executive Branches of the central government are the main sources of the controversial situation. Secondly, scarcity of revenues sources prevent local governments even from effectively fulfilling the limited responsibilities. According to data provided Agayev *et al* (2007), it is clear that some municipalities are even unable to pay the salaries of their staff by using local taxes. For example, in Ismayilli, Masalli, and Lerik municipalities the estimated annual property and land taxes were much less than annual salary fund of the municipal servants (see Appendix 6). These two observed trends present real difficulties to further progress in the system of decentralization.

In sum, the above-discussed brief analysis of expenditure side of local governance in Azerbaijan reveals that municipalities face significant challenges in terms of both limited responsibilities assigned to them and less availability of revenues causing difficulties in their service provision.

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[16] For furhter analysis on this situation, see Mikaylov (2006) and Agayev *et al* (2007).

2.2.3 Intergovernmental Transfers

A system of intergovernmental transfers present in the country is totally based on only on one form of fiscal flows, i.e., unconditional grants, which is to say that other forms, e.g., tax sharing and conditional transfers, do not exist in Azerbaijan. Grants are channelled from central government to directly SNGs. Article 2 of the Law on Municipal Finance states these vertical flows are regulated by the Law on Municipal Finance, the Law on the State Budget, and partially the Law on Banking. More specifically, according to the existing legal framework, transfers from the central state budget should close the gap in municipal budgets ensuring that they effectively perform the assigned service provision, which is decided annually. In the legislation, transfers may appear in conditional and unconditional forms. To be precise, article 26 of the Law on the State Budget defines four specific types of interbudgetary fiscal flows:

1. Budget loans – earmarked for a certain period of time within a year and shall be paid back;

2. Budget funds – allocated to close the gap between expenditure and revenue assignments;

3. Subvention – given for a specific purposes (conditional grants);

4. Subsides – given without any conditionality leaving spending priority to the responsibilities of municipalities.

Article 8.4 of the Law on Municipal Finance further stipulates mechanisms for central budget allocations, which is based on number of population living in municipality's territory, the role of a municipality in the country's financial power, e.g., a region's tax contribution, and other factors.

Before moving on to examine how the system works in practice, it is worthwhile to emphasize that the allocation mechanism enshrined in law falls short in three respects. First, in a

country whose fragmental municipal system is not based on number of population, application of this criterion is not feasible. Secondly, measuring a region's role in the country's financial power is a vague term to be employed, and there is a number of measurement problems associated with that. Thirdly, "other factors" are too general and can be considered "motivation" for misuse and corruption. More importantly, absence of legal framework specifying clear terms and conditions for both conditional and unconditional grants is another deficiency inherited in the legal system.

This is in part because in practice grant allocation is based on vague criteria. For example, in 2000 central government allocated 1.5 million manats to each municipality aimed at addressing general problems (Mamedova *et al*, 2001), which is to say that local governments independent of their capacity and size received the same amount. Moreover, the earmarked allocations are not delivered in timely manner, causing unpredictability in municipal budgeting.

Furthermore, the analysis of growing trends leads to two important conclusions. First, the central government has never used conditional grants for any purpose, which is to say all allocations were unconditional grants (Agayev *et al*, 2007), and these always were only small share of overall national budget expenditure. As a case in point, while amount of grants to municipalities was 2 million mantas, the overall national budget expenditure was 3790.1 million manats in 2006, which is 0.05 percent of the entire budget expenditure (State Statistics Committee, 2007). Secondly, the amount earmarked from the state budget to local governments does not reflect developments appearing in the country. As figure 5 shows,

Figure 5
Transfers from the central budget to municipalities (Mln manats)
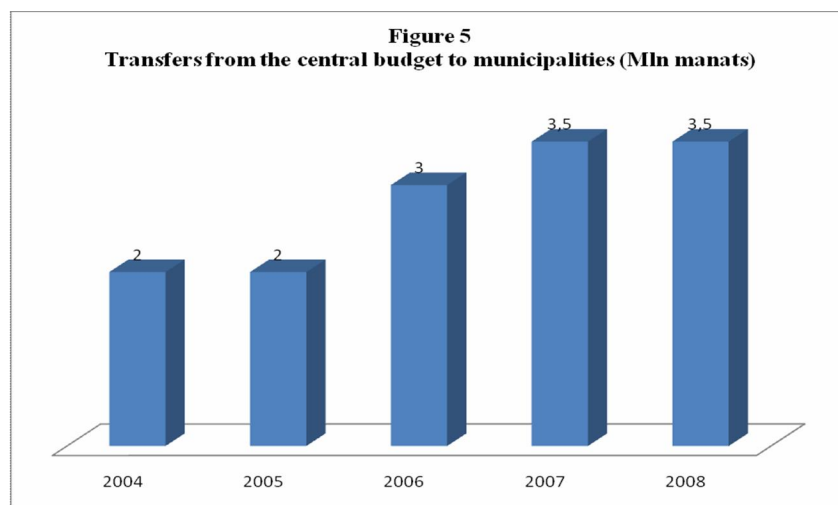
Source: State Statistics Committee

the amount of central government grants to local governments has been almost remained unchanged or increased slightly. That is, while the amount of grants increased only from 2 million mantas in 2004 to 3.5 million mantas in 2008, there has been significant rise in other sides of the central budget. As a consequence of this trend, share of transfers to local governments has largely decreased compared to other interbudgetary flows, as seen in figure 6.

Figure 6
Share of transfers to municipalities in overall central budget allocation (%)
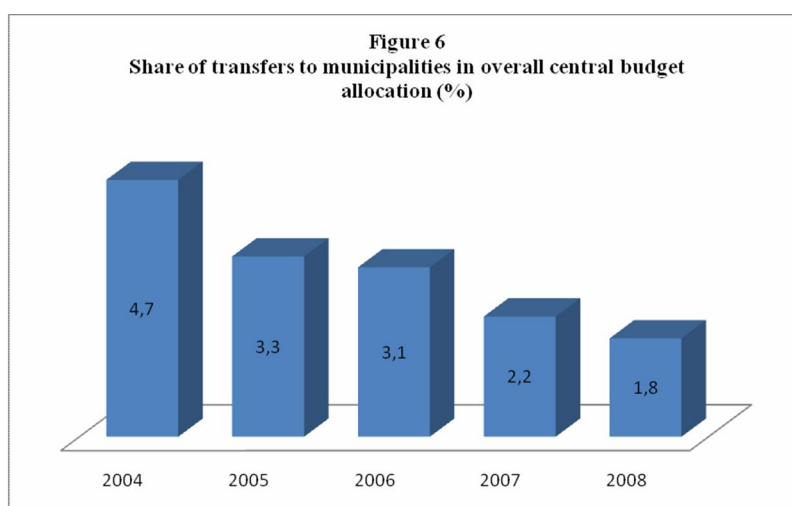
Source: Mehtiyev, 2007

Figure 6 indicates that a place of the central budget grants to municipalities in overall inter-budgetary allocations have been constantly decreased, e.g., from 4.7 percent in 2004 to 1.8 percent in 2008[17]. All this implies that transfers have become to constitute a tiny proportion of the local revenues. Figure 7 illustrates,

Figure 7
Transfers as share of overall local revenue
(%)
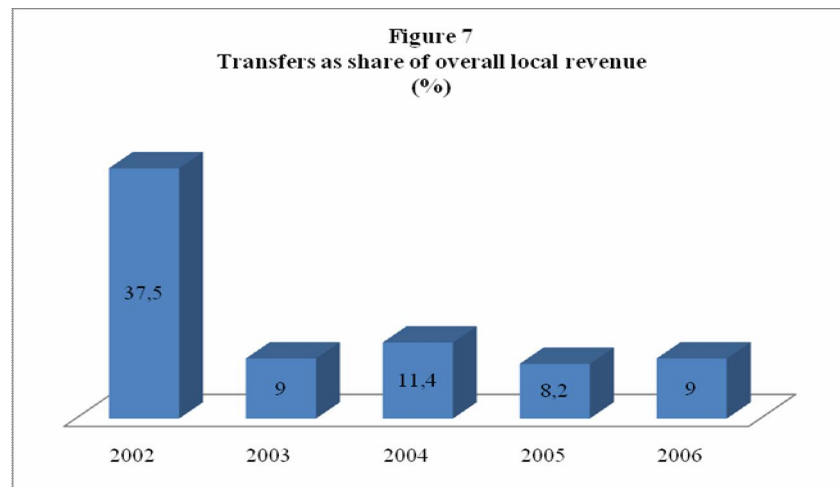
Source: State Statistics Committee and Ministry of Finance

while in 2002 transfers presented 37.5 percent of all municipal revenues, in 2006 this number was 9 percent.

Looking at the prevailing trends from various perspectives demonstrates that there has been a constant reduction in central budget grants to municipalities, and generally, financing local governments through central budget allocations has become less priority for the central government. Moreover, on the basis of the interviews conducted with the fieldworkers, this trend can be associated with the following assumption: gradually, the center has allocated less money to municipalities, with the purpose of showing "improvements" in fiscal decentralization process

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[17] This prevailing situation indicates that while the national budget revenues have increased incrementally, which is based on the increasing oil revenues, the amount of allocations to municipalities has remained almost unchanged.

in the country, implying that municipalities have already become capable enough to finance themselves, which is not true in practice.

What should be stressed is that the above-discussed nature of other sources of revenues, particularly the critical situation inherent in the system of local taxes, explicitly shows that reducing the central grant allocation is a bad practice existing at the current situation. What, at the end, can be concluded is that weak and vague legal framework and the present policy on intergovernmental transfers are one of the significant problems in the country, and present enormous challenges in the process of fiscal decentralization.

2.3 Final Remarks: Summarizing the Findings

The brief examination of both legal and practical characteristics of the current status of fiscal decentralization process in Azerbaijan reveals that the country has established its municipal system and some progress has been made up till now. Moreover, presently there are 2800 elected municipalities with expenditure and revenue powers, accompanied by further central government assistance, e.g., intergovernmental transfers, in the country.

However, the analysis of the real situation related to the three pillars of fiscal decentralization illustrates that there is a need to do a lot more to improve the current system further. To be precise, the challenges facing local governance in Azerbaijan can be divided into two categories. First, generally, the idea of decentralizing the country further does not seem to be among the "prioritized" policies of the central government in the present situation. To see this prevailing situation, it is enough to look at the characteristics, examined in subsections 2.2.1, 2.2.2, and 2.23, of the current status of local governments:

- Limited responsibilities;

- More weight on central state representatives in local service provision, e.g., overlapping responsibilities;

- Less priority in central budget allocations;

- Weak legal framework particularly with respect to expenditure assignments and intergovernmental transfers;

- Ignorance of important notions in fiscal design of the country (contradictions between the characteristics of fiscal architecture and intergovernmental relations) e.g., placing no difference between rich and poor regions, lack of "carefully" designed mechanisms for the regulation of intergovernmental relations in the country, etc.

Secondly, and more importantly, the absence of local financial capacity makes it hard to carry out even basic municipal functions[18]:

- In the legislation, limited place for local revenues, e.g., four tax and seven non-tax revenues;

- In practice, inadequacy of taxes, e.g., less applicability of some locally assigned taxes in some regions;

- A tiny share of central government allocations.

These two types of challenges facing municipal system in the country can be handled in different ways. The analysis of the interviews conducted with the fieldworkers suggests that there are two predominant ways to be developed. First, to simultaneously reform the overall

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[18] As this chapter demonstrates, there is a huge gap between the revenue and expenditure assignments of the municipalities, which is documented on the basis of the analysis of the reports, background research and interviews.

system of local government. That is, to change both legal framework and real situations in place, implying that giving more weight to municipalities in local service provision with proper financing. Secondly, to reform the system with an emphasis on financial aspect, which is to say that improvement of revenue assignments of municipalities will let them autonomously fulfil those limited service delivery.

On the basis of both experience of various countries and the country-specific analysis, it can be concluded that the second approach is more feasible at the current situation. That is, the reform with a focus on financial side is a less challenging task than the reform the overall system, and it may seem more attractive to the central government in the present time, as it is currently less interested in further decentralizing the country. Finally, this also can be considered a gradual approach, which is an essential factor in decentralizing a country. This, in turn, implies that reforming FLG without much "corrections" to the overall system is more applicable at present. It is, therefore, more practical to improve the revenue assignments of municipalities at the present time, which will enable them to function effectively with no much responsibilities. Providing effective functional municipal system will gradually lead to decentralize the country more in the future. This also constitutes the main idea of this research, which is the most distinctive aspect of it compared to other background researches. Thus, the next chapter of the thesis will evaluate local government financing options available in the country and focus on more appropriate choice fitting its architecture.

Chapter 3. Modelling Azerbaijan's Fiscal Decentralization: Exploring Opportunities for Municipal Financing

3.1 Exploring Options: Combining the Theory and the Country-Specific Nature of Financing Local Governments

The discussion of FLG, examined in section 1.1, reveals that an effective model of fiscal decentralization is largely dependent upon finding a proper form of financing. While own source revenues are considered a priority number one in ensuring local autonomy, the limitations driven from both theoretical and practical considerations suggest that they can not be sufficient enough for SNG's effective activities. In this regard, the situation is worse in the case of Azerbaijan. That is, the evaluation of municipalities' revenue assignments in sub-section 2.2.1 has demonstrated that local governments face significant challenges with respect to locally available revenues. Furthermore, the legally assigned four tax and seven non-tax revenues seem very limited, and some municipalities can not even apply the majority of those taxes. This is because own source tax revenues constitute a small proportion of the overall local revenues, e.g., 18 percent in 2007.

On the basis of the discussion in section in 1.1, it can be concluded that subnational borrowing is not feasible option to be employed in Azerbaijani in the present situation, the reason of which is twofold: First, local capital investment and infrastructure development are not handled by municipalities[19]. Secondly, the risk involved in macroeconomic management is high

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[19] As noted earlier, this is based on the analysis of the interviews.

in Azerbaijan, as it lacks sound fiscal design, implying that giving more space to municipal borrowing may cause macroeconomic instability.

The analysis of both theory and practice illustrates that the constraints that are inherent in intergovernmental fiscal relations leave a great need for another form of financing, i.e., intergovernmental transfers. The examination of Azerbaijan's fiscal reality (section 2.1) shows that the majority of natural resources and industrial sectors are highly unevenly distributed in the country. Besides, the demographic (e.g., population grows and migration) and employment structure of the country (high concentration of jobs in the capital) create a high degree of disparities. This implies that there is no local business in the regions, and the economy of the country is highly concentrated in the capital, referring to the fact that the municipalities in the regions face enormous challenges with respect to income generating activities. Also, it should be underlined that under this circumstance, implying the fact that tax base in non-existent in certain areas, broadening the list of locally assigned taxes will not help much. All these characteristics of Azerbaijan make the issue of intergovernmental transfers more than important in its case. If intergovernmental transfers should be a priority in FLG in Azerbaijan, then the question is what kind of transfers can be more applicable and productive, e.g., tax sharing or grants, which is discussed in the forthcoming sub-section.

3.1.1 Intergovernmental Transfers in the Context of Azerbaijan

Considering the fact that vertical and horizontal imbalances are high, and the realities of fiscal architecture of Azerbaijan are hugely ignored in the current system of local governance (see section 2.3), the importance of intergovernmental transfers becomes a vital issue in

Azerbaijan's case, which can chiefly take two forms: tax sharing and grant. In line with what is discussed in section 1.2, it is clear that tax sharing is a more desirable and effective form of FLG because of more revenue stability and budgetary predictability it gives for SNGs. What, however, should be underlined is that there are some practical considerations that can significantly undermine the application of tax sharing. That is, in a case when a country has a high concentration of the economy only in certain regions, where "revenues from shared taxes are concentrated in highest income areas" (Fox 2004, p., 150), the implementability of tax sharing is not feasible. The examination of Azerbaijan's fiscal architecture, in section 2.1, reveals that the tax sharing type of intergovernmental transfers does not fit into its realities in the present situation. To expand it more, due to the below-listed considerations, the application of tax sharing does not seem promising:

- *Ninety percent of tax revenues of the state budget and eighty five percent of GDP are raised in the capital (Agayev et al, 2007).*

- *The results of the interviews show that the majority of the population in rural areas are involved in the informal economy, e.g., farming and some traditional forms of non-farm economy, which is to say that they do not pay taxes, particularly income taxes. Besides, the majority of the population works in various cities without registration, referring to the fact that the origin of taxation is problematic to be identified.*

- *In general, taxation is in a vague situation "due to flawed taxation laws and inefficient taxation" present in the country (Mamedova et al, 2001).*

- *As the majority of interviewees outline, revenues driven from the oil export increasingly tend to constitute larger share of the state budget and GDP, which is to say that revenues from the taxation become a small proportion of the state budget[20].*

- *There is a fragmental municipal system in the country (e.g., like in the Czech Republic and Hungary), the existence of many small local governments, which lack a sound tax base (Peteri, 2008).*

- *The administrative capacity of municipalities is very low to deal with wider taxation issues (shows the analysis of the interviews).*

Tax sharing in the Azerbaijani context, for instance, means that the municipalities located in the capital will receive a significant proportion of the intergovernmental flows, since this is based on a system where tax originates, particularly in the case of a derivation basis approach. Or considering the general situation inherent in the taxation of the country, anything based on tax sharing, whether it is a formula basis or a surcharging system, will not work effectively.

The above-discussed county-specific characteristics imply that the main source of Azerbaijan's of FLG should be based on the other form of intergovernmental transfers, which is to say that the central government's grant allocations to municipalities should be a priority at the current situation. Furthermore, like in some countries (see Appendix 1), Azerbaijan should establish a well-designed grant allocation mechanism. This, in turn, implies that the allocations to municipalities should constitute a much larger share of the central budget compared to what is allocated now, 0.5 percent of the entire budget expenditure (State Statistics Committee, 2007). The lessons drawn from other countries' experiences, e.g., in neighbouring Armenia, four percent of the total central budget goes annually to municipalities only in the form of

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[20] The share of oil revenues grew by 42% from 2005 to 2006 in the country's GDP, and this tendency is growing (State Statistics Committee, 2007).

unconditional grants (Agayev *et al*, 2007), demonstrate that more weight to grant allocation may trigger the process of fiscal decentralization further, if properly designed. Moreover, the system should be based on pre-set standards, leaving less space for negotiability of grant allocation, which in turn can minimise external influences on the system, e.g., varying lobbing power of different municipalities.

What, however, should be stressed is that the other options, the above-evaluated, of FLG should not be underestimated and developed in parallel. That is, grant allocation should not have distortion effects on other forms of financing, and it should encourage the development of other options. In this regard, gradual improvements in, for example, local infrastructure and the administrative capacity of the municipalities will let them have more own source revenues and deal with wider taxation issues in the future, all of which, in turn, are greatly dependent upon designing an appropriate model in accordance with the country-specific characteristics. This, therefore, should be the guiding principle in modelling Azerbaijan's grant allocation system.

3.2 Modelling a Grant Allocation System of Azerbaijan

The discussion on the specific types of grants based on the analysis of Ebel and Peteri (2007) in section 1.4 shows that choosing a grant allocation system is dependent upon country-specific characteristics.

In this regard, the gap-filling model's characteristics associated with its transfer-dependence nature, and its vulnerability to the issue of transparency makes the application of it to the Azerbaijani context hardly feasible. That is, allocating grants to municipalities to cover the difference between their estimated degree of expenditure and planned revenues without any other

considerations may, for example, undermine the accountability of the system, as municipalities can manipulate various aspects of the budgetary planning, e.g., showing more expenditure than revenues. This can easily become a case in Azerbaijan, as it faces enormous challenges with respect to the issue of the transparency of governance at both national and local level, in local institutions, etc. Furthermore, its centralizing nature, making municipalities become permanently dependent on the center's allocations, may distort the under-developed own source revenue system, and worsen the process of fiscal decentralization in the country. This model is thus a less practical option to be employed in the country.

Given the fact that the hard budget constraint model is characterized by its highly unconditional nature (e.g., giving discretionary power to municipalities to use the allocation) and organizational complexity, its applicability is not feasible in the Azerbaijani context, either. Furthermore, absolute autonomy offered by this model can not be forcible and predictable in the country, as local "intentions" to manipulate/ undermine the efficiency of discretionary power attached to the allocations can be frequently observed in Azerbaijan. More significantly, it is questionable whether under the discretionary power municipalities will keep themselves tied to their functions, as the system is new. To put it in another way, it is important to keep a certain degree of the central government's control on the earmarked money with some autonomy to municipalities in the Azerbaijani case, as the capacity of municipalities are weak. All this implies that this model can work effectively in countries where transparency and local institutions are strong, implying that it does not fit the Azerbaijani case, as the issue of transparency and local institutions are the challenging tasks to be overcome at the current situation.

The fiscal capacity based method's emphasis on expenditure needs and own-source revenue capacity may work effectively in the Azerbaijani case. That is, since considering factors

such as local incentives and own source mobilizing capacity is an important issue in reducing the constant dependence on transfers and local manipulation, as well as triggering the process of fiscal decentralization further, this model seems promising. Moreover, this method may fit more into two important characteristics of Azerbaijan's fiscal architecture. First, there is a high degree of disparities among regions, referring to the fact that the revenue potential of the regions varies greatly. Secondly, the expenditure needs of the municipalities are different, e.g., spending on social services is higher in regions which are overpopulated with internally displaced people (IDPs). *All this implies that Azerbaijan's grant allocation mechanisms should be based on the fiscal capacity based method, which is summarized in Table 2.*

Table 1. Criteria for choosing Azerbaijan's grant design system.

Names of the models	Main feature of the model	Azerbaijani context	
		Feasible	Not-Feasible
Gap-Filling	-transfer-dependence -high sensitivity to the issue transparency - ignorance of varying capacity of municipalities		**X**
Hard Budget Constraint	- highly unconditional grants - discretionary power to municipalities - organizational complexity		**X**
Fiscal Capacity Based Method	-less discretionary power to municipalities (e.g., dependence on performance criterion) - consideration of more factors associated with diversity within a country	**X**	

In other words, fiscal capacity based method can be predictable and forcible in Azerbaijan, calculated by the following formula, constructed by Ebel and Peteri (2007).

$$(E_{\text{estimated needs}} - R_{\text{potential}} = G_{\text{calculated}})$$

What should be underlined is that there should some specifications to this model, adjusting it to the Azerbaijani realities. For example, there should be more focus on municipal performance in grant allocation, and this will keep municipalities tied to their functions. That is, since every municipality is interested in getting the grants, they will spend the allocations on the target areas, with the purpose of showing "good" performance, referring to less discretionary power. As for the center, since the grant pool will be predefined for a certain period of time as a share of the budget expenditure, it is less interested in allocating less money (the predefined money should go to SNG in anyway) but in focusing on the performance of municipalities, implying that there is a control by the center with limit. This creates a harmonized approach to the intergovernmental relations of the country, e.g., giving less discretionary power to municipalities on their spending the allocated transfers and minimizing the central government's control on municipal autonomy.

Moreover, there should be less categories, e.g., unlike in the case of Hungary, in grant distribution in the sense that a less complex system should be developed, as Azerbaijan lacks the sophisticated mechanisms of intergovernmental relations. Another aspect of the country-specific nature of the model has to do with the main target of the allocations, which is to say that the priority number one in Azerbaijan's grant allocation should be ensuring the existence of municipalities, as the examination of the current trends (see sub-sections 2.2.1 and 2.2.3) shows that local government's functions may worsen if the prevailing situation continues growing. To put it in another way, unlike in the cases of countries that give more space to grant allocation,

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e.g., Hungary and Poland, in Azerbaijan municipalities are not assigned with much expenditure responsibilities, which can be a chief principle of grant allocation mechanisms through sectors, e.g., education and health. As discussed in section 2.3, in Azerbaijan municipalities are not able to finance their limited responsibilities, and this tendency is growing. So, Azerbaijan's grant model should intend:

- To make sure that municipalities fulfil their limited responsibilities.

- To encourage municipalities to be interested in raising other sources of revenues.

- To motivate good local/budgetary performance, and to assist poorer regions.

These three points lead to three conclusions. First, more weight to grants will essentially solve the financial problems facing municipalities by simply covering the difference between their expenditure and revenue assignments. Secondly, it will serve to equalize more needy regions, as it also considers expenditure needs. Thirdly, this model, particularly its incentives for municipalities to be constantly interested in own-source revenue generating and a good local performance, will gradually improve the financial capacity of the municipalities, so that in the future there will probably be less need for grant allocation. So, this is a periodic mechanism intending to overcome the current financial problems, which are driven by the macroeconomic characteristics of the country.

3.3 Key Issues in the Model

As examined in section 1.5, a key factor to be identified in designing a grant model is closely related to the issue of standardization, e.g., the equalization in Australia based on the national average, or regional minimum standards in Canada (Searle, 2000). Furthermore, while there are various sets of measures to define the criteria for standardization, fiscal gap is considered to be a more proper option to equalize regions where disparities are high, which, in turn is calculated by the formula developed by Martinez -Vazquez and Jameson Boex (2005):

Fiscal Gap = Fiscal Needs – Fiscal Capacity – Targeted Transfers

Given the fact that expenditure needs and revenue bases of municipalities are very different in Azerbaijan, close attention should be given to the fiscal gap in designing the allocation formula. This implies that the first task is to define the fiscal gap, which can be implemented in the following steps, as offered Martinez -Vazquez and Boex (2005, p., 22):

"Step 1. Measure fiscal gap and Fiscal Expenditure/Needs

Step 2.   Define the fiscal gap for each local government

If Fiscal Capacity > Fiscal Needs, then Fiscal Gap = 0^{21}

If Fiscal Capacity < Fiscal Needs, then Fiscal Gap = Fiscal Needs – Fiscal Capacity

Step 3. Define the transfer to each local government:

Transfer to local government $_{i\,=}$ (Fiscal Gap $_i$ / $\sum$ Fiscal Gap $_i$) * Fund"

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[21] Considering the fact that inadequate municipal revenues are high in Azerbaijan, the gap is expected always to be positive in the present situation.

It should be highlighted that there are a wide range of ways to define measures for fiscal capacity and fiscal expenditure e.g., the level of revenue collection, the sources of revenues and measures of physical capacity/input (Martinez -Vazquez and Jameson Boex, 2005). Extreme care should be taken in defining these measures in the Azerbaijani context, as there is no tradition of such allocation measurements, to avoid potential negative implications.

More importantly, there should be several categories in measuring fiscal expenditure and fiscal needs in the country, the reason of which is related to the fact that a single category can not be sufficient enough to cover "everything", particularly because of the ill-designed municipal system. For example, designing some categories can be based on the following considerations:

- Since it is not clear on which criteria the municipal system is based, e.g., population, size, etc., the best criteria to employ is to take the number of users of the municipal services
- Considering the fact that Azerbaijan is a small country, measurement should be based on a national average. This implies that there should be an average indicator of fiscal capacity and expenditure needs.

Considering such factors will essentially provide an effective mechanism for the allocation, which, in turn, will cover municipal budgetary deficits, and increase the performance of municipalities, as the transfers depend in part on their local revenue efforts. More significantly, focusing on the performance of the municipalities in grant allocation will encourage them to work effectively, as the system punishes the municipalities performing low tax efforts.

This implies that, for example, if a municipality has lower tax potential or more expenditure needs based on the nationally set standards, then it should get transfers to cover this gap. For example, the Ali-Bayramli, Agsu, and Masalli municipalities will get more transfers, as

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they can only apply three of those assigned income sources (see Appendix 3), or Sumgayit and Mingachevir will receive transfers because of their more expenditure needs on social services.

Additionally, there should be specific purpose grants, i.e., conditional grants, aiming at assisting target areas. For example, like in the Sudanese case, where different regions receive different amounts of grants, depending on the development priority of the center (Bell, 2005), there should be specific grants to cover, for example, municipalities' infrastructure needs that are overloaded by the government's regional development programs, e.g., the roads of municipalities in the southern part of the country are overused by the tourism development plan of the central government. Or a municipality facing more environmental problems, e.g., Sumgayit, should receive specific grant for these purposes.

After all, the central question is how to ensure the effectiveness of a system in working with many governments. In line with what is discussed in section 1.5., it is clear that there is a need to create a separate grant commission in the Azerbaijani case to deal with this issue because of two reasons. First, there are 2800 municipalities, working with whom requires a lot of coordination effort. Secondly, the creation of an independent commission with wider discretionary powers is more effective than leaving the issue to some line ministries, as it has more space to independently judge the situation. It is, therefore, important to establish an independent commission (comprised of experts), e.g., like in Great Britain and Australia (Ahmad and Searle, 2005) in dealing with a grant allocation system. Moreover, the problem with the collection of the sufficient information for the effective work of the commission should be handled by distributing responsibilities among local sectoral departments, central representations – sectoral ministries and statistical agency.

Besides, it is critical to improve the legal framework, without which the effectiveness of the system can be easily undermined. Moreover, there should be some modifications, e.g., important notions such as the bases and targets of grants should be backed by the primary law. To be more specific, the current law should stipulate specific allocation mechanisms for both conditional and unconditional grant allocations, and it should include national standards for measuring expenditure needs and the fiscal capacity of municipalities. Additionally, the grant pool to municipalities should be enshrined in the law, e.g., the Law on Municipal Finance and Budgetary Law. Furthermore, since revenues, particularly tax revenues, of the state budget are less predictable, and this is a new system in Azerbaijan, it is important to give a certain degree of flexibility to the central government, with some budgetary predictability for municipalities, referring to the fact that the period for the amount allocation should be neither too long nor too short. In this regard, a period of two to three years seems to be a reasonable term to be stipulated in the legislation.

In sum, careful consideration of the above-discussed issues in designing Azerbaijan's *fiscal capacity based method* of grant allocation is a key factor in ensuring its effectiveness. In doing so, the following concrete steps should be taken:

- The Creation of the Independent Commission. The commission should include the representatives of respective line ministers and independent experts, and its status should be strengthened in the appropriate legislation, as it is important to keep its impartiality. Immediately following its establishment, the commission should identify more technical details of the allocation system based on a careful examination of the country-specific characteristics of the municipal system.

- Following the technical preparation, the above-described important notions should be enshrined in the appropriate legislation.

- When these steps have been completed, the implementation should be started.

Conclusion

The analysis of the theory on local governance finance, and the lessons learned from other countries' experiences illustrate that own source revenues can not be sufficient enough in financing local governments. More significantly, while various types of municipal finance are of great importance, a grant type of intergovernmental transfer deserves special attention in countries where the application of other sources of revenues is less feasible.

Through examining the present problems challenging the municipal system of Azerbaijan, the thesis has identified that the key obstacle observed in the system can be handled by focusing on the current form of financing. That is, inadequate and unstable own source revenues, small central government allocations and the absence of other sources of income present enormous difficulties for municipalities to carry out even basic municipal functions. Moreover, the research underlines the importance of reforming the revenue assignments of local governments without many corrections to their expenditure assignments, implying that in the present situation it is more practical and attractive to offer less challenging solutions to the central government.

Based on the analysis of Azerbaijan's fiscal architecture the thesis argues that, since there are no local business activities in the regions and the economy of the country is highly concentrated in the capital, there should be more focus on a grant type of intergovernmental transfers in municipal financing. Furthermore, the consideration of the general situation observed in taxation issues (e.g., ninety percent of tax revenues of the state budget and eighty five percent of GDP are raised in the capital (Rovshan Agayev *et al*, 2007), the weak administrative capacity of the municipalities with respect to dealing with wider taxation in the country demonstrate that a

tax sharing type of intergovernmental transfer is less practical in the Azerbaijani context. It is, therefore, important to give more weight to the central government grants in the present situation.

The analysis of different grant allocation models outlines that the *fiscal capacity based Method* is more forcible and predicable in the Azerbaijani case. That is, the method's emphasis on expenditure needs and own-source revenue capacity covers the high economic disparities within the country, and motivates municipalities to give special attention to their revenue efforts. More specifically, through some country-specific modifications, this method creates a harmonized approach to the intergovernmental relations of the country, e.g., giving less discretionary power to municipalities on their spending the allocated transfers and minimizing the central government's control on municipal autonomy. The application of this method thus serves to make sure that municipalities fulfil their limited responsibilities, encourage municipalities to be interested in raising other sources of revenues and to motivate good local/budgetary performance, and to assist poorer regions. Additionally, the research has identified concrete steps in implementing the recommended way of financing.

Considering the factors and solutions the research identifies will trigger the process of fiscal decentralization further in the country. What, however, should be stressed is that due to space limitation, the more technical details of the recommended model are not developed, and this requires further research.

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Appendices

Appendix 1

Fiscal Transfers in Percentage of Local Revenues

Country	[Percent]	Country	[Percent]
Italy	65	Belgium	46
Netherlands	62	Austria	39
Greece	60	Luxemburg	37
Spain	59	France	25
Germany	55	Finland	23
Portugal	49	Denmark	18
Ireland	47	Sweden	13

Source: Dexia.2004. Local Finance in the 15 Countries of the EU. Paris: Dexia

Shared Tax Revenue and Grants in Percentage of Local Revenues

	Total of Shred Taxes and Grants	of this	
		Shared tax	Grants
Lithuania	88	78	10
Estonia	81	43	38
Czech Republic	76	41	35
Latvia	74	46	28
Poland	72	13	59
Slovenia	63	42	21
Hungary	60	16	44
Slovakia	52	33	19

Source: Dexia.2003. Local Finance in the 10 Countries Joining the EU in 2004. Paris: Dexia

Appendix 2

Alternative Methods of Grant Allocation

Types of transfers	Expenditure	Revenue	Transfers
1. Gap-Filling	Individual decision on appropriations $(EI_{estimate})$	Individual revenue assessment $(RI_{planned})$	Individual bargaining $(EI_{estimate}-RI_{planned})$
2. General Grant influences the tightness of the Budget Constraint	Local decision on expenditure levels $(E=R+G)$	Local authority to generate revenue (R)	General grant (G) determined by the donor government; distinct from gap-filling since the donor controls the transfer amount at the outset and (presumably) does not negotiate local deficit situations.
3. Fiscal Capacity	Accepted expenditure levels based on objective (policy neutral) measures of "needs" $(E_{estimated})$	Potential revenue at standardized revenue bases subject to nationally average tax rates and revenue charges. $(R_{required})$	Calculated grant $(G_{calculated}=E_{estiamted\ needs}-R_{potential})$

Source: Robert D. Ebel and Gabor Peteri (2007)

Appendix 3 Interview Protocol

For the examination of the real situation in Azerbaijan's local governance system and formulation of unexplored solutions, twelve fieldworkers have been interviewed. A semi-structured e-mail interview with open ended questions was designed to provide opportunities for interviewees to share their views on the present state of local governance system, as well as on more feasible solutions to the problems facing municipal financing. The interviewees include the list of two ministerial representatives, three private consultants, four representatives of national NGOs and three foreign experts. These twelve fieldworkers have been involved in project implementations and research preparations of international and national organizations (OXFAM, UNDP, US EMBASSY, Economic Research Center, Counterpart International, Nederland's ICCO and International Foundation of Elections System) on various aspects of local governance system. Since the respondents are communicated via *e-mails*, the list of questions has included a limited number of issues.

Questionnaire No….

I.   The interview is part of the research methodology in my MA thesis to be submitted in academic year 2008, and the information provided by you will be used for academic purposes.

II.

1. What, in your opinion, are the problems associated with the process of fiscal decentralization in the country as a whole?

2. What is the most challenging issue in municipal finance?

3. What are the more practical ways of improving municipal financing in the country?

4. What kind of principles should be observed in increasing municipal autonomy on local spending?

5. What, you think, this research should tackle most in offering more practical solutions?

Thematic Answers[22]

1. While the legal framework on the country's local government system illustrates a certain degree of progress in the process of decentralization, the actual situation remains almost unchanged. The central government seems sceptical with the idea of decentralizing the country further, e.g., limited municipal responsibilities, more weight in local service provision given to the central state representatives, less priority to local governments in the central budget allocations. Municipalities lack the power to develop local infrastructure and to have local capital investments, all these are handled by the central governments' local representations (e.g., EXCOM).

2. Lack of local businesses, tax bases, existence of informal economy in the regions and massive migration to the capital without proper changes in registration are the main factors facing the issue of local taxation. High concentration of the economy on oil-sector, which is highly unevenly distributed across the country, is the chief character of Azerbaijan's realties, and this is not reflected in the fiscal design of the country. Weak administrative capacities of municipalities hinder them to deal with the issue of local taxation effectively. The problems associated with imposing locally assigned taxes are also bad practices existing in the country, e.g., municipalities in some big cities that have less territories can not make income from land taxes. In some

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[22] This only summaries the key points, and avoids direct questions. The results of interviews were shown in the second and third chapters.

regions, e.g., in Baku, municipalities' one of the huge income sources, i.e., fees from advertisements, are collected by central body of the city's EXCOM.

3. Offering less challenging and more attractive solutions to the central government seems more feasible in the present situation. Increasing the amount of the central budget allocations to municipalities should be priority. More focus should be given to capacity building of municipalities, and they should have an access to credit market to improve local infrastructure.

4. Under the current circumstances, there should a certain level of control on municipalities' discretionary power in local spending, e.g., the central transfers can be conditional upon to the effective spending of a municipality and/or some *performance indicators* of municipalities should be nationally set fitting into the Azerbaijani context. Community participation should be increased in local decision making, e.g., donor organizations should give more space in work with local people.

5. Offering less changes, examination of the applicability other similar countries' experiences, etc. can be the main target of this research. Extreme care should be given to the country specific characterizes of Azerbaijan in reforming an aspect of local government financing. It is also important to be critical with the official statistics in examining the trends in the country, referring to the fact the official numbers may not present real developments in the country, e.g., the central government allocates less money to municipalities, saying that they have already have become capable enough to finance themselves.

Appendix 4

Number of Municipalities Applying Various Taxes and Fees as Stipulated in the Law for 2005

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	
Лenkoran			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			

Source: Agayev *et al* (2007)

Appendix 5

Share of Local Tax Revenues in Overall Municipal Budget

Years	2002		2003		2004		2005	
	Budget revenues (in billion AZM)	Share of budget revenues (%)	Budget revenues (in billion AZM	Share of budget revenues (%)	Budget revenues (in billion AZM	Share of budget revenues (%)	Budget revenues (in billion AZM	Share of budget revenues (%)
Tax revenues of municipalities	24899.6	38.8	26670.1	48.07	28248.2	32.19	6239.8	25.6

Source: State Statistics Committee

Appendix 6 **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 (+, -) (гр.4 – гр.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

Source: Agayev *et al*, 2007