

The role of fiscal decentralization in Azerbaijan's economic growth in the context of the recent oil price drop related crisis.

By
Togrul Safarzade

Submitted to
Central European University
Department of Public Policy

In partial fulfilment of the requirements for the degree of Master of Arts
in Public Policy

Supervisor: Professor Izabella Barati-Stec

Budapest, Hungary

2016

I, the undersigned Togrul Safarzade hereby declare that I am the sole author of this thesis.

To the best of my knowledge this thesis contains no material previously published by any other person except where due acknowledgement has been made. This thesis contains no material which has been accepted as part of the requirements of any other academic degree or non-degree program, in English or in any other language.

This is a true copy of the thesis, including final revisions.

Date: 17.06.2016

Name: Togrul Safarzade

Abstract

Recent drops in world oil prices have created many challenges to developing oil producing countries in terms of economic sustainability. Azerbaijan is also one of the victims of this phenomena. Excessive dependence on oil and failure in diversification of the economy put the country in the verge of severe crisis that recently led to devaluation of the currency significantly. Since then, by taking too many responsibilities the government has been trying to tackle with crisis. On the contrary, such excessive responsibilities slowed down the application of effective crisis-related policies of the government. Thus, this research argues that nowadays distribution of more economic power to subnational governments to make their own revenues is essential in order to meet some part of their expenditures instead of totally depending on transfers from the central budget. Especially, it assumes that positive modifications in local tax policies would lessen the impact of recent oil price drop related crisis.

Acknowledgements

Firstly I would like to express my profound gratitude to my parents, brother Orkhan and sister Gulistan for providing me with continuous support and encouragement throughout my Master degree and thesis period. All of these would not have been possible without them. Thank you.

I am also indebted to my thesis advisor Prof. Izabella Barati-Stec for always willing to help me and guiding in writing this thesis. In addition, I would like to thank my tutors from Intergovernmental Fiscal Relations and Local Financial Management class, Prof. Robert D. Ebel and Prof. Gabor Peteri for their theoretical input and providing me with the right tools that I needed to choose. Without them nothing would get done.

Last but not the least, my gratitude goes to my Academic Writing teacher Agnes Toth for her unswerving support of my work and inspiring me to think in new ways. My insights were greatly enriched by her feedbacks.

Contents

Abstract	ii
Acknowledgements	iii
Introduction	1
Chapter 1 - General Information and Theories on Fiscal Decentralization	6
1.1 <i>Models of Fiscal Decentralization</i>	7
1.2 <i>Arguments on fiscal decentralization</i>	8
1.3 <i>The pillars of fiscal decentralization</i>	10
1.4 <i>Grant Design/Intergovernmental Transfers</i>	11
Chapter 2 - Overreliance on oil: Fragile economy of Azerbaijan	12
Chapter 3 - Fiscal Decentralization in Azerbaijan	14
3.1 <i>Budget system of the local governments in the Republic of Azerbaijan</i>	15
3.2 <i>Revenue assignment</i>	16
3.3 <i>Expenditure Assignment</i>	20
3.4 <i>Development of local tax system</i>	23
Conclusion	27
References	28
Appendices	33

It might therefore be better for the decentralization to be designed by a centralized authority, with the interest of the less advantaged or less powerful in mind. Power to the people, but not all the power.

Abhijit V. Banerjee

Introduction

After the dissolution of the Soviet Union in 1991 and the difficult passage from command economy to the free market system, the future of the fifteen newly independent countries has gone into a state of limbo. In other words, being deprived of sovereignty in administrative and economic decisions for almost a century, most of those states failed to respond immediately for steady growth. However, Azerbaijan, located on the coastline of the Caspian Sea that puts the country in an advantageous position in terms of rich oil wells, was able to take control in short period of time. By signing the Contract of the Century¹, Haydar Aliyev, the second president of the independent Republic of Azerbaijan, managed to boost the fragile economy despite of the hardships caused by the war on Nagorno-Karabakh². Since then, Azerbaijan has seen a huge increase in its GDP every year. To illustrate, according to World Bank (2013) statistics Azerbaijan's GDP increased from \$3.3 billion in 1994 to \$75 billion in 2014. Thus, even though the starting point of all fifteen countries were same, Azerbaijan went far ahead than most of them. Even so, unfortunately the notion of the "resource curse" that was introduced into literature towards the end of the 20th century, throughout the time became also applicable to the case of Azerbaijan. Resource curse refers to the "decline of in the productivity and competitiveness of the manufacturing and other tradeable

¹ A treaty that signed in 1994 between a Consortium of foreign oil companies and the Republic of Azerbaijan to advance Caspian oil reserves of Azerbaijan. The ratification of the treaty played a huge role in the development of the economy.

² An enclave in southwestern Azerbaijan. The clash between Azerbaijani and Armenian troops over the area between 1991 and 1994 led to death of hundreds of civilians. The war ended up with ceasefire agreement between two governments and establishment of de-facto state of Nagorno-Karabakh, which is not recognized by any country till today.

sectors following the real exchange rate appreciation in the wake of a resource boom” (Neumayer, 2004). Consequently, excessive dependence on oil put this country at risk by enhancing concerns about long term stability and sustainability. In addition, relying on the power of long-standing high prices of oil incumbent government failed to develop powerful and reliable economic institutions, making the whole economy susceptible to oil price falls. Rather than developing strong macroeconomic policies towards making some savings in case of economic downturns, the incumbent government in Azerbaijan spent huge amount of money by relying on the power of long-standing high prices of oil and consequently huge influx, making the whole economy susceptible to oil price falls. One of the mistakes was making huge transfers to local governments from central government to meet their expenditures rather than developing local revenue sources and giving more financial power to local authorities. In this way, towards the end of the first half of 2015, when oil prices started to go down, the government had no other choice than depreciating the currency, Manat, by one-third. Further drops in the prices made the situation even worse, leading to 97% of total depreciation. These two consequent depreciations took the economy of the country to a severe crisis. Since then, by taking too many responsibilities the government has been trying to tackle with crisis. One of the major responsibilities is sustaining transfers because of poor own revenue sources of the subnational governments. Notwithstanding to ratification of European Charter of Local Government in 2002, the saying of local municipalities are extremely constrained and, hence, the central government took much of the control of local administration on itself. I believe that, on the contrary, such excessive responsibilities slowed down the application of effective crisis-related policies of the government.

In general, the topic of fiscal decentralization in Azerbaijan has been in the center of attention for several years and different authors have expressed their viewpoints on the problem of poor

fiscal autonomy of local governments. Ibadoglu (2006) emphasizes that the one of the biggest problems of local self-governments is their poor fiscal capacity. Based on the Statistical Yearbook of Azerbaijan for 2005, he mentions that the monthly income of each municipality was less than \$824. He also offers a wide range of possible reforms in order to improve the fiscal capacity of subnational governments (SNGs), including the improvement of payments and tax collections techniques by local officials through the registration of all immovable and movable properties in the country, the introduction of additional payments and taxes in the local level, and giving arable lands that fall under the properties of the State Land Fund, to the municipalities' surplus fund. In the same way, according to Mikaylov (2006) the major source of funding of municipalities in Azerbaijan is automatic government subsidies determined based on the per capita base and law on local governments that sets down tax types does not authorize the generation of budget with minimal revenues needed in order to guarantee local budgets' independence. Taking into account such low fiscal capacity of municipalities, the necessity for huge transfers from the central government emerged. That is, to fill gaps in fiscal capacities of municipalities, multiple ways employed by the state, such as specific (conditional) and general purpose (unconditional) grants, and budget loans. Accordingly, the author argues for the introduction of the practice of tax-sharing into the Azerbaijan's intergovernmental fiscal transfer procedure, rather than opting for the collection of taxes by the central government and eventually allocate among local governments. Lastly, a local NGO in Azerbaijan, namely the Alliance for Municipality Development, in their review on the 'current situation of local self-governance in Azerbaijan' talks about the problems that exist in municipalities. They underline that currently government lacks essential decentralization reforms and confined those reforms exclusively to a few normative and legislative acts. The main area of concern of the review authors is failure of efficient organization of local self-governance on the basis of the existing legislature that does not meet the requirements of the

European Charter of Local Self-government. Towards the end of the review, in order to find a solution for existing problems and enhance the idea of local self-governance the authors identified priority reforms areas; that is municipal competencies, an optimal size of municipalities, an enhanced financial potential of municipalities, a larger property potential of municipalities, an organization of municipalities and a division of competencies among municipal members, municipal associations, staff capacity of municipalities, and accountability of municipalities and supervision over functions of municipal institutions (Alliance for Municipality Development, 2011). However, none of the authors has tried to analyze an ongoing oil price drop related crisis from the perspective of fiscal autonomy of the local governments, leaving a gap in the literature written on the fiscal decentralization in Azerbaijan.

This research will analyze the current level of autonomy in the fiscal issues of the local governments in Azerbaijan and why the central government is not able to prevent one of the severest crises in the history of the country since its independence from Soviet Union brought by decrease in oil prices. By looking at the fiscal structure of the country in terms of fiscal trends (i.e. economic structure and institutional relations), revenues and expenditures, it intends to recommend a better financial system for local self-governance. Specifically, the thesis argues that under the current environment of decreasing world oil prices that also led to the decline of overall revenues of Azerbaijan considerably, an incumbent government should focus on attractive tax sources for SNGs to make sure that they make their own revenues to meet some part of their expenditures instead of totally depending on transfers from the central budget. As it is emphasized by Barati (2016) defining the degree of granting power to local governments in making own revenues based on natural resources essentially leads to volatility in the budget. Hence, central governments in resource rich countries should not see natural resources as substitute for tax income (Barati, 2016).

On the contrary, in Azerbaijan oil sector that throughout years made country's economy one of the least diversified, became main element in taxation system. To illustrate, from 2007 to 2011 60-70 percent of GDP covered by VAT from oil sector. On the other hand, in business sphere entrepreneurs freed from corporate income, value added and personal income taxes. Only taxes applied to their overall proceeds and ranged between 2 and 4 percent (Ipsa, 2012). Therefore, I am going to propose that these days the distribution of more economic power to SNGs by improving fiscal decentralization is essential. At least to certain extent, positive modifications in fiscal decentralization in terms of tax policies would lessen the impact of recent oil price drop related crisis.

In overall the research will be based on the combination of both quantitative and qualitative methods. I am going to analyze different documents, primary and secondary sources on the topic of fiscal decentralization. These materials are of great value in understating general trends, theories and information on fiscal decentralization and applying it to the case of Azerbaijan.

Relying on above mentioned methodology, I am going to divide my thesis into three main chapters. The first chapter will provide general information and theories on fiscal decentralization and the role of local governments on the decision making process. The second chapter will be more about fragile economy of Azerbaijan and how it got into the crisis. Lastly, the third chapter will focus on the current status of fiscal decentralization in Azerbaijan, including challenges that local governments face in the revenue making. This will allow us to understand possible revenue making areas of the SNGs and based on the findings possible recommendations will be provided for better ways for local self-finance in Azerbaijan.

Chapter 1 - General Information and Theories on Fiscal Decentralization

Starting from the beginning of the 1990s, the process of decentralization, mixing administrative, political and fiscal aspects, have been exercised by most developing countries. Each of these aspects has played a huge role in their success. Yet, some group of countries have embarked all three aspects simultaneously, other just decentralized in one or two respects (Boschmann, 2009). Especially, the practice of fiscal decentralization became an important tool in right equalization between lower tiers and central government. In recent years, different forms of fiscal decentralization became as one potential way to escape the pitfalls of insufficient economic growth, macroeconomic uncertainty, and inefficient and ineffective governance (Vaillancourt and Bird, 1998). Indeed, wide range of international organizations as the Asian Development Bank and United States Agency for International Development (USAID) and Bretton Wood Institutions such as the International Monetary Fund (IMF) and World Bank supported fiscal decentralization, eventually becoming part of a global ‘reform’ program (Bahl, 1999).

According to Worldbank (2005) “fiscal decentralization refers to the public finance dimension of intergovernmental relations. It specifically addresses the reform of the system of expenditure functions and revenue source transfers from the central to sub-national governments”. In order to make fiscal decentralization work properly, subnational governments have to have substantial own revenue raising potential, that is to say, fiscal autonomy. Thus, based on decisions made at the local level independently, three types of fiscal decentralization can be identified: deconcentration, devolution and delegation. The following section of this chapter will provide more detailed analysis of these three type of fiscal decentralization.

1.1 Models of Fiscal Decentralization

As other types of decentralization three types of fiscal decentralization can be distinguished: deconcentration, delegation and devolution. To begin with, deconcentration refers to dispersion of policy obligations to area offices of the central government. Although such transfer alters the geographical and spatial allocation of authority, it does not change the autonomy of the body that gets authority substantially. Strictly speaking, under deconcentration order the authority over the local office is retained by central government through the hierarchical channels. Despite the fact that deconcentration form of fiscal decentralization allows more autonomy than centralized government systems, it comprises the least degree of self-government compared to other two forms. On the contrary, in the devolution type of fiscal decentralization central government does not control policy responsibilities that are transferred to semiautonomous organizations or local governments, but keeps them accountable. Agreeable relation exercised by central government that retains control and obliges accountability of local governments is the fundamental difference between deconcentration and delegation. Local entities possess a bit higher level of fiscal autonomy compared to deconcentration. Lastly, under devolution quasi-autonomous local branches of the central government are allowed to have administration over the transferred policy and implement power. For the local governments devolution type of fiscal decentralization grants the highest degree of autonomy in contrast to the other two types. Consequently, it is the relationship between central government and SNG that gets resources and power that distinguishes these categories (Scneider, 2003). However, we should also bear in mind the fact that while analyzing a specific country case, sometimes it is hard to determine what type of arrangement is exactly employed. Ebel (2014) perceives the understanding of centralization-decentralization as a continuum rather than a

dichotomy and argues that in practice, all administrative structures are likely to combine different components of deconcentration, delegation and devolution. For example, in case of certain unitary systems, although central government has authority over the fiscal decisions it may grant some authority to subnational entities through deconcentration and devolution. Thailand, Japan, Turkey, the Central and Eastern European countries, and Korea can be included to such set of unitary states (Ebel, 2014).

1.2 Arguments on fiscal decentralization

Nowadays most of the literatures written on fiscal decentralization revolve around its effects on efficiency and economic growth. However, traditionally, the objective of economic growth took less attention in the practice and theory of fiscal decentralization. Only a short time ago, in terms of economic stabilization, efficiency in the distribution of the resources, and horizontal fiscal imbalances, economic growth dimension has become an important discussion element of the topic. Contrarily, the assurance of significant economic efficiency in sharing out resources in the public sector is the primary traditional argument for fiscal decentralization. It assumes that local public officials in a better position in responding to differing preferences and desires across jurisdictions and subnational governments (Mcnab and Vazquez, 2003).

In a chronological way three main arguments can be identified for the support of fiscal decentralization. The first and one of the most dominant arguments on fiscal decentralization can be cited from Tiebout's (1956) model of local public good provision. He argues that problem of the inefficient distribution of the public goods can be resolved in places where mobile households are matched with decentralization. Based on this model, basically subnational governments engage in competition for proposing a composition of public goods and tax and according to preferences

about public goods and tax citizens take a decision where to dwell (Porcelli, 2009).

Decentralization Theorem of Oates (1972) is the second model arguing that:

“For a public good-the consumption of which is defined over geographical subsets of the total population, and for which costs of providing each level of output of the good in each jurisdiction are the same for the central or for the respective local government – it will be more efficient (or at least as efficient) for local governments to provide the Pareto-efficient³ levels of output for their respective jurisdictions than for the central government to provide *any* specified and uniform level of output across all jurisdictions” (Oates, 2006, p.2).

As we can see in theoretical frameworks offered by both Tiebout and Oates an efficient public good provision can be guaranteed by fiscal decentralization merely because local preferences are less satisfied in centralized system of governance than in case of decentralization (Porcelli, 2009). The last argument is Leviathan hypothesis introduced by Brennan and Buchanan (1980). They claim that monopolistic power increases along with increasing centralization of the government, leading to “fiscal exploitation”. On the contrary, the ability to carry out monopolistic actions such as in tax-prices is getting lesser with greater degree of decentralization and subnational government competition (Pereira, 2000). It is also reasonable to emphasize that the main reason why Leviathan hypothesis supports fiscal decentralization is to decrease scale of the central government and eventually prevent its unproductive actions.

Besides the above mentioned theories that focused on advantages of fiscal decentralization, there are also wide variety of arguments have been put forward by many scholars regarding negative correlation between economic growth and development and fiscal decentralization. The feasibility

³ “Theorized by the Italian engineer and economist Vilfredo Pareto, Pareto’s efficiency is defined as the economic situation when the circumstances of one individual cannot be made better without making the situation worse for another individual. It is a purely economic concept and has no relationship with the concept of equal or fair utilization of resources. Pareto’s efficiency takes places when the resources are most optimally used” (Pareto, 2015).

of the positive influence of fiscal decentralization on economic growth has been questioned by a number of studies, proposing that fiscal decentralization could actually be harmful for macroeconomic productivity of the government in general (Amagoh, 2012). For example, it is argued that one of the possible detriments of the fiscal decentralization is social fragmentation. “Fragmentation hypothesis” developed by Buchanan and Brennan (1980) states that “the potential for fiscal exploitation varies inversely with a number of competing governmental units in the inclusive territory” (Buchanan and Brennan, 1980, p. 185). That is to say, in case of decentralization of spending decisions and tax, each of the fragmented governmental units will compete with each other to induce citizens and other movable resources. This in turn diminishes central government’s taxing power and subsequently leads to inefficiency (Lee, 2009). Moreover, another argument against fiscal decentralization could be given from capture effect. Capture makes reference to times when local elites take control over regional governments with increasing access to public resources after transformation of power from central government which eventually causes rising corruption opportunities. At the cost of the non-elite, an inclination emerges to supply local elites with services excessively (Amagoh, 2012).

All these theories and arguments demonstrates that, implementation of fiscal decentralization can be both curse and blessing for locals in the lower tiers. Thus, before making any general argument, it would be reasonable to look at country specific cases and construct any policy suggestion based on ongoing political and economic environment.

1.3 The pillars of fiscal decentralization

The main element of decentralization is financial accountability. For effective conduct of decentralized functions, sub-national governments must have sufficient degree of revenues and also saying in expenditures decisions. Such revenues could be either transferred from the central

government or made locally. Consequently, various forms can be observed in fiscal decentralization, including: a) enlargement of local revenues by indirect charges, or sales or property taxes; b) conveyance of either sub-national or national government assets by means of loans guarantees and borrowing permission for the municipals; c) cost recuperation or self-financing through user charges; d) Disposal of common revenues from taxes raised by central government by intergovernmental transfers among local governments for particular or general uses; e) participation of the users in the services provision through co-production or co-financing disposition by means of labor or monetary contribution. Administrative divisions or subnational governments in numerous developing countries have legal power levy taxes. Still, because of the weak tax bases, they heavily depend on subsidies from the central government (World Bank, 2001).

1.4 Grant Design/Intergovernmental Transfers

To exercise national policies and fund spending of local governments, many countries widely use intergovernmental grants. For sub-national governments grants are vital source of revenue that accompany locally made revenues as non-tax revenues and direct and indirect taxation (OECD, 2006). Distribution of the complete number of transfers from central government to budgets of sub-national governments basically can be done in three ways (see Appendix 3). First method is gap-filling. In this model of intergovernmental transfer system the difference between estimated degree of expenditure and local revenues that are planned equals to the grant for a local tier ($E-R=G$). In the second method in which local government respects hard budget constraint, total amount of both available grants for the local governments and own source revenues together equals to government spending ($R+G=E$). Depending on the objective stimulus can be spending discipline and/or increased revenue attempt. Lastly, in fiscal capacity based model on the ground of approximate calculations by subtracting own source that receiving local government able to get from a group of

revenue bases that are standardized nationally from a total number of nationally standardized expenditure tasks ($G_{\text{calculated}} = E_{\text{estimated needs}} - R_{\text{potential}}$). Taking as an overall, incentives produced from each of these methods for local governments are different (Ebel and Peteri, 2007).

Chapter 2 - Overreliance on oil: Fragile economy of Azerbaijan

Since its break-up from the Soviet Union, Azerbaijan's excessive dependence on oil puts the country at risk and enhances concerns about long-term economic stability and sustainability. Despite the fact that the country has been showing strong economic stance in world arena, this particularly was because of foreign direct investments (FDIs) in terms of extraction of hydrocarbon resources. However, recent falling oil prices resulted in considerable devaluation of Azerbaijani Manat against US dollar (as it was pegged to dollar).

After the Contract of the Century, one of the biggest mistakes of the incumbent government was failure to develop non-oil sector, hoping for permanent high oil prices. To illustrate, if in 1995 the percentage of hydrocarbon extraction in GDP was about 10.2%, in 2007 it increased enormously and accounted for 53.7% (ppi, 2015). Taking into account some attempts to reduce the significant role of oil sector in an economy, it still remains high as 50% (adb, 2014).

By 2015 63% of the state budget dominated by revenues from oil. In addition, it was also equal to 86% of exports in total and produced 31% of Azerbaijan's gross domestic product (GDP). Right after the devaluation, in the global economy the ranking of the country declined to a great extent, as 56% drop in GDP per capita was witnessed. In addition, two more consequences are also remarkable. Firstly, among oil producing states ratio of public debt to GDP in Azerbaijan was one of the lowest. However, nowadays this is not the case anymore. Secondly, if in 2015 public external debt to GDP ratio was just 8.6%, today it equals to 19.8% (Ahmadov, 2016). The fact that the

country largely depends on imports makes current state of affairs even worse. Dependency on imported foods is 70%, and goods as cars, clothes, and medicine is nearly 100% (Jafarli, 2016). Consequently, already starting from December 2015 Central Bank of Azerbaijan decided to free-float the national currency, leading to value-fall of social allowances, wages and pensions that are paid in Manat. Job cuts have been announced by many state-owned and private entities (Guliyev, 2016). Despite the fact that only in November 2015 \$589m had been spent by central bank to preserve the value of Manat, Central Asia and Caucasus analyst at GPW risk consultancy, Livia Paggi mentioned that “the peg was no longer sustainable. Without action, foreign actions would have been entirely depleted within six months at the fixed exchange rate” (Financial Times, 2015). To mention, since 2001 until the recent oil price drop related crisis in Azerbaijan 0.78 Manat was fixed against one dollar, but after two consecutive devaluations the currency almost lost twice its value (1 dollar fluctuates between 1.5-1.6 manat).

Recently, in one of his speeches President of Azerbaijan, Ilham Aliyev, said that:

“Actually we have been working on the diversification of the economy for many years, but now that the oil prices are very low this has become our main priority. We have managed to reduce the dependence on oil and gas; now oil and gas is only 30 percent of our GDP, but our target is to create a model of development which will not depend on oil prices. It is happening, we are introducing broad package of reforms which is supported by the International Monetary Fund and our main concern of areas of the non-oil sector, agriculture, IT development, tourism and other sectors. Therefore I am sure that in the coming years Azerbaijan’s dependence on oil will even reduce” (Euronews, 2016).

Actually, favorable geographic location and climate of Azerbaijan makes it suitable for the development of many other sectors as agriculture and renewables. Easy access to rail transport, huge cultivable areas (4,588,703 ha out of 8,641,506 ha) and mild climate that allows growth of

crop throughout year puts the country in a comparative advantage to produce and export agricultural products (Kosayev and Guliyev, 2006). Also, there are number of renewable sources that have not been exploited yet. For example, within a year because of 250 days of medium to strong wind, possible wind power in Azerbaijan annually able to produce up to 2.4bn kilowatt-hours (kWh) of electricity. In the same way, annual 2,400-3,200 hours of sunshine creates huge possibilities for processes of heat generation and solar powered electricity (Caspianinfo, 2013).

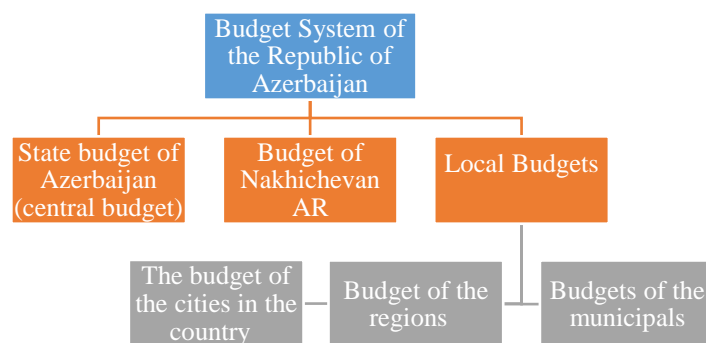
Chapter 3 - Fiscal Decentralization in Azerbaijan

Based on the Law on “Territorial structure and administrative territorial division” in the Republic of Azerbaijan, the division of administrative territories is comprised of villages, settlements, regions and cities. In the Law on Municipal Territories and Lands these divisions were the primary element in designating territories of municipalities. According to the data from State Statistics Committee, there are one autonomous republic (Nakhichevan Autonomous Republic), 4249 villages, 66 administrative districts, 261 settlements, and 78 cities in the country (stat, 2016). However, it is also reasonable to mention that based on article 2.5 of the Law “On the Territorial Structure and Division” if in a certain unit public authorities do not exist, then that unit is not counted as administrative-territorial unit. To illustrate, despite the existence of the 4229 villages, there are only approximately 1600 executive village authorities (i.e. one executive committee per 2.6 villages). At the same time, there is no hierarchical subjection among city, district and city municipalities, demonstrating a single-stage type of municipal system (Mirzayev, 2015).

3.1 Budget system of the local governments in the Republic of Azerbaijan

The Budget of the Nakhichevan Autonomous Republic, the state budget of the Republic of Azerbaijan and budgets of the subnational governments form Azerbaijan's budget system (see Figure 1). By setting up planned budget funds, utilizing managerial profit sources, and allocating financial funds among the lower tiers, the harmony of the budget system depends on the reciprocal action of the budgets (azerbaijans, 2015). Including the land tax of legal entities, excise for import of goods into Republic of Azerbaijan, incomes from the State Oil Fund of the Republic of Azerbaijan, interests from the loans lent to foreign country governments and many other sources constitute the state budget of the country. In accordance with this, collected revenues directed to expenditures as general state services, the maintenance of state obligations and debts, grants designated to the budgets of municipalities and Nakhichevan Autonomous Republic, national security, security forces, education, healthcare, social security and social protection, protection of environment, agriculture, state investments, commercial or economic activities (maliyye, 2015).

Figure 1: *The scheme of budget system in the Republic of Azerbaijan*



Source: Azerbaijanians.com

3.2 Revenue assignment

In reality almost in all countries the lack of success of the central government to hand the authority of revenue-making to local governments is one of the biggest obstacles for a ‘right’ fiscal decentralization. Decentralization will not run if Ministries of Finance do not desire to assign substantial revenue sources to sub-national governments (Bahl, 2001). Getting a sufficient degree of financing in a way that assigned functions could be implemented by local governments is the most underlying objective of revenue assignments. In other words, in order to increase local governments’ political accountability, the provision of revenue autonomy becomes critical necessity for revenue assignments. At various governmental tiers to solve the tough problem of discrepancy in revenue sources and expenditure needs, or vertical instabilities, the best way (if not the sole method) is local level tax autonomy (Vazquez, 2007). In Azerbaijan, as in many transition economies, the absence of a contemporary tax governance has both negatively influenced revenue collection of the general government, and impeded the realization of everyday revenue assignments. Tax administration in most of BRO (Baltics, Russia, and Other countries of the former Soviet Union) countries belongs to a central government. In order to collect taxes at all tiers of government those central governments appoint special agencies. This implies that local and regional governments do not have enough power to demand their own tax administrations, and even if they have, it is in very tiny degree (Ebel and Yilmaz, 2001). In turn, a huge part of revenues to meet expenditure assignment comes from transfers.

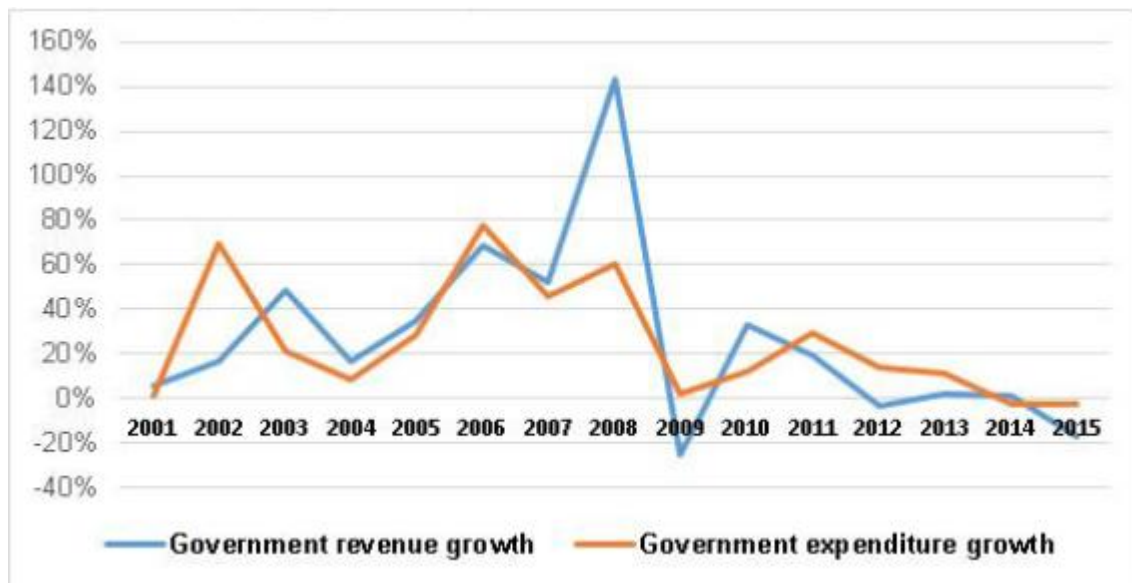
Among different countries the percentage of transfers in local revenue differs significantly. From Appendix 5 we can see that in countries as Albania and Azerbaijan transfers from the central government to local governments are high. This demonstrates not only unwillingness of the center to leave an instrument for managing lower tiers, but also lower tiers’ inability to consolidate

authority over their own revenues (Dabla-Norris, 2006). In fact, taking into the fact that after the 2000s when the price of oil started to go up and fluctuate between \$110-120 per barrel, the central government in Azerbaijan started to further ignore the development of proper fiscal policies that could help to keep the economy stable even during downturns. Basically, a high price of oil created a more relaxed environment within the central government, hoping for an infinite influx of money. As a consequence, the power of the local governments to raise their own revenues went down even more as the center was capable to make significant grants. Even from the approved state budget for 2016 it becomes clear how subnational governments in Azerbaijan are in a disadvantaged position in making revenues. Approximately only 766, 344 million manats out of 14.566 billion manats that are projected fall into duty of the local governments, the rest are assigned to revenues of the center (see Appendix 4) (Karimova, 2016).

Based on above mentioned information, it can be argued that the economy of Azerbaijan is based on a pro-cyclical fiscal policy. This policy simply refers to an increase of spending during boom times and cuts in recessions, leading to macroeconomic instability in the long term. According to Guliyev (2016) in Azerbaijan during the oil boom poor spending options have been selected by the government. A fiscal policy, normally, would separate expenditure from revenue flow, that is, accumulating when the economy goes through good times and spending during shocks. Norway, also an oil producing and exporting country, is a perfect example that saved a lot when oil prices were high. However, unfortunately, Azerbaijan implemented totally an opposite policy. When the price oil was at its peak it did not have an exact provision on how much should be spent (see Figure 2). Based on informal rule of Azerbaijan, up to 75 percent of revenues from oil could be expended and 25 percent should be saved (Guliyev, 2016). Guliyev continues by mentioning the reasons behind the social costs of the present-day economic crisis, including failure to develop a non-oil

sector and a huge spending on international events. However, at the current condition it would be reasonable to focus on substantial reforms that can positively affect the overall economy of the country and decrease the effect of the recession, rather than sticking to and criticizing the faults.

Figure 2: *Pro-cyclical fiscal policy in Azerbaijan*



Source: *International Monetary Fund WEO*

The formation of efficiency and bigger accountability in a sound regulatory and institutional structure is highly dependent on the autonomy of local governments in terms of revenue making through taxes. On the other hand, it is likely that local governments stay subject to central transfers or taxes if their own source revenues are inadequate. In other words, in meeting expenditure duties central governments' transfers become the most important subnational financing. However, this in turn can negatively affect the mobilization local revenues. An increase in locally made revenues can help to reduce the level of overall transfers, as in Ukraine, Moldova and Belarus (Dabla-Norris, 2006). Even the Minister of Finance of Azerbaijan, Fazil Mammadov, early this year in his speech emphasized that:

“Everyone knows that enough funds are allocated from the state budget to ensure continued and sustainable growth of the regions. But one should take into account the fact that these funds are formed mainly from tax revenues and transfers of the State Oil Fund. We should increase the revenue part of the budget to provide the sustainability of this process. But today’s reality is that oil prices have dropped by four times for a year, and as this process cannot be predicted, the revenues of the budget should be formed mainly from the tax revenues, and partly from the incomes from customs in the future” (Karimova, 2016).

In this way, from the perspective of fiscal decentralization the most feasible solution for the country in the current situation is to restructure the local tax system and subsequently grant policies. Increasing revenues through the proper local tax assignments will ease the “taking care of everyone” burden of central government and hence prevent depletion of the central government budget in a very short time. Of course, while enhancing the power of the lower tiers to raise revenues by local taxes, the central government should also make certain grants.

According to the World Bank (2001) jurisdictional tax assignment is partially contingent on the compound of different taxes that is employed in the country general. Based on the theory of public finance, in the unitary state system the subject matter of the perfect tax mix has not been thoroughly improved yet. Today, balanced tax systems used nearly worldwide by governments. Such systems have a characteristic that essentially the same bases are applied to different taxes. For instance, there are substantial overlapping in in bases of income taxes, general sales taxes, and payroll taxes (World Bank, 2001). Appendix 2, designed by Ebel and Taliercio (2006), demonstrates six largely accepted normative criteria that helps to prefer one revenue source over another for different country cases. In order to be able to define which sources of revenue match certain presented objectives those criteria tagged along with a checklist. From the Appendix 2 two particular issues become clear. First, trade-off is an inseparable part of criteria choice, while

changing or picking one tax or group of taxes. It is impossible to fulfil all the goals of “good” tax by one revenue instrument. Also, some taxes may disturb one criterion and satisfy another. Second, it is reasonable to apply a composition of different taxes to let the revenue system of local governments function well. The main reason for implementing such a policy is to prevent intolerable defects of revenue sources in case of intensive usage as intrinsic structural inequalities are embedded in them (Ebel and Taliercio, 2006).

3.3 Expenditure Assignment

The expenditure side is another item that should be considered while designing intergovernmental fiscal policy. Among the different levels of the government a well-defined and certain institutional structure in the expenditure assignment responsibility along with adequate budgetary autonomy to fulfil obligations allocated at each tier of the government are needed for meaningful and enduring fiscal decentralization (Vazquez and McLure, 2005). Therefore, the key issue is to determine where the lower tiers should simply carry out centrally directed expenditures versus where the distribution of expenditures is determined by local governments. Doing this can be based on numerous issues such as cost/benefit spillovers, economies of scale, budgetary selections flexibility while formulating public spending, preferences of the consumers, closeness to beneficiaries, and economies of scope by means of coordination and information economies and cost recovery and elector participation related increased accountability, suitable package of public services to enhance productivity (World Bank, 2001).

It should be emphasized that it is hard to base the assignment of expenditure responsibilities among sub-national governments on a fixed frame. Boex, Timofeev and Vazquez (2006) emphasize that in different states the degree of the utilization of a decision-making power by lower tier governments changes considerably. It can also vary in one specific country from time to time

depending on the changes in the choices of the citizens and technology for the delivery of services and public goods. At the same time, the authors continue by underlining actual possibilities for worse and better expenditure assignments. For example, according to some common tenets of best practices from the globe and economic theory, it is the best way to assign economic stabilization policy decisions to the central government. While, policy decisions concerned with efficiency distributions, as supplying goods and services by using accessible resources in a reasonable manner, should be assigned to the sub-national governments. Otherwise, there is a risk for policies to be inviable and inefficient, and some disputes and improper incentives may come to light if local governments are responsible for income distribution and economic stabilization policies. The primary duty of local governments is least-cost service provision, assigning the benefits inside of the geographic area and efficient allocation (Boez, Timofeev and Vazquez, 2006).

In the Appendix 1, we can see a matrix of traditional expenditure assignment. More or less such matrix can be seen in several country studies. From the Appendix it becomes clear that the delivery of complicated services like primary education cannot be taken as one single duty that needs a sole jurisdictional assignment. Rather, it should be seen as a group of a few various functions in the fashion of parallel and/or supplementary intergovernmental authorities. Indeed, this mistake is widespread in many governments that decentralized recently (Ebel and Peteri, 2007).

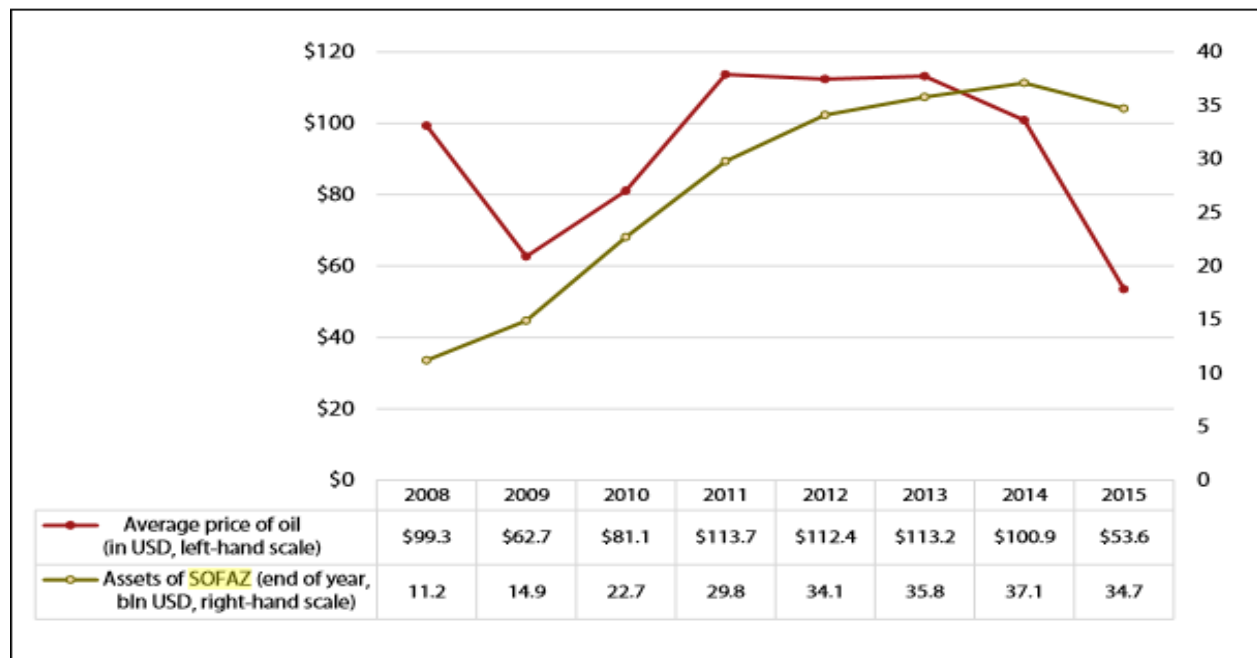
In a great deal of transition countries, including all Central Asian countries, Ukraine, and Georgia, while the appointment of the leaders of the regional governments is executed by the central government, democratically elected governors/mayors lead the local governments such as in Russia, Hungary, the Baltics, the Czech Republic, and Poland. On the other hand, in countries like Azerbaijan, Turkmenistan and Belarus subnational governments do not have elections (Wade and Dabla-Norris, 2002). However, regarding issues of local finance in Azerbaijan, according to

the Law on Municipal Finance local budgets can be autonomously projected, approved, executed and observed by municipalities themselves. Excluding some cases that specified in the law, intervention to the budget activities of the municipalities is forbidden by present legislature. As the center is not responsible for the duties of the local budget means that there is fundamental division between municipal and state budgets. Nevertheless, several security measures are assumed by the central government based on article 6 of the Law of Municipal Finance, including building environment for the improvement of industry by means of national monetary and investment policies and helping during deficit times through allotment of complementary funds. At the same time, municipalities are required to report activities in local budget to the statistical committee of the central government (Mamedova, Hasanov, Bayramov and Huseynov, 2002). However, in reality everything stands differently. As it was discussed in the previous section, in order to meet expenditures local governments heavily rely on transfer incomes, making their financial power enormously weak. In such economies with decreasing overall state budget during economic downturns central government is also compelled to decrease the amount of transfers, leaving no choice for the local governments but to comply with the rules of the game and subsequently decrease the amount of local expenditures (even in important areas as social welfare).

In Azerbaijan, for 2016 the amount of state budget decided as 14.566 billion Manat. Comparing with 2014 and 2015 budgets, this number is less 4 billion and 5 billion accordingly. Within the past five years 2016 state budget is the lowest. Budget of State Oil Fund of the Republic of Azerbaijan (SOFAZ), one of the key governmental entities that was created in 1999 with the purpose of control and accumulation of gas and oil revenues, declined from \$37,104 billion in the first half 2015 to \$35,783 in 2016 (Gurbanli, 2016). Although, the Ministry of Finance which is accountable for determination of expenditures and revenues for a fiscal year in the Republic of

Azerbaijan, has already diminished the amount of expenditure, still because of the underdeveloped and weak administrative institutions that do not have almost any fiscal autonomy and consequently heavily depends on transfers from state there is a huge risk of depletion of budget in very short period before any alternative ways will be realized. Thus, to prevent the drastic effect of the recent oil price drop related crisis and depletion of state budget, a number of reforms should be introduced in certain areas that can be realized comparatively quickly with significant revenue returns. One of these areas is fiscal decentralization policy of the government that will be discussed in depth in the following chapter.

Figure 1: *Assets of the State Oil Fund of Azerbaijan (SOFAZ, end of year, in billion USD)*



Source: *Caucasus Analytical Digest, No: 83, 2016*

3.4 Development of local tax system

In order to decrease the amount of transfers to local governments, different tax policies should be adopted towards stimulating and reshaping the revenue assignment of subnational governments.

First of all, based on the local preferences and condition, local governments should be able to decide on the amount of fees and charges as a part of non-tax revenues for the services that they supply. Bird (2001) argues that the promotion of economic efficiency is one of the rationale behind user fees and charges. Considering the size of the country and the current development of the lower tiers it is hard to implement various non-tax revenue sources at the same time. For instance, it will take decades for the local governments in Azerbaijan to develop strong financial institutions in order to implement non-tax revenues as bond issues, which barely evolved even in the capital. However, it is not the case for the user fees and charges that can be levied almost in all areas, and thus, in Azerbaijan the central government needs to take serious steps to encourage such type of non-tax revenues in the local governments.

The Law on Municipal Finance of the Republic of Azerbaijan mentions about fees such as parking and hotel fees as an income for the local budget. Still, while analyzing statistics for local government revenues it becomes clear that the percentage of user fees and charges in the overall non-tax revenues remain very small (see Appendix 6). The main reason is that, except big cities like Baku, Nakhichevan, Ganja and Lankaran, it is hard to see the proper enforcement of such important revenue generating sources mentioned in the law. For example, in the case of parking fees, payment per vehicle per day in either various temporary and permanent parking places or officially approved private parking spots set as not surpassing 0.1 manat. Furthermore, the collected money has to be delivered to the budget of the local municipalities in certain predefined dates (Yusifov, 2015). Taking into account an increasing number of cars in the country every year, such kind of incomes are an important source of revenues. However, nowadays either those fees are not collected at all, so the people use those parking areas for free, or some unauthorized individuals collect it with lower rates than it is supposed to be that generally goes to “private pockets”. Because

of the huge revenues from the oil sector for more than two decades, it was easier for the central government to simply make transfers to the local governments to cover their expenditures rather than spending time on the development of similar non-tax revenues. Apart from growth in the budget of the local governments, according to Appendix 1 process of thorough progress in this way can also increase accountability among local policy makers and decrease horizontal and vertical inequalities.

In the same way, the role of property and land taxes in revenue raising is very crucial. Within the lands of the Republic of Azerbaijan organizations or physical persons who utilize or possess land spaces regardless of economic outcomes are under the obligation to pay land tax. For agricultural lands tax rates are decided by conventional points, 0,06 manats each. While determining those points geographical location, quality and objective are also taken into account. Also for properties, either municipal enterprises or physical facilities, different rates are employed for every 100 m² (taxes, 2015). Although the amount of revenues collected from property and land taxes is comparatively higher than other sources (see Appendix 6), still it is low and for local governments in Azerbaijan this source of revenues is attractive. Ibadoglu (2006) identifies that in 2005 subnational governments were able to collect only 24.8 billion manats through land and property taxes. So, the functioning of such considerable revenue yielding taxes is under question. The first and major problem in this respect is connected to the collection and calculation of property and land taxes. This problem, in turn, associated with an undervaluation of the monetary worth of the property and land that had a severe influence on the aggregate tax collection and inexistence of common system for the registration of properties and lands possessed by the people. In addition, with regard to the taxation of transportation means identical situation can be detected. In most of the instances the State Road Police approves technical care to vehicles that avoid property tax

payment, even though it is prohibited by the Tax Code. In this way, every year the amount of property taxes transferred by ordinary people to local budgets appears much lower. For example, in 2003 this number was just 4.7 billion manats and taking into account the fact in Azerbaijan there are more than 3 million private vehicles and real estates, it has to be much bigger (Ibadoglu, 2006). These facts demonstrate that land and property can become an important source of income. At the same time, as suggested by Ebel and Taliercio in Appendix 2, while enforcing property and land taxes local governments have to make sure that they will not impede private choices of the producers, factor suppliers and consumers.

Consequently, it has become clear that there are number of attractive taxes and non-taxes for the lower tiers that can be significant sources of revenue. Thus, rather than making huge transfers to the local governments to cover some part of their expenditures the central government in Azerbaijan should take the necessary measures immediately to make these tax and non-tax revenue sources work. To some extent such policy will prevent the distortion of the state budget, especially in the context of recent oil price drop related crisis. However, it does not mean that no transfers should be made at all as local governments are not economically powerful enough to be totally on their own, as in some western countries. That is why, in this context it would be appropriate to apply the gap-filling model of grant allocation. That is to say, firstly, including whole government revenues, expenditures and own source revenues for each subnational government should be estimated and later the gap that is left after extraction predicted total revenue from verified amount of expenditures of the local governments should be filled with central government transfers ($EI_{\text{estimate}} - RI_{\text{planned}}$, see Appendix 3) (Ebel and Peteri, 2007).

Conclusion

All in all, the main point of this research was to look at current oil price drop related crisis in Azerbaijan from the perspective of fiscal decentralization. This research analyzed why the central government is not able to prevent one of the severest crises in the history of the country since its independence from Soviet Union brought by decrease in oil prices. It argued that rather than developing strong macroeconomic policies towards making some savings in case of economic downturns, the incumbent government in Azerbaijan spent huge amount of money by relying on the power of long-standing high prices of oil and consequently huge influx, making the whole economy susceptible to oil price falls. Thus, towards the end of the first half of 2015, when oil prices started to go down the government had no other choice than depreciating the currency that took the country into crisis. In that sense, one of the mistakes was making huge transfers to local governments from central budget to meet their expenditures rather than developing local revenue sources and giving more financial power to local authorities. Nowadays, because of poor own revenue sources of the subnational governments central government does not have any other choice than continuing to make transfers. Thus, it is offered that under the current environment of decreasing world oil prices that also led to the decline of overall revenues of Azerbaijan considerably instead of taking too many responsibilities while tackling the crisis, the central government should focus on attractive tax sources for SNGs to make sure that they make their own revenues to meet some part of their expenditures instead of totally depending on transfers from the central budget. Positive modifications in local tax policies can lessen the impact of recent oil price drop related crisis. At the same time, it should be stressed that research can be developed more by making more quantitative research through calculating possible bases for above mentioned or other taxes that are attractive for the local governments in order to see clearly to what extent proposed policy can be successful in curbing the effect of the crisis.

References

- Adb (online). *Economic Analysis*. Available from:
<http://www.adb.org/sites/default/files/linked-documents/cps-aze-2014-2018-ea.pdf>
- Amogah, F. (2012). An Examination of the Impacts of Fiscal Decentralization on Economic Growth. *International Journal of Business Administration*, Vol.3, No.6.
- Ahmadov, I. (2016). Low Oil Prices: Economic and Social Implications for Azerbaijan. *Caucasus Analytical Digest*, No. 83.
- Azerbaijan (2015). *Budget System of the Republic of Azerbaijan*. Available from:
http://www.azerbaijans.com/content_731_en.html
- Bahl, R. (1999). "Fiscal Decentralization as Development Policy." *Public Budgeting & Finance*, pp. 59-75.
- Barati, I.S. (2016). *Reversing the Resource Curse: Session on "Budgeting in Resource Rich Settings"* [Power Point slides].
- Bahl, R. (2001). Fiscal Decentralization, Revenue Assignment, and the Case for the Property Tax in South Africa. (International Studies Program Working Paper 01-07). Georgia State University: Andrew Young School of Policy Studies.
- Bird, R. (2001). User Charges in Local Government Finance, in Stren, R. and Emilia, M. F. (eds.), *The Challenge of Urban Government* (Washington, DC: World Bank).
- Boex, J., Timofeev, A. and Vazquez, J. (2006). *Reforming Regional-Local Finance in Russia*. Washington: World Bank.
- Boschmann, N. (2009). *Development Partners Working Group on Local Governance and Decentralization DPWG-LGD: Fiscal Decentralization and Options for Donor Harmonization* (Final Report). Available from:
http://www.delog.org/cms/upload/pdf/wg/Fiscal_Decentr-FinalReport2009.pdf
- Brennan, G. and Buchanan, J.M. (1980). *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Cambridge: Cambridge University Press).

- Caspianinfo (2013). Azerbaijan: Alternative and Renewable Energy – A Business Perspective. *Caspian Information Centre*. Available from: <http://www.caspianinfo.com/wp-content/uploads/2013/05/Azerbaijan-Alternative-and-Renewable-Energy.pdf>
- Dabla-Norris, E. (2006). The challenge of fiscal decentralization in transition countries. *Comparative Economic Studies*, 48, pp. 100–131.
- Ebel, R., and Yilmaz, S. (2001). On the Measurement and Impact of Fiscal Decentralization. (Policy Research Working Paper 2809). World Bank Institute: Economic Policy and Poverty Reduction Division.
- Ebel, D.R. and Taliercio, R (2006). *Subnational Tax Policy Design and Administration*. Washington: World Bank, Decentralization and Intergovernmental Fiscal Reform Seminar.
- Ebel, R., Peter, G. (edt.) (2007). *The Kosovo Decentralization Briefing Book* (Budapest: Kosovo Foundation for Open Society and Local Government and Public Service Reform Initiative, Open Society Institute).
- Ebel, D.R. (2014). *Democracy, Decentralization and Development*. Available from: <http://www.frp2.org/english/Portals/0/Library/Inter-Governmental/Democracy.pdf>
- Euronews (2016). Azerbaijan's president insists low oil price are bringing reforms and diversification. *Euronews*. Available from: <http://www.euronews.com/2016/03/11/azerbaijan-s-president-insists-low-oil-price-are-bringing-reforms-and/>
- Farchy, J. (2015). Azerbaijani Manat Collapses After Government Abandons Dollar Peg. *Financial Times*. Available from: <http://www.ft.com/intl/cms/s/0/b5f46eac-a7c4-11e5-9700-2b669a5aeb83.html#axzz49fz9toEG>
- Guliev, Y. and Kosayev, E. (2006). *Azerbaijan*. Available from: <http://www.fao.org/ag/agp/agpc/doc/counprof/Azerbaijan/Azerbaijan.htm>

- Guliyev, F. (2016). Paradox of Plenty, Redux: Azerbaijan Grapples with Low Oil Prices. *Natural Resource Governance Institute*. Available from: <http://www.resourcegovernance.org/blog/paradox-plenty-redux-azerbaijan-grapples-low-oil-prices>
- Gurbanli, A. (2016). The Impact of Declining Oil Prices on the State Budget of the Republic of Azerbaijan: Public Finance and Budgeting. *Oval*. Available from: <http://oval.az/the-impact-of-declining-oil-prices-on-the-state-budget-of-the-republic-of-azerbaijan-public-finance-and-budgeting/>
- Ibadoglu, G. (2006). *Problems of fiscal equalization and decentralization of local governments in Azerbaijan*. Budapest: LGI
- Ipsa (2012). *Rethinking the Post-Soviet Resource Curse: Are Azerbaijan, Kazakhstan and Turkmenistan Rentier States?* Available from: http://paperroom.ipsa.org/papers/paper_34621.pdf
- Jafarli, N. (2016). Azerbaijan: Approaching Crisis Point. *European Council on Foreign Relations*. Available from: http://www.ecfr.eu/article/commentary_azerbaijan_approaching_crisis_point5096
- Karimova (2016). Tax Revenues from Azerbaijan's Region Exceeds \$387M. *Azernews*. Available from: <http://www.azernews.az/business/92135.html>
- Lee, S (2009). *Tax Competition among Governments and the Effects on Government Performance: Empirical Evidence from Local Governments* (Ph.D. dissertation, University of Pennsylvania, Pennsylvania, United States). Available from: <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.607.4905&rep=rep1&type=pdf>
- Maliyye (2015). *The Law of the Republic of Azerbaijan: On the State Budget of the Republic of Azerbaijan for 2015*. Available from: http://www.maliyye.gov.az/sites/default/files/Budget_law_2015.pdf
- Mamedova, M., Hasanov, H., Bayramov A. and Huseynov, M. (2002) Local government in Azerbaijan, in Munteanu, I. and Popa, V. (eds). *Developing New Rules in the Old Environment*. Budapest: Open Society Institute, 371–402.
- McNab, M.R. and Vazquez, M.J. (2003). Fiscal Decentralization and Economic Growth. *World Development*, Vol. 31, Issue 9, pp. 1597-1616.

- Mikaylov, E. (2008). *Modelling Azerbaijan's Fiscal Decentralization: Examining Trends and Exploring Opportunities* (Master's thesis, Central European University, Budapest). Available from: http://www.etd.ceu.hu/2008/aliyev_mushfig.pdf
- Mirzayev, V. (2015). *Study Mapping the Obstacles to Inter-municipal Co-operation in Azerbaijan* (Strengthening Institutional Frameworks for Local Governance Program 2015-2017: Council of Europe).
- Neumayer, E. (2004). Does the "resource curse" hold for growth in genuine income as well? *World Development*, 32(10), pp. 1627-40.
- NGO Alliance for Municipality Development. (2011). *Current Situation of Local Self-Governance in Azerbaijan*. Available from: http://www.alda-europe.eu/public/doc/276-Report_ingilis-2011_son.pdf
- Oates, E.W. (2006). *On the Theory and Practice of Fiscal Decentralization*. Available from: <http://www.ifigr.org/workshop/spring06/oates-workshop.pdf>
- OECD (2006). Intergovernmental Transfers and Decentralized Public Spending. *OECD Journal on Budgeting*, Vol.5, No: 4.
- Pareto (2015). Definition of 'Pareto's Efficiency'. *Economic Times*. Available from: <http://economictimes.indiatimes.com/definition/paretos-efficiency>
- Pereira, P. T. (2000) "Fiscal Decentralization, Public Sector Size and the Wealth of Nations", in APDR (ed.) *Economia Pública Regional e Local* (Coimbra: APDR).
- Porcelli, F. (2009). *Fiscal Decentralization and Efficiency of Government: A Brief Literature Review*. Available from: http://www2.warwick.ac.uk/fac/soc/economics/staff/fporcelli/dec_efficiency_gov.pdf
- Ppi (2015). *Boosting Economic Growth in Azerbaijan through Economic Diversification*. Available from: <http://www.ppi.az/publication/boosting-economic-growth-in-azerbaijan-through-economic-diversification/>
- Schneider, A. (2003). Decentralization: Conceptualization and Measurement. *Studies in Comparative International Development*, Vol. 38, Issue 3, p.32.

- Taxes (2016). *Municipal Taxes*. Available from:
<http://vn.taxes.gov.az/info/verginovleri/eng/belediyye.pdf>
- The Statistical Committee of the Republic of Azerbaijan (2016). *Statistical Information for 2016*. Available from: <http://www.stat.gov.az/source/demography/>
- Vaillancourt, F. and Bird, R. (1998). *Fiscal Decentralization in Developing Countries* (Cambridge: Cambridge University Press).
- Vazquez, J. and McLure, C. (2005). *The Assignment of Revenues and Expenditures in Intergovernmental Fiscal Relations*. Available from:
<http://www1.worldbank.org/publicsector/pe/PEAMMarch2005/AssignmentRevenues.pdf>
- Vazquez, J. (2007). Revenue Assignment in the Practice of Fiscal Decentralization. (International Studies Program Working Paper 07-09). Georgia State University: Andrew Young School of Policy Studies.
- Wade, P. and Dabla-Norris, E. (2002). The Challenge of Fiscal Decentralization in Transition Countries. (IMF Working Paper 02/103). International Monetary Fund: IMF Institute
- World Bank (2001). *Fiscal Decentralization: An Overview*. Available from:
<http://siteresources.worldbank.org/PSGLP/Resources/FeruglioandAndersonoverviewofFiscaldecentralization.pdf>
- Worldbank (2001). *Intergovernmental Fiscal Relations*. Available from:
<http://www1.worldbank.org/publicsector/decentralization/fiscal.htm>
- World Bank (2013). *GDP at Market Prices*. Available from:
<http://data.worldbank.org/indicator/NY.GDP.MKTP.CD>
- Yusifov, S (2015). *Local Finance Benchmarking in Azerbaijan*. Strasbourg: Council of Europe.

Appendices

Appendix 1

Illustrative Assignment of Functions		
Expenditure Function	Concept	Rationale for Assignment and Comments
Defense, Foreign Affairs, Trade	C	Benefit and costs are national in scope
Post and telegraph	C	Economies of Scale
Monetary policy, currency, banking, fiscal policy	C	The institutional reality is that the center must control the central bank or currency board. Benefits of monetary stability are national in scope.
Water and air ports	C, R, L	Often special purpose public authorities; and may be sub-central. There are numerous examples of sub-central units managing ports. Clearly, however, some national coordination is needed, especially if ports are few. Customs entry is surely national.
Transfer payments to persons (pensions, large anti-poverty programs)	C	Redistribution. In many countries emergency safety net programs are local and may reflect local preferences.
Immigration	C	Benefits and costs are national in scope and thus this is a typical central matter (also have foreign policy implications); but there are exceptions of practice: Switzerland Cantons (regional/intermediate governments) and UAE Emirates have decision control over immigration.
Expenditure Function	Concept	Rationale for Assignment and Comments
Table Notes: The designations are -- C : Central; R a regional or intermediate tier of government that is sub-central and yet overlaps municipal/local/village boundaries; L : Local (e.g. municipal, special district) Source: Ebel, R. and Peteri, G. (2007): The Kosovo Decentralization Briefing Book		

Illustrative Intergovernmental Assignment of Functions (continued)		
Environment	C, L	Economies of scale suggest that the center would be responsible for activities such as geological surveys and ensuring clean air and water; but the benefits and preferences arguments suggest a regional or even local role for activities such as irrigation and land reclamation. In the case of deterioration of a local environment due to mining operations – the goal is to internalize the costs of clean/up control to the mining operations. This may require central and local regulation and taxation.
Land use planning, zoning, licensing and regulating of building, residential occupancy permits; managing municipal property, fairs and local markets	L	Depends on the benefits area; but the principle is that local (e.g., urban) planning and zoning is a local affair
Capital Investment Planning	R, L	Depends on benefits area; but except for very large infrastructure projects having significant economies of scale and/or national benefits, the capital investment decision is usually subnational.
Primary and Secondary education, Literacy	C, R, L	A classic case of the need for intergovernmental partnership due to differing benefit areas (literacy is surely a national goal but the operation of a school is local – indeed, may even be at the school level)
Health: Dispensaries, and local hospitals	R, L	Benefits argue municipal (local); but there may be a regional role (economies of scale).
Community Fire Protection	R, L	Primarily local benefits; police are central; fire services are a local responsibility. Unless there is a clear externalities argument (e.g., local police are corrupt, the center is not), there is no good justification for any central role in community policing (beyond, perhaps, information sharing).
Community policing	C, L	Applying the benefits rule, there is a case for special policing for provincial or central activities (e.g. inter-municipal and inter-provincial highway control), but the benefits rule also argues that community police matters are local issue. Of course, there should be intergovernmental police coordination.
Water supply and distribution	L	Water supply tends to have a regional character (to manage watersheds that cross over municipal boundaries); however, the responsibility of getting water to home and business has a large local/municipal character (benefits, preferences, management).
Parks and recreation	C, R, L	Primarily local responsibility, but some “heritage” parks may be national.
Roads Interstate	C	Internal common market
Interregional	C, R	Interregional benefits and costs
Local roads and streets	L	Includes street lighting

Appendix 2

Criteria for Making Subnational Tax Choices			
Criteria/Objective	Comment	Taxes that satisfy the objectiveand those that fail
Accountability: Local policymakers responsive to citizen preferences. Those taxed have political redress.	Local officials determine “own” tax rates; tax burdens borne locally; transparency	Local Personal Income Taxes (may conform to higher level tax base with rate set locally). User Charges	General; Business Taxes Visitor (tourist) Natural resource taxes
Revenue Productivity: Taxes that help to promote the EU Charter (Art. 9) call for financial resources commensurate with spending responsibilities	As a system, recognizes a balance between bases responsive to changes in economic conditions, growth (elasticity or buoyancy) and stability (certainty)	Ad valorem property tax (distinguish between and improvements) and or Area-base property Personal Income Tax General Broad Based Business Tax (e.g. gross receipts/turnover) Single stage sales taxes and some market excise taxes	Corporate profits, natural resources (both highly volatile) Many user charges
Source: Ebel and Taliercio, 2005			

Criteria for Making Subnational Tax Choices (continued)

Criteria/Objective	Comment	Taxes that satisfy the objectiveand those that fail
Tax Price: to extent possible taxes should function as a payment for the flow of services that accrue to the tax payer/citizen	Taxes set to perform a <i>quid pro quo</i> function and may be tailored to local and regional variations and benefit areas. Service spillovers (whether positive or negative) may call for special purpose districts and/or inter-local cooperation and revenue harmonization.	User fees and charges; Visitor taxes Moderate tax rates on business enterprises (generalized benefits – e.g. gross receipts)	Non-resident based income tax (assumes non-residents are subject to alternative taxes for services received: e.g. user charges, sales taxes, visitor taxes, general business tax)
Non-Distortion: taxes should not unintentionally interfere with private decisions of consumers, factor suppliers and producers; they should be “neutral”.	Variability in tax rates is possible; Immobile tax bases work well here as do taxes on commodities that exhibit a relatively high inelasticity of demand. Providing for tax payer certainty in making tax rate and base policy is desirable.	Taxes on immoveable property Land value tax plus charges User Charges Resident based Personal Income Sumptuary Taxes Taxation of “bads” Poll and communal taxes	Non-resident based Income Tax Gross receipts taxes Severance Taxes (if high rate)
Tax Equity: Tax burden should be reasonable and fair	Vertical equity (differential treatment unequal as usually measured by income or wealth – “gressivity”); Horizontal (equal treatment of those in equal circumstances as measured by income, consumption, or wealth).	Progressive Resident Personal Income Taxes Ad valorem property taxes Some local sales taxes; excises	Poll and communal taxes Area-based property taxes Gross-receipt taxes
Simplicity: administration and compliance	Citizens should be able to understand and control the system; cash flow preferable to accruals; standardized tax bases.	Piggyback Personal income Single stage sales and excise (market tax) Turnover/receipts taxes Some user charges Market taxes	Multi-rate taxes Potentially broad based taxes narrowed by exemptions, deductions and tax preferences Property tax

Appendix 3

Types of transfers	Expenditure	Revenue	Transfers
Gap-Filling	Individual decision on appropriations (E_{estimate})	Individual revenue assessment (R_{planned})	Individual bargaining ($E_{\text{estimate}} - R_{\text{planned}}$)
General grant influences the tightness of 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
Fiscal Capacity	Accepted expenditure levels based on objective (policy neutral) measures of “needs” ($E_{\text{estimated}}$)	Potential revenue at standardized revenue bases subject to nationally average tax rates and revenue charges (R_{required})	Calculated grant ($G_{\text{calculated}} = E_{\text{estimated needs}} - R_{\text{potential}}$)
Source: Ebel and Peteri, 2007			

Appendix 4

Share of local budget revenues and expenditure in overall state budget revenue and expenditure (%)		
Years	Share of local budget revenues in overall state budget revenue (%)	Share of local budget expenditure in overall state budget expenditure (%)
2002	1.4	1.37
2003	0.91	0.90
2004	1.16	1.17
2005	1.18	1.13
2006	0.85	0.87
2007	0.83	0.82
2008	0.40	0.40
2009	0.26	0.28
2010	0.25	0.24
2011	0.22	0.22
2012	0.21	0.21
2013	0.24	0.25
Source: Yusifov, S., 2015		

Appendix 5

Transfers from other levels of governments as a percentage of subnational revenues	
Albania	93.81
Azerbaijan	59
Belarus	23
Bulgaria	43
Croatia	3.4
Czech Republic	17
Estonia	29
Hungary	43
Latvia	22
Lithuania	3.2
Moldova	25
Poland	46
Romania	23
Russian Federation	9
Slovakia	18.9
Slovenia	22
Source: Data from IMF International Financial Statistics, 2000	

Appendix 6

Local government revenues 2013	
Land tax	14.1%
Property tax	9.1%
Mine tax	11.1%
Enterprise Profit tax	0%
Tax Revenues	24.3%
AD tax	0.5%
Land and asset sale	48.8%
Land and asset lease	8.8%
Non-tax revenues	58.1%
Aids	2.2%
Transfers	11.2%
Others	4.2%
Total	100%
Source: Statistical Committee of the Republic of Azerbaijan	