INTERGOVERNMENTAL FISCAL TRANSFERS IN AZERBAIJAN:

ROLE OF TAX - SHARING IN LOCAL GOVERNMENT FINANCING

Policy Paper
by

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Abstract

Subnational governments in developing and transition countries are granted limited taxing autonomy. This is compensated by leaving the bulk of revenue raising power at the central level and providing a subsidy to local budgets to remedy the mismatch. The result is that transfers comprise a major component of subnational government revenues (Bahl 2000). The term "intergovernmental transfers" takes a number of forms which include *shared taxes*, *grants*, *subsidies* and *subventions* etc. Some of them are characterized by their nature of being very centralizing while others are decentralizing (Bahl 2002). Two main objectives are pursued through tax sharing and grants: vertical and horizontal equalisation (Davey: Introduction).

In this paper, Elshad Mikayilov[1], assesses the role of shared taxes type of transfers as a source for municipal financing in Azerbaijan. In particular, it argues that tax sharing will improve the fiscal capacity of local self-governments and thus promote their local autonomy. It is done by presenting a number of effects that are likely to take place when tax sharing is used to provide decentralized jurisdictions with shared tax revenues.

Keywords: Fiscal decentralisation, intergovernmental transfers, tax sharing, local taxes and expenditures, etc.

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INTRODUCTION

The proper implementation of fiscal decentralization requires that subnational governments have "own" source revenues under their control. Those that do not have enough independent sources of revenue would never enjoy the real fiscal autonomy and may be under the financial thumb of the central government. However, while it is easy to determine which services are demanded, it is much harder to define *appropriate revenue sources* for lower levels of government. The question then arises which revenue sources should or can be assigned to subnational levels of government and how these assignments must be enforced. Subnational governments should at least theoretically have revenues that are adequate to finance the expenditures assigned to them (Charles *et.al* 1997). Some of the developed countries have gradually worked out their intergovernmental finance systems with each of them possessing specific features (Hewitt, Ruggiero, Ahmad 1997).

Like other transition economies, Azerbaijan also launched its decentralization process and formation of a new local self-government system in the late-1990s. Some activities of public importance were relinquished to local governments and certain taxes announced to be local due to the decentralization process. It should be noted that subsidiarity principle in the assignment of local expenditures is implemented better, if the individual municipalities appropriately and efficiently adopt sufficient own fiscal resources and unconditional transfers according to their own needs (Frenkel 1986, Hyman 1993). The adequacy of revenue sources with expenditure asignments is also supported by the European Charter of Local-self-Government (Strasburg 1985, Article 9). On the basis of his research in some transition countries, Bahl (1992) holds that irrespective of the source of revenues, be it local own taxes, shared taxes or intergovernmental transfers, it is critical for sub-national governments in transition economies to have a sufficient revenue base.

However, the current revenue bases assigned to municipalities in Azerbaijan are insufficient to adequately cover their expeniture needs. They do not safeguard stable inflows to local budgets either. Local autonomy is confined to 1) some own source revenues which do not generate enough revenues and 2) minor intergovernmental transfers. The study of some transition countries reveals that lower tier governments are, in most cases, assigned more basic revenue sources[2]: own-tax revenues, ceded (non-tax) revenues and shared tax revenues. However, in the case of Azerbaijan, instruments such as tax-sharing, which is capable of bringing significant income, remains underdeveloped. So the adequate revenue bases is missing. In response to filling this gap, the paper porposes tax-sharing instrument.

Problem Description

The municipal councils in Azerbaijan are confronted with financial restrictions such as: Their sources of funding are limited to two areas: *automatic government subsidies* calculated on a per capita base and *tax and non-tax revenues*. In the first case, since 2001 subsidies have been successively decreased and are now down to ¼ of their original levels[3].

Furthermore, as is the main concern of local authorities, the tax types stipulated by the law do not allow to create a budget of minimal needy revenues in order to ensure independence of local budgets. So considering the fact that the *tax base* (fiscal capacity) of most municipalities is low, there emerges a need for transfers. In an attempt to remedying the fiscal capacity of municiaplities, the state is employing multiple ways to accomodate

[2] The country-specific examples in chapter 2 will broaden the issue.

[3] Management Systems International (MSI). *Azerbaijan Civil Society Sector Assessment.* January 11, 2005. Final Report. URL: http://pdf.dec.org/pdf_docs/PNADD277.pdf

subnational government budgets, such as *general purpose* (unconditional), specific (*conditional)*[4] grants, budget loans, etc. without any target and on *an ad-hoc basis*[5]. Besides, subsidies and subventions to the localities are not *direct,* as most local authorities complain, in the sense that funds go to the accounts which are very close to Local Executive Committees[6] (hereinafter referred to as local excoms). The accounts that the funds are transferred to are not transparent and can be easily manipulated by Local Excoms. Despite the fact that the powers to the municipalities is increasing and the resources at their disposal inadequate for their required expenditures, the amount of subsidies is decreasing from year to year. For example, they made up 37.4% of local budget revenues in 2002, while they were 10.7% in 2004[7]. The statistics (2002-2006/first half) shows a decreasing tendency in the amount of state transfers to local government budgets.

The own tax revenues of subnational governments is about 25.6%, while non-tax revenues contain 65.6% according to the statistical indicators of 2005[8]. The tax revenues, as shown by Figure 2**,** are also gradually starting to play a minor role as compared to other revenue sources in local budgets. The central government, however, does not take any remedial measures, like increasing the transfers, to compensate this resulting gap. So the increasingly declining low portion of these revenues in Subnational Governments' (SNGs) budgets leads to the greater *vertical imbalance*. Shah maintains that the vertical imbalance delivers an indicator of *external dependance*. This means that subnational governments have no much room for autonomous budgetary decision-making (1994: 40).

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[4] Subsidies and subventions in the context of Azerbaijan

[5] *Problems of Local Self-Government.(2003).* Scientific and Practical Journal for Municipalities. The Publication of the Centre of Civil Initiatives.

[6] Local excoms are the agencies with direct subordination to the central government not to the electorate. They are referred to as local state administrations or local executive powers in other ex-soviet countries. Further information on this structure will be provided in Chapter 3.

[7] Source: State Statistics Committee 2002 through 2006 first half

[8] Source: State Statistictics Committee 2005. *Revenues and Expenditures of Local Self-Governments.* pp. 10

Hypothesis

Although some taxes were designated as local, it seems, under the current inefficient tax collection, it is less likely that their amounts will be increased in the near future. Nor is it likely that other existing income sources will provide a considerable contribution to municipal budgets.

Therefore, the paper aims to show that in the context of intergovernmental fiscal transfers, tax-sharing leads to increased tax collection and thus more and stable revenues for subnational governments (SNGs). Despite its broad application among developing and transition countries as a means to resolve the problem of the low fiscal capacity, the tax-sharing method is of absolutely no importance in the present municipal legislation of Azerbaijan. Nor has the role of tax-sharing ever been researched or introduced as a source for municipal financing. The paper argues that Azerbaijani municipalities are not assigned enough revenue sources. It therefore explains the problem of low fiscal capacity. The hypothesis is that tax sharing transfers can improve the *fiscal capacity* of local self-governments in Azerbaijan. Along with completing revenue bases of localities, tax-sharing will resolve the problem of limited local government autonomy as well.

Methodology and Structure

The most important concerns were found out during the analysis of financial documents regarding fiscal capacities of the local self-governments and interviews with local government officials. Accordingly, the reserach has used the following qualitative research methods:

Content analysis of the legislative and strategic documents as well as reports has been applied in the first part of Chapter 3. However, the documents were not considered enough.

There was a need to do interviews to learn the actual situation. Eighteen interviews have been conducted with the predominance of *semi-structured face-to-face interviews*. Interview questions have been designed according to the objectives of the paper ahead.

After the content analysis and conducting interviews, the second part of Chapter 3 contains an overall *critical analysis* of the fiscal position of local governments in Azerbaijan and corresponding guidlines are proposed to resolve the problem.

Another basic method of analysis used in the study is the cross-country review of transition economies. Mostly transition economies were selected due to the similarity of intergovernmental problems by nature in this group of countries.

In order to achieve its goal, the paper proceeds as follows: First it will start with a short theoretical insight. In chapter 2, tax sharing will be analized both from theoretical and practical viewpoints with country-specific application examples. This can be of value later to develop recommendations for Azerbaijan. Chapter 3 will describe the existing fiscal decentralization process in the country providing a background for the problem aimed to be resolved. The theoretical considerations will then be put in contrast with the current experience in Azerbaijan. The chapter will further be developed with empirical information gained through using the most recent data on the revenues and expenditures of local self-government, tax collection and interviews. The existing legal and regulatory framework uderpinning the current local self-government system will be reviewed, the role of local self-governments in the public administration system shown and other explanatory variabes having an impact on low local financial performance presented.

In the end, concluding section will enumerate basic research findings and highlight relevant policy proposals. Some policy considerations will be developed and very critical guidelines will be suggested for the realization of these policy recommendations. The policy recommendations concerning the issue will be weighted and suggested in the context of Azerbaijan. They may not be applicable in case of other countries.

CHAPTER 1: BASIC CONCEPTUAL CONSIDERATIONS

Before starting to introduce the concept of tax-sharing to Azerbaijan and thinking why this is important, this chapter will formally overview the some fiscal decentralization components closely associated with tax-sharing. A first sub-section lays out some reasons for and against fiscal decentralization, before the following sub-sections deal with each of them in separate. This general theoretical framework provides necessary grounding against which tax-sharing can be judged from different perspectives and enables a reader to reflect about tax-sharing in a broader scope. It will then be possible to elucidate what is right and wrong with the tax-sharing.

The fiscal decentralization encompasses two closely related issues. The first is the spending responsibilities and revenue sources assigned between levels of government. The second is the amount of discretion that subnational governments enjoy in defining their expenditures and revenues (Davey 2002)

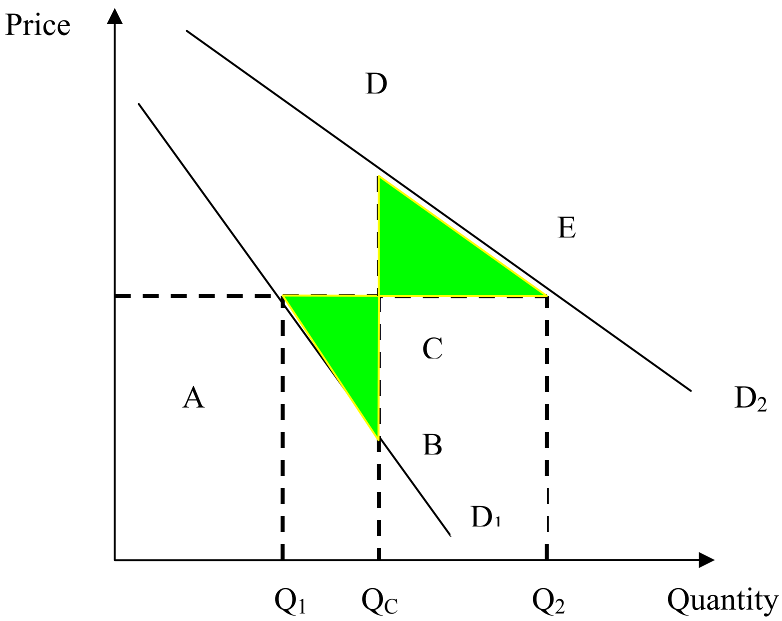
Brown and Jackson categorize systems or structures of government according to their degree of decentralization. The amount of autonomy that local governments bear over expenditure and tax decisions is taken for granted as the degree of decentralization. They also call the government decentralized when a number of small autonomous governments join together to form a federation of states or governments (1990: 261).

Reasons that one can argue for fiscal decentralization can be classified as follows: According to Oates, decentralization leads to increasing economic efficiency by providing a range of outputs of certain public goods that corresponds more closely to the differing tastes of groups of consumers (1990: 559). This is generally referred to as Oates' decentralization theorem. The *decentralization theorem* as proposed by Oates (Oates 1972: 55) says that "each public service should be delivered by the jurisdiction that has control over the minimum geographical area internalizing benefits and costs of the provision". Oates (1990: 559) also deals with other outcomes of fiscal decentralization, such as greater *experimentation and innovation* in the production of public goods, *efficient levels of public output* due to the close tie between expenditure decisions and real resource costs. These reasons will be covered in more detail in the coming subsections.

1.1 Efficiency gains

From the perspective of the subsidiarity principle, financial resources are efficiently allocated if the responsibility for each type of expenditure is assigned to the level of government that most closely represents the people who benefit from provided public goods and services (Frenkel 1986; Hyman 1993; Ter-Minassian 1997). Oates (1990: 559) example provides a good illustration of this principle: Consider, a public good provided only to and consumed by the residents of a certain community. If its provision was up to the central government, the good would be consumed at the similar level in all communities. Such uniform levels of consumption may cause inefficiency in the sense that possible variations in the tastes of residents of various communities may not be taken for granted. On the contrary, If each community had its own local government, this public good might be provided at various levels across different localities, and the differences in tastes of the residents of the jurisdictions may, to a certain degree, be reflected in these variations.

Brown and Jackson illustrates the welfare gains of decentralized public choice as in Figure 1 (1990: 262). Here the population is split in two groups. For the sake of ease, assume that the demand curve representing the public good happens identical for all members in each group but that demand differs between them and the public good is provided at a constant price for each member. So group 1 possesses demand curve D1 and group 2 demand curve D2. The people in group 1 will prefer Q1 level of output and group 2 will choose Q2. **Figure 1. Efficiency gains of fiscal decentralization**



Source: *adapted from Brown and Jackson 1990: 262.*

The centralized government system would provide public service at a single uniform level, say Qc. In this case, the welfare loss for group 1 is marked by the area shaded ABC. This shows the additional costs for each individual over his valuation of the more consumption (Q1Qc). The welfare loss for group 2 is shown by the area shaded CDE. In the previous case, Qc is excessive and but later it is too little. That is what the Oates's decentralization theorem stand for (Brown and Jackson 1990: 263).

It would also be appropriate to analyze the welfare gains from the perspective of the consumers' mobility as provided by Tiebout (1956). He maintains that consumers are able, to a certain extent, select a community as his place for residence that provides a fiscal package well matching to his tastes. Local governments can possibly be thought of as s system where a local public good is provided by each community at a different level of consumption and consumers by "voting with his feet" can choose the community according to their varying preferences. This mechanism can provide a kind of market solution to the problem of producing some public goods and services at efficient levels. Thus through a decentralized form of government, the privelege of various levels of output of some public goods can be achieved and resources can subsequently be used in a more efficient way to suit the consumers' preferences (Oates 1990: 560).

1.2 Experimentation and Innovation

When there are multiple independent producers of a good, various approaches (e.g. varying instruction techniques applied in local public schools) that lead to greater technical progress in ways of providing these services and goods in the long run can be expected. The other issues that are closely connected to this point are the competitive pressures arising from a bigger number of producers. These pressures necessitate that the most efficient ways of production be adopted. If, for instance, an effective way of providing a certain service has been discovered in one community, the neighboring jurisdictions will have to obtain similar techniques so as to avoid any possible criticism from local inhabitants. On the contrary, if all public goods are provided by a single central government with no competitors, the forces compelling innovation and efficiency will be less strong. So local government system promotes efficiency, both static and dynamic, in the provision of public goods and services (Oates 1990: 560).

1.3 More efficient level of public output

One more advantage of the local government system is that an institutional setting can be created. This setting can induce a better public decision-making compelling that the costs of public programs be more explicitly recognized (Oates 1990: 561). If, for example, a community is forced to fund its own public programs from local taxes, the benefits of the program can be weighed against its the real cost by the residents of this community. In contrast, if local public projects are fully financed by a central government, residents of a community will be inclined to expand levels of local public services as much as they canpossible, because they may be responsible only for a negligible part of the costs.

However, fiscal decentralization may also cause distortions and concerns, like intergovernmental externalities, tax system inefficiency, tax wars, problems related with redistributive programs. They also need to be mentioned since it would be better to look at the role of tax-sharing in resolving these problems. The following subsections will provide more insight into these issues.

1.4 Externalities

Oftentimes, the consumption of local public goods (or private goods provided publicly) by one community may have an impact on the utility levels of people from other localities. Externalities between jurisdictions comes out when governments can not fully account all benefits or costs that citizens of other governments will bear (Marlow 1995: 593). If people emigrate from one jurisidiction which gave them good education to another, then other communities will be prieveleged by having a better-educated work force. In contrast, if sewage-treatment plant of one locality has a polluting effect on the river passing through areas of other communities, people of these communities will be worse off (Marlow 1995: 593).

Thus, both positive and negative externalities can be created by localities. Such externalities are ignored when each jurisdiction cares about only its own individuals and resources are allocated in an inefficient mode as a result (Rosen 1992: 534).

1.5 Tax wars

Marlow (1995: 594) argues that tax wars may arise in the case of a federal system. Under these cirumstances, there is a competition between state and local governments on the basis of tax burden. The author adds that tax wars also produce sub-optimal tax collection. If governments fear that they may lose their businesses and citizens to other governments, which set lower tax rates, they are compelled to impose tax rates lower than what is needed for high-quality programs. In contrast, if there is only one government and no other governments to compete with, then policymakers can impose higher interest rates, furthering a higher level of public spending. Some non-optimal Nash equilibrium is a matter of concern which can usually be caused by tax wars. Consider, in case of choosing between high and low tax rate, as Table 1 illustartes, jurisdictions prefer low tax rates at Nash equilibrium. The result is lower payoffs (taxes collected), which could be higher when tax rate is high and equal for all jurisdictions.

Table 1. Nash equilibrium under tax wars.

		Community 2	
		Low tax rate	High tax rate
Community 1	Low tax rate	**<u>40, 40</u>**	80, 0
	High tax rate	80, 0	50, 50

1.6 Tax system inefficiency

The decentralization also brings about inefficiency in tax system. Efficient taxation should impose relatively high tax rates on inelastically demanded goods and vice versa.

However, jurisdictions tend to select taxes according to their exportability to outsiders. For instance, when a locality is the only one that has coal mine in the country, then a local tax will mainly be imposed on coal users outside the jurisdiction. A coal tax would seem reasonable for the community, but not from the viewpoint of nation (Rosen 1992: 535).

Another consequence of tax shifting under decentralization, as argued by Rosen (1992: 536), is that local governments may consume inefficiently large amounts of local public goods. This is in opposition to the efficiency principle that requires local public goods should be consumed on the basis of the equality between marginal social cost and marginal social benefit. In the case of the burden shift to other localities, the community's perceived marginal social cost becomes less than marginal cost. Consequntly, local public goods are consumed inefficiently largely.

1.7 Economies of Scale

The economies of scale lead to the reduction in the average costs of producing services and goods as the output expands. Public goods can be provided by large governments at lower at lower costs than smaller governments can like big businesses producing goods using economies of scale (Bruce 1998: 152). If average costs keep falling as the production gets larger, it becomes cheaper with one large government rather than more smaller governments to produce public goods and services. Economies of scale also help to avoid duplicative administrative costs which could be the case when there are many smaller lower-tier governments. That is why economies of scale can arise from centralization of government and it produces, in theory, cost saving that flow to taxpayers (Marlow 1995: 590). Bruce (1998: 152) maintains that collecting taxes is one of the government functions which can lead to the economies of scale. Taxes are usually collected at lower administrative costs by higher level government. Duplicative facilities for tax administration can be avoided by the lower costs.

Higher level government has also lower costs in terms of enforcement as taxpayers cannot avoid taxes by changing their place to another locality.

1.8 Macroeconomic stability

One of the shortcomings of fiscal decentralization is that the central government can not fulfill it traditional macroeconomic management function so effectively. For example, the central government can maneuver very limitedly in increasing taxes or cutting down expenditures to solve an overheated domestic demand because of a loss of basic tax tools or control over a big portion of public expenditures (Ter-Minassian 1997).

Macroeconomic stability can be a serious concern as a result of poorly handled decentralization (World Development Report 1999/2000). The central government's control is reduced by fiscal decentralization over public resources. The Philippines' government, for instance, has to allocate almost half of its internal tax revenues to local governments. This in turn restricts its ability to adjust the budget to respond to shocks. Deficit spending of local governments can also hinder central government attempts to stabilize the economy by cutting public spending. If the decentralization of the revenues is done before that of expenditure responsibilities, the central governments will be obliged to keep expenditure levels with a smaller resource base. The central government may have large deficits, for example, in many Latin American countries. More generally, division of taxing and spending responsibilities enables local governments to incur only a small part of the political and financial costs of their spending, particularly when most local resources are funded out of a common pool of tax revenues. The macroeconomic instability is a threat only in countries where substantial resources are controlled by local governments, usually very decentralized wealthy countries or large federations. However, even in these cases, the correlation between macroeconomic instability and decentralization is confusing. A few studies argue that decentralization has not caused instability in the United States or in Western European countries. In Latin America, except for federa ones, subnational governments had a negligible effect to the national deficit in most countries (World Bank 2000: 111).

After this short insight into the theory, effects of tax-sharing can be shown more comfortably on its basis. The coming chapter is accordingly concerned with advantages and disadvantages of tax-sharing.

C H A P T E R 2: TAX SHARING ADVANTAGES AND DISADVANTAGES

OECD (1999) defines three basic sources as subnational revenues: tax revenues, non-tax revenues and intergovernmental grants. However, the OECD data give further information on tax revenues allowing to further subdivide them into *own tax revenue* and *tax sharing*. In the first case, tax rates and bases are set by subnational units. The other, tax sharing, deals with the portion of revenues on which subnational governments have no significant control in terms of tax rate or base defining. In response to overcoming the low fiscal capacity, the system of tax sharing appears to be one of the central elements of intergovernmental finance in transition economies. Yilmaz says that tax sharing and grants function as key instruments of decentralization (2004). Moreover, OECD regards the split of tax revenues across the levels of government as one of the main criteria for evaluating local autonomy (1999). Spahn refers to tax-sharing as the most popular instrument for funding transfers (2004). According to Gonciarz (1999), the need for tax sharing between various levels of government arises due to the assignment of only few minor taxes to subnationals which provide no sufficient funds to finance their significant responsibilities. Bird (*et.al 2002*) classifies tax-sharing transfers as the most decentralizing mode of vertical revenue sharing and stresses considerable effects of this approach upon the improved fiscal position of subnational units. This in fact allows subnational governments to claim for some share of national revenues. The authors add that the idea of sharing taxes gives an impression of partnership between levels of government in the performance of the central tax system. Local governments can have access to broad-based and income-elastic taxes. According to the authors, “shared taxes” can also be termed as truly subnational if the definition of rates are at the discretion of subnational governments (“piggybacking”), despite the involvement of central government in tax collection. It is also argued (Charles E. Mclure 1999) that the advantage of tax-sharing over subnational surharges is that it avoids the problems that emerge from extreme independence of subnational governments in tax policy.

The following sub-sections will deal in more depth with the arguments suggested in the literature both in favour of and against tax sharing.

2.1 Arguments for Tax-Sharing

From the perspective of tax wars, tax sharing is, as Marlow (1995) maintains, a good technique in preventing tax wars. Communities will become unable to compete through lowering taxes due to the same level of tax rate set across a country. Taxpayers are not either able to decrease regional tax burdens by moving (or driving for commodities) to another jurisdiction.

Marlow further holds that common shared taxes resolve the concern of inefficient tax system which is a usual consequence of the fiscal decentralization. The reason is that it is the central authorities who levy the taxes and therefore these taxes tend to be more efficient from a national viewpoint than those which local governments levy. Under tax sharing, taxes can not be exported to outsiders as well. In other words, communities become unable to shift tax burdens to other jurisdictions (1995).

According to Kelly (1999), tax sharing can also allow local governments to access the tax bases which are more buoyant and usually at the discretion of the central government.

Gonciarz (1999: 98) argues that tax sharing does not tie expenditure decisions so closely to real resource costs. Local expenditure may in fact be raised not via greater tax burden on community individuals, but through acquiring larger portion of centralized taxes that are paid by the members of community. Individuals of a given community will accordingly tend to expand levels of local public services as far as possible. As a result, decentralization is not likely to lead to more efficient level of public output.

The promotion of vertical equity is the likely result of tax sharing (Bruce 1998: 165). In general, poor jurisdictions can not afford the same level of government goods as rich jurisdictions can because determinants of the local tax bases, such as incomes, property values, and other economic activities are smaller. That is, a poor jurisdiction possesses a low fiscal capacity. In this case, tax-sharing may be in the role of equalizer of fiscal capacities by increasing revenues to poor jurisdictions.

One of the positive consequences of tax sharing is that it stimulates increase in tax effort, especially when shared on a derivation basis, since there is normally a direct connection between the tax collection and the amount of revenues going to the local budget (Bahl 2000).

Another main pro-tax sharing argument, as made by Roy, comes from the fact that revenues from shared taxes are regarded as 'earned', unlike those of grants (Abstract). Although the actual tax rate or tax base can not be set by sub-national governments in the system of tax sharing, the *size* of the tax base located within their territory is under their control. In this case, they will tend to develop policies (like pro-inward migration policy, innovation, business start-ups policies, etc), which lead to the improved tax base in their jurisdiction. This will in its turn yield more revenues for them. They might also work out policies with a bad effect over the tax base that would consequently reduce the revenues. In both cases, they will carry responsibility for their actions. Hence, the tax-sharing system stimulates sub-national governments into increasing their 'earnings' from the shared taxes, developing relevant policies.

Smoke emphasizes the advantage of some certainty as to the flow and timing of revenues from the higher to local governments for fiscal planning (*et. al* 2003). And Rodden

(2003) maintains that in comparison with intergovernmental grants revenues, the central government may have less discretion in the yearly determination of tax-sharing revenues. The system of grants allows only for the unilateral determination by the centre or 'needs-based' formula of the amount of grants earmarked to the sub-national units. The decision about the amount of grants to be distributed to the lower level jurisdictions usually remains at the full discretion of the central government despite the fact that some localities may have influence regarding the grant allocation to them to a limited extent (Rodden 2003)[9]. Less discretion of the central government in the determination indicates that under the tax-sharing arrangement, the amounts of revenues are more stable.

In terms of both some stability to local governments and flexibility to the central government, Bird recommends tax-sharing. It is possible by setting a fixed proportion of all central taxes to transfer. He further stresses the reasonability of sharing all national taxes than sharing specific national taxes. Under the latter condition, the central government might become gradually inclined to raise more those taxes which are not shared (1999). Thus, tax-sharing may be a good tool for local governments in achieving more certainty in order to organize their budgeting and fiscal planning better.

Most importantly, the tax-sharing, as compared to other forms of transfers (i.e. ad-hoc transfers, cost reimbursement), do not impose much administrative costs thus allowing to benefit from the economies of scale in collecting taxes. In this case, tax collection can be done at a lower cost by the central government and some funds are transferred to local governments for spending on local goods. Nor is the monitoring of the use of funds a concern. In the case of the local governments' involvement in tax collection (like in Russia and China), the central government have to keep a watch over the local collection rates, since local governments are likely to hide certain funds out of the sharing pool (Bahl 2000).

[9] Note: this source is quoted in the following internet source which was accessed on June 15, 2006: URL: http://www.economics.strath.ac.uk/graeme/ghent.pdf)

As is the case with other insturments of public financing, tax-sharing has also its drawbacks. The following subsection will describe these deficiencies.

2.2 Arguments Against Tax-Sharing

The shared tax approach could be a serious problem for the fiscal flexibility of the central government (Bahl 2004). Moreover, if the form of shared taxes is chosen, subnational government revenues become directly sensitive to tax policy changes made by the central government. A high tax sharing rate makes the central government less enthusiastic for vigorous enforcement thus reducing the revenue flows to local governments. Tax sharing may bring about political problems as well: What happens when the higher level government, who makes rules for tax sharing, has a tight fiscal situation? Will it use the sharing rates as an inviolate contract or will it cut them back for the sake of some of its own programs (Bahl 2004) ? Kelly regards as one prominent disadvantage of tax-sharing the fact that the local authority, who can not define tax base, tax rate or engage in tax administration, would be deprived of accountability and economic efficiency in matching expenditures and revenues (1999).

Moreover, Marlow supposes that sharing of common taxes by jurisdictions diminishes the expectation that citizens' mobility will bring about efficiency in government policies. That means voting with feet is not perceived to result in tax policies that better suits to the tastes of residents. The Tiebout model should be recalled here which predicts the varying tax rates resulting from the preferences of local governments. Put it another way, when residents wish a "wide" public sector, they will more likely support higher tax rates than when they want a "small" public sector. However, the ability of citizens to choose regional tax rates by moving freely across local governments becomes very restricted when common taxes are shared (1995: 595).

According to Kelly (1999), tax sharing may also produce disincentives for central government collections in the sense that due to differing tax sharing ratios between the taxes, the central government would be more inclined to collect those taxes from which the central budget benefits more.

After reviewing in theory and looking through some pro and contra arguments on tax-sharing, it is worth looking at tax-sharing systems across several countries, mostly transition ones. It may provide reasonable justification of employing tax-sharing. It would also be of value in terms of clarifying the appropriateness of policy choices for Azerbaijan. In these countries described below, the vertical gap is filled through tax-sharing and even surcharges (e.g. Bulgaria). So the following sub-section describes the current tax sharing trends in a few of transition economies.

2.3 Tax Sharing In Practice

Many countries (such as transitional countries both of central and eastern Europe and former Soviet Union) apply the tax sharing method to finance thier municipalities (Bird et al. 2001). The VAT revenues, corporit income tax (CIT), most excises and taxes imposed on foreign transactions, and in the case of Russia, natural resource taxes, go to the federal or national government further being shared with lower level governments (Kopits and Mihaljek 1993: 169). The countries use various shared taxes. For example, In 1988 Poland split turnover tax between central and local governments (Hewitt and Mihaljek 1992: 342).

Personal income tax (PIT) is the most significant of the shared taxes in Hungary making up approximately 15 percent of current revenues. Its share has reached by 4 percent since 1993 (Pigey 1999).

Bulgarian municipalities are also benefiting from tax-shares. The two main national taxes shared with local governments are the personal income tax and the corporate income tax. The share of PIT revenues has remained stable i.e. at 50 percent. Going a little bit ahead by using the "surcharges" instrument, the municipalities impose an additional 10 percent on this tax rate, which is known as the "municipal tax", and this is enforced by an especially adopted legislative act (Epstein et.al 2000).

One of the key goals in reforming local budgets in the Czech Republic was to replace the high proportion of national subsidies in municipal budgets by other revenue sources. Instead of introducing local taxes as a substantial part of municipal revenues, a shared tax system was introduced (Kamenikova 1999). In Czechoslovakia in 1992 (prior to the dissolution) the two main taxes – the profit tax and the turnover tax – were split among the Federal Government, which received 35 percent of the total, and the Czech and Slovak Republics receiving 41.5 % and 23.5 % of the total respectively (Prust 1993: 54). Now, the generous Czech revenue sharing system allocates 20 percent of the corporate income tax (CIT) and 20 percent of the personal income tax (PIT) to municipalities on a per capita basis (Kamenikova 1999). The shift from earmarked transfers that stifle local autonomy and economic efficiency to revenue sharing which gives municipalities greater freedom in spending decisions is regarded as the significant attainment of the Czech revenue-sharing system. The goal pursued was to enable the municipalities' representatives to do self-reliant decision-making, granting municipalities a certain degree of freedom from the central government. The funding was improved via the introduction of tax-sharing.

In Estonia, municipalities get 56 per cent of the personal income tax, generating from the income of the inhabitants of a municipality. The tax is collected by the State Tax Board through its regional offices. Besides, land tax is fully paid into local budgets. Land tax is 0.5-2.0 per cent of the estimated value of land. The local council determines the tax rate within limits given by law (OECD 2000).

Along with central government grants, the Kyrgyz legislation also inlcudes the component of tax-sharing as one of the three revenue sources for subnational government financing and tax-sharing comprised 24 % of local budget revenues in 2002 (Gerster 2004).

Untill 1999, Romania applied the discretionary tax-sharing as an equalization mechanism (Slukhai 2003) and shares of PIT was allocated to the counties.

In China, local governments, mostly provincial and city governments, are in charge of collecting virtually all major taxes. The revenue is then shared upward with the next level of government. The sharing arrangements are not uniform, are subject to negotiation, and may vary from one case to another. Over the years, the revenue-sharing arrangements have undergone many changes, but, since the inception of the reforms in the late 1970s, the trend has been toward granting local governments more fiscal authority and allowing them to retain more revenue (Blejer 1993: 264).

The experience of two countries (Armenia and Hungary) shows that changes both in the amount of subsidies and shared taxes were accompanied by compensatory measures. For example, when Armenian government decided to include shared income tax fully to the state budget, it increased subsidies in return. Also Hungary introduced reduction in the share of the personal income tax allotted to local governments increasing the number of normative grants[10].

The lessons from the experience of the above mentioned transition countries are clear. Tax sharing can promote local autonomy and economic efficiency (OECD 1999). Furthermore, from an economics perspective, the good point of having this method is that shared taxes are very frequantly passed to local governments as unconditional grants and this kind of grants respect the autonomy of local governments in spending such financial means (Shah forthcoming).

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[10] for more info see: http://unpan1.un.org/intradoc/groups/public/documents/nispacee/unpan004549.pdf for for Armenia and *Pigey 1999* for Hungary.

Although typified by OECD (2002) as an option granting most of the important local revenue autonomy, surchares are, as seen from the empirical part, not so much popular among the transition countries. This may be explained by the reason suggested by Kelly that they can produce interjurisdictional difference from various tax rates and equalization would be impossible without including other methods of revenue allocation (1998).

As is obvious, most countries have individual income tax to share with subnational jurisdictions due to, may be, its less requiring administrative costs and advantage of being very close to local residents.

CHAPTER 3 - THE CASE OF AZERBAIJAN

This chapter will deal with the overall current framework regarding municipal affairs. Given the specificity of the issue and space limitation, only laws[11] concerned with the financial issues will be addressed for the purpose of the paper. However, some other issues having indirect relationship will formally be reviewed. For the purpose of later having a critical approach, this chapter will first set up the background information and then analyze problems with each of the mentioned items, like own-source financial resources, etc.

3.1 Legal and Regulatory Framework for Local self-governments

The role and structure of municipal bodies and guarantees of legal and financial autonomy by the state are reflected and regulated by *the Law on the Status of Municipalities*. The law also outlines the local adoption and implementation of programs on social protection, economic development and environment.

In general, the laws laying the foundation for municipal finance are: *the Law on the Transfer of Assets to Municipalities*, *the Law on Municipal Finance and the Law on Municipal Territory and Lands*. *The Law on Municipal Finance* establishes principles for local finance and the split of responsibilities between the local governments and local excoms. The law further contains legal items regarding the adoption, execution and monitoring of the local budget. *The Law on Municipal Territory and Lands* regulates intermunicipal boundaries. Article 7 of the Law on Land reform is concerned with the municipal property, municipal lands.

[11] Source: Khuduoglu, Shahbaz. (2005). "*Belediyyeler Haqqinda Senedler Toplusu*". *(**Translation**) The Volume of Laws on Municipalities. "*Qanun" Publishing House, Baku

Bələdiyyələrin maliyyə-iqtisadi fəaliyyətinin hüquqi tənzimi. (2003). *The legal regulation of the financial-economic activities of municipalities.* Baku, (*translation*)

Now let's be specific and start with what guarantees local units have for autonomy.

3.2 Guarantees for Local Autonomy

The local autonomy of municipalities is provided in the Constitution, where they are considered as independent of local branches of state administration. These guarantees are also stressed in other legislative acts. Although unclearly, article 14 of ***the Law on the Status of Municipalities*** says that municipalities are not included in the system of state government bodies. This blocks any intervention by state officials or bodies with municipal affairs. In managing municipal property, subnationals are absolutely autonomous. According to the legislation, they freely employ their right of passing and carrying out local resolutions. Article 6 of the Law on Municipal Finance gives local self-governments certain guarantees of financial autonomy to be provided by the state, such as:

- Give local government additional funds for their budget deficits when the state budget allows;
- Transfer grants and subventions for full financing of social and economic development programs, in case of less local budget funds;
- Allocate funding to municipalities in parallel with any additional transfer of responsibilities.

3.3 Administrative-territorial structure

Azerbaijan's territorial structure, just like in the soviet time, is consistent of cities, regions, villages and settlements. Municipal territories are determined on the basis of these units by ***the Law on Municipal Territories and Lands.*** There is no regional establishment of local self-governments. Each municipality appears to be an independent legal entity not being subject to any subordination, be it horizontal or vertical. Cities are subdivided into units with each functioning as an independent jurisdiction. These cities are; Baku, the capital, and Ganja. There are 2773[12] municipalities in total with more than twenty two thousand elected local councillars.

3.4 Local State Administration

For the purpose of clarity, this sub chapter will be concerned with government structures performing kind of the intermediate level bodies. It is critical to note that unlike local self-governments, these structures are included in the system of public administration.

According to the Provision on Local Executive Authority adopted on the 16th of June 1999, the Azerbaijan president establishes regional branches of state administration, designating their heads. These heads later appoint their own persons or representatives in the villages and settlements located within their boundaries.

Local administration expenditures are funded out of the state budget. In brief, the executive tasks of local excoms are;

- Economic, social and cultural development;
- Coordinate activities between local self-governments and excoms;
- Implement both state programs assigned by the president of Azerbaijan and other local programs;
- Establish and dissolve local excom departments, services, enterprises and organizations.
- Arrange elections, referenda and public discussion as stipulated by the law.
- Prepare and submit proposals on local development to the appropriate executive bodies.

[12] Personal calculation; various sources show different figures.

Local branches of state administration are directly subordinate and accountable to the central government and carry out its executive tasks regionally.

3.5 Revenue Assignment: Municipal Finance and Property

Article 3 of *the Law on Municipal Finance* determines the key principles about local finance. Particular issues of municipal finance are further governed by the Constitution, the Law on Municipal Finance, the Law on the State Budget and the Law on Banking. The law on the status of municipalities also incorporates devolution of some financial authorities, including mobilization and independent use of revenues for their activities. In Azerbaijan, municipal housing, cultural and social institutions, land, and other facilities in the common use of citizens (non-populated settings, roads, health care, education and sports facilities) are included into municipal property. Municipalities can rent or redistribute their property as per the law. However, many of these properties were privatized prior to the compilation of the list of properties to be relinquished to municipalities.

According to article 7 of the Law on Municipal Finance on the financial sources of municipalities, local self-governments have access to two main revenues sources: local tax (own-source) and non-tax revenues (ceded revenues), and central government transfers. The own-source tax revenues include;

- Personal Land tax,
- Personal property tax[13],
- Subsoil taxes on local construction materials, i.e. mining tax,
- Income tax paid by municipal enterprises (legal entities).
- Local fees and duties, such as fees for advertising on public property, parking fees and hotel fees, other duties.

[13] It implies that the land and property taxes can only be collected from the private persons, but not from legal persons or entities.

Non-tax (ceded) revenues;

- Revenues from privatization and rent of municipal properties,
- Financial aids from physical and legal entities,
- Financial aids and grants from international organizations and funds, and
- Other revenues not forbidden by the law.

Central government transfers include:

- Unconditional (subsides) and conditional grants (subventions),

The list of local taxes (and the tax bases and rates) are determined by the taxing code. The collection of local taxes is realized by the municipalities themselves. They were originally collected by the center. However, as per the 3rd August 2000 dated amendment to the legislation, municipalities collect private land and property taxes to their local budgets.

The rates of local duties and fees are defined by the local self-governments up to the limits set under the legislation of *the Law on Municipal Finance*. Despite its small portion, municipalities are also financially assisted by some legal entities.

In Azerbaijan, local taxes, together with local fees, comprise 20.4 % of budget revenues to finance local expenditures according to the statistics of 2005[14]. All revenues from local taxes flow into local budgets. Municipalities exert no control over the *definition* of the tax base and rate. The rest of income is obtained from non-tax (ceded) revenues or from the state transfers. In spite of 'one-time' character, the ceded revenues presently constitute predominant share of revenues in Azerbaijani municipalities (see Table 1 in Appendix that shows Local Self-Government Revenues over 2002-2006). Far more important income among the ceded revenues is from privatization or municipal property rent (one third of the total).

[14] Source: State Statistictics Committee 2005. *Revenues and Expenditures of Local Self-Governments.*

3.6 Intergovernmental Transfers

Central government allocates transfers to the municipalities in order to provide them with resources sufficient to deliver local expenditure programs. These transfers are of two kinds, unconditional (subsidies) and conditional grants (subventions). Subsidies are intended for equalization purposes and approved in the State Budget on a yearly basis. Pursuant to Article 34.4 of the Law on Budget, subsidies shall be allocated to municipalities based on two principles:

1. Number of the population
2. Role of a region in the establishment of the country's financial power.

The role of intergovernmental transfers in forming the revenue side of local budgets is too marginal.

As earlier stated, there is currently no practice of tax-sharing transfers allowing local governments to keep a fraction of the revenues generated by a centralized tax within the territory of their jurisdiction.

3.7 Expenditure Assignment

Municipalities have autonomy over budget expenditures as well as revenues. According to the legislation, they may make decisions about the programs of public service delivery and create municipal bodies for their fulfillment independently. The subnational expenditure responsibilities are: sanitation, water supply, education, health care, housing, culture, sewerage, local transportation and communication. These services must be performed at the the state defined level of standards. In terms of determining the method of public service delivery, Municipalities are completely autonomous and local conditions can be taken for granted by them in doing so.

Local budgets also involves outlays for administration (almost 40%), road maintenance (12 %), education (3.5 %), financial aid (2.1 %), reimbursement of income losses (2.8 %), debt recovery (4 %), maintenance of housing, social, cultural and sport premises, parks, squares and streets[15]. Municipalities may also assign funding to support social protection, economic development and environmental purposes.

Theoretically, the Azeri legislation seems, to a certain degree, to be supportive of fiscal decentralization (e.g. local governments have been assigned local land and property taxes which are most popular and supported both theoretically and practically). However, the existing situation does not offer enough practical opportunities for the fiscal independence of localities and improving their fiscal capacity. So these practical shortcomings, especially, those of local budgeting will be further detailed under the coming sub-section.

3.8 Problems with the present system.

3.8.1 Inconsistent Regulations

From the perspective of municipalities, the legal and regulatory framework creates serious impediments to their proper revenue mobilization. Efficient mobilization of revenues is limited by contradictory and overlapping regulations.

One of the biggest and most important inconsistencies of regulation is concerned with the uclear division of authorities by the legislation between local governments and regional branches of state administration (local excoms): The current Azeri legislation provides vague description of intergovernmental relations between local governments and local excoms. In principle, municipalities and local excoms should carry out their activities autonomously. However, there is no explicit division of authority in the current legislation. The topic is not even touched upon in the Constitution. The resulting ambiguity, therefore, needs clarifying.

[15] Calculated on the basis of the data available for the 2005 year for the average local government.

The opposing interests of municipalities and local state bodies will inevitably cause a dissention in the absence of a precise clarification of authority. In the legislation, many issues referred to municipal competence are also referred to the discretion of the local excoms. In some cases, local excoms even continue to manage those areas delegated to municipal authority. One example can show the seriousness of the concern: According to the law, municipalities are entitled to advertisement revenues in their territories. However, most municipalities in Baku are concerned about the fact that the Baku Advertising and Information Department, which is a subordinate entity to the Baku Executive Committee (Excom), hinders the municipal budget in getting these revenues. Subsequently, more than 50% per cent of municipalities in the capital city can not receive advertisement profits as properly.

The same occurs around local taxes. For instance, in the case of Barda district municipality, although land and property taxes are stipulated to flow to municipalities, the local excom of Barda district imposed some illegal amount on these taxes that has to flow to the regional tax department. So the current legislation does not provide any perfect regulation of the role of local excoms.

3.8.2 Problems with local taxes

As earlier stated, the main problem of local government is the gradually increasing lack of financial resources. At first sight, one can think that subsidiarity principle is almost ensured in the assignment of local taxes. That is, the land and property taxes are at the discretion of local governments. However, even these taxes are difficult to implement in Azerbaijan due to the following reasons; First of all, although the *land tax* seems to be as an attractive tax source for local government, in practice, the size of tax applied on land is insignificant. In 2005, the land tax was collected to local budget only to the extent of 25.6%. The low level problem of land tax can be explained in this way: For example, *the Law on*

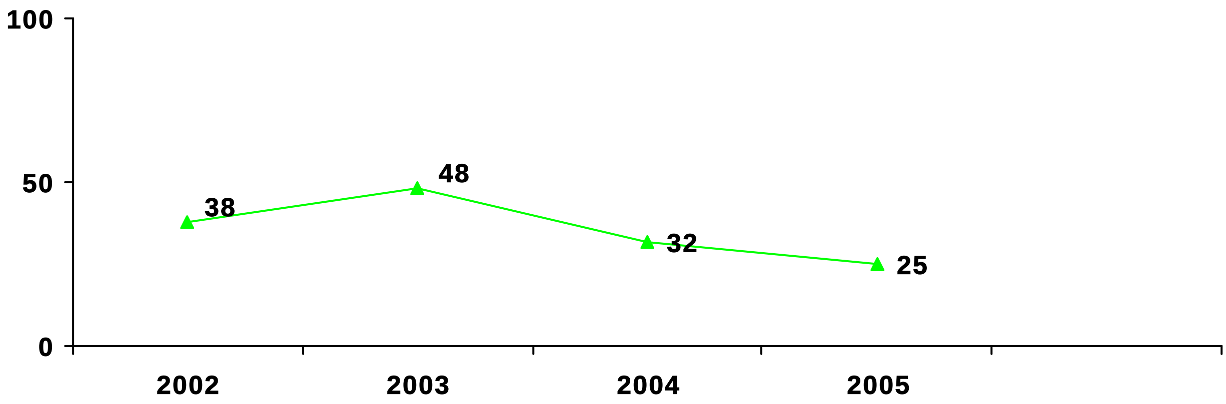
Land Reform states that thirty-three percent of common lands should be possessed by municipalities. These cover all lands not privatized or retained by the state and appear in the possession of the reserve fund. The law also stipulates that municipal lands are determined and transferred by the relevant local excoms to local governments. However, as most local government officers of big cities like Baku, Sumgayit and Ganja, say, the state administration bodies do not seem willing to transfer these lands to municipalities, since there are land plots bringing in big profits. In many cases, local excoms have already leased many of these lands for a long-term.

International experience shows that the property tax is very important among the local taxes. In general, the main reasons for handing over the property tax to subnationals are 1) it is possible to localize the taxpayer within the territory of local self-government 2) efficiency costs of using it as a tax base turns out less thanks to its impossibility of being immovable[16]. However, another problem is related with this second biggest propert tax. The Property tax diminished to 2.3 % in 2005, while it made up 6.6 % in 2002. There are problems with both calculation and collection of property tax, thus being main obstacles in collecting high level tax. Reasons for less property tax are also as follows: there is no concrete registration system of properties owned by local residents; the value of registered properties is incorrectly calculated; the minimal amount of property tax reflects no real economic condition; The property tax is assessed on the basis of its inventory price not on the market price; Local governments are not fully authorized to collect property, as well as, land taxes in the sense that, as mentioned above, municipalities are only authorized to collect these taxes from private persons, not from legal persons or entities. Legal entities have territories, which occupy huge municipal areas and these property taxes which are collected by central tax

[16] See 2005/2006 Intergovernmental Fiscal Relations course material dated February 21, 2006 by **Shah Anwar** and Robin Boadway, Revenue Assignment Ch. 5, Fiscal Federalism: Principles and Practices. Washington, DC: World Bank.

authorities flow directly to the state budget. The revenues from property tax thus become limited.

As opposed to 2002 (38.8), internal tax revenues and duties decreased to 25.6 % of the total budget revenues in 2005. In 2004 only 53 % of planned land tax and 57 % of planned property tax was collected. In general, the growth factor of tax revenues through the years 2002- 2005 is shown in percentage in **Figure 2** below:



The decreasing trend is also attributed to the fact that the authority to collect this tax has been transferred to municipalities who do not have enough legal competences to collect these taxes. The authorities of municipalities claim for the inclusion of local self-governments into the public administration system. At present, municipalities are not included in the Public Administration system.

Subsoil mining tax appears another income resource for a few municipalities. However, the natural resources are unequally distributed across jurisdictions and there are construction materials in only 20-25 % of all municipalities' territories. It implies that not all local governments can benefit from this source for their budgets.

Share of local fees and duties in local budgets also indicates the autonomous local governemtns. However, As is seen from the table, the share of inflows from duties and fees in local budgets does not even account for 1 percent (0.92% in 2003). The small share of fees in the local budgets can also be explained by the fact that the parking fees have recently been taken from municipalities and given to the authority of Local Excoms. Another problem, like in the case of local taxes, is the collection of these fees. Municipalities are unable to collect all fees and taxes.

Furthermore, as Table 1 shows, a great part of revenues are not reproducible, nonrecurring and thus incidental by nature. It means that they are unsustainable over a long run, although they make up a large share of revenues for municipalities both at present and during the past years.

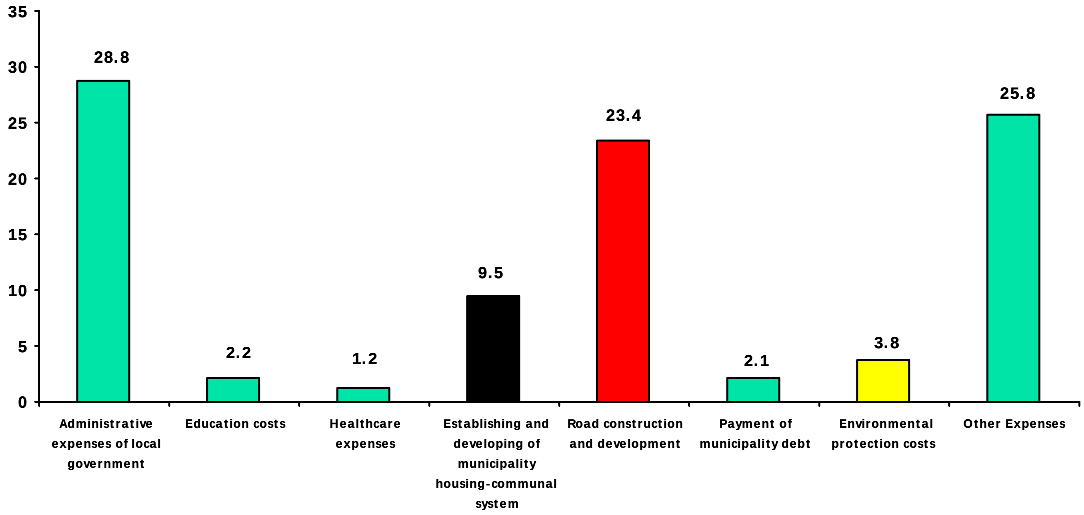
Moreover, the revenue base information is incomplete and collections are low. It should also be added that central government transferred the function of collecting land and property taxes to municipalities in lack of clear and necessary legislative tools. Legal enforcement is practically non-existent. Local governments are not equipped with legislative competences in tax collection. *In some cases there is a proposal made by some interviewed local government authorities to pass the administration of all local taxes to centre, claiming that they do not have necessary legal leverages and proper equipment to satisfy all requirements of tax collection.* However, this is not a reasonable solution. As it is emphasized in World Bank Report 2000, transfers are almost always necessary, but they should not be so large as to exceed the need for local taxes. Local taxes ensure that subnational governments face, at least to some degree, the political consequences of their spending decisions. And political necessity leads to the need for relying heavily on local taxes.

3.8.3 Local Budget Expenditures

It would further, be better to look through the expenditure-related problems of local budgets, as are shown by the table below for the years 2002 through 2005.

It can be seen from Table 2 (Appendices) that the great part of local government expenditures is dedicated to administrative costs. Their share in total budget expenditures is even higher in several regions. For example, this figure in the Yardymly district is 39.6%, in Lenkaran City – 40.7 %; and in the Zakatala district - 48 %. In the other districts this figure ranges from 30% to 60%. The distribution of expenditures for an average local government is reflected in the pie-chart below:

Figure 3: Structure of local budget expenditure in 2005 (%)



Source: State Statistics Committee 2005. Revenues and Expenditures of Local Self-Governments.

Hence, looking at the decreasing level of receipts and increasing expenditures across the years, it is obvious that local governments are coming subject to weak financial power. Furthermore, a comparison of local government's current financial power with their responsibilities as defined in Azerbaijan law indicate that to realize social and economic projects, financial resources are lacking.

3.8.4 Lack of fiscal Choice

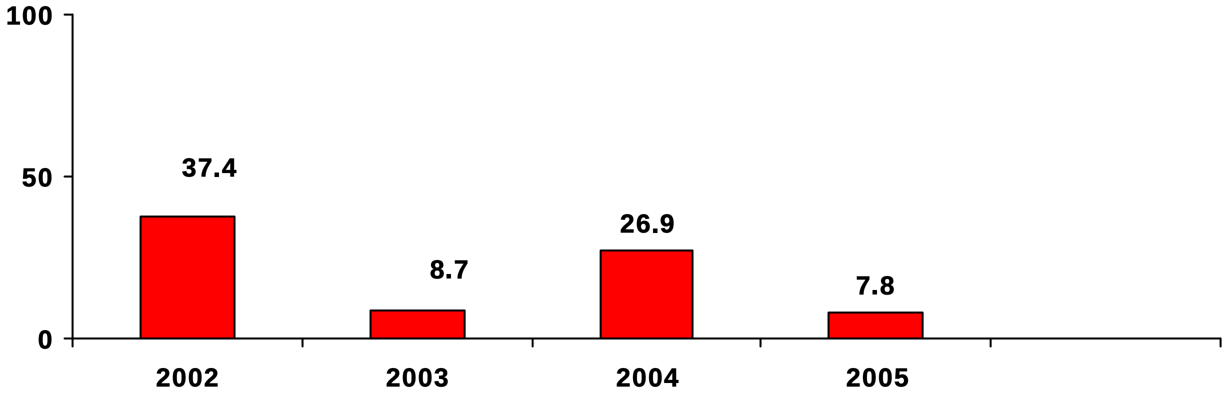
Local self governments have legal authority to decide on their budgets. But the fact that the state funds go to the accounts that are easily politically manipulated by the Excoms (Local state administration) limits sub-national autonomy. Yet, it is emphasized that in order to fully realize the subsidiarity principle in the field of local expenditure assignment, sufficient own fiscal resources and unconditional transfers, which can be appropriately and efficiently adopted by the individual municipalities according to their own needs, should be provided (Frenkel 1986, Hyman 1993). These intermediate levels remain accountable and subordinate to higher levels of government, rather than to the electorate. This subordination has therefore a negative impact on the flow of state funds through these intermediate levels in terms of limiting real autonomy and decision-making power by the lowest levels of government (who are accountable to the electorate). Bird emphasizes objectivity, simplicity and transparency as important elements in designing transfers for the better performance of the system (1999). However, the transfers are not transparent in the sense that due to the greater discretionary authority of this intermediate level, party affiliation or nepotism oftentimes prevails while these funds are distributed to subnationals. All this indicates the deconcentration or even delegation of activities, rather than practical decentralization.

Furthermore, as it was mentioned above, although all municipalities have had property allocated to them, in many cases this property has not yet been distributed, but remains in the hands of the excoms. This parallel system rather than only local governments in managing services causes tension and impedes proper sharing of responsibilities. That is why this parallel decision-making should be maximum reduced or even eliminated.

3.8.5 Problem with the current transfers

Finally, the last reason for increasing lack of financial resources in municipalities is a symbolic state financial aid. For the purpose of fair and effective equalization of municipal budgets, unconditional (subsidies) and conditional grants (subventions), budget loans, etc. other techniques are employed. The budget law says that if local governments are unable to fulfill their responsibilities at the expense of their own financial resources, they should get state financial aids. According to the budget law, these transfers are allocated in the form of subsidies and subventions. Nevertheless, the legislation defines neither principle nor criteria for distribution of subsidies and subventions to local municipalities. These state transfers are often spent without conditions – they are not related to any specific expenditure functions. This makes local government officials less accountable and interested in spending these funds. The amount of subsidies and subventions do not make any significant contribution to the *total municipal fiscal capacity* and this is likely to be the case in the future. In 2002, 37.5 % of local government's income was generated from state transfers, while this figure accounted only for 7.8 % in 2005. Local government officers hold that the transfers do not only happen to be insufficient, but also very volatile. According to the Law on the Budget System does notprovide any defence of subnational units with state financial aids, including subsidies. Consequently, when state budget faces financial problems, the amount of state financial aids decreases. In 2002-2004, state official transfers to local budgets were quite irregular and characterized with systematic delays. Although the state financial aid in the amount of AZM 53.000 billion to municipalities was planned in 2002, AZM 24 billion (45 %) was appropriated only. In 2005 the Azerbaijan government decreased the amount of estimated financial aids to municipalities to 7.8% (see: Figure 4 below). That is why, state transfers do not contribute much to the stability of local budgets and causes unpredictability in local budget planning. The same concern also applies to privatization revenues since they are time-limited and sustainability of theses revenues can not be expected. Furthermore, the amount of subsidies is decided by the government and the parliament individually. In other words, municipalities not only lack specific income sources, but also have problems with financial aids allocated from the state budget.

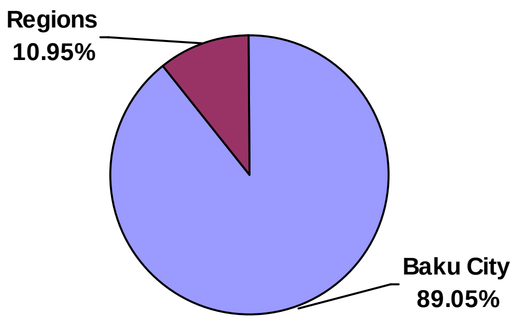
Figure 4: Total share of subsidies and subventions in local budget revenues (%)



In addition, although the law in force envisages full independence of budgets of all levels, the cash-flow from the center to local budget has been accepted as a key principle. It can be inferred that the inclusion of these principles in the law is of formal nature and therefore during distribution of state transfers to municipalities, a lot of manipulations are the case (i.e. a local state administration authority in a region has closer relations with concerned government structures). In 2004, state transfers to municipalities in Akdash district accounted for AZM 149.9 million, while this figure for Mingechevir (a city in Central Azerbaijan) has been in excess of about 50% (AZM 80 million). Similar cases can be observed at Aksu and Yevlah or Lerik and Ismayilly or Agcebedi and Barda.

The role of the respective region in the establishment of the country's financial power (that is to say the region representing municipalities to receive State grant) is in the limelight not only due to its formality, but also its lack of concreteness. For the country, financial capacity is a broader term, and it is a challenge to assess the real situation for each region under this notion. Most probably the point here is about the role of regions in the establishment of State budget revenues.

Figure 5: Share of the regions in state budget revenues



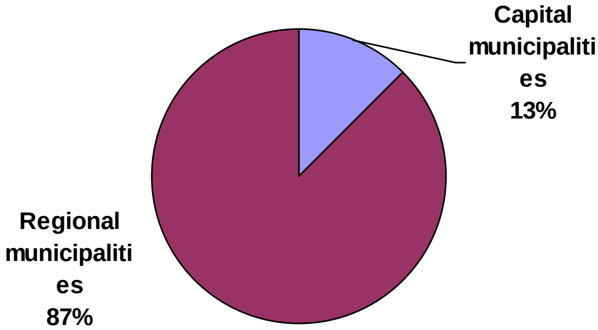


Figure 6: Share of state grants as per capital and regional municipalities

As may be seen in the Pie-chart above for 2005, 89% of budget receipts came from Baku, while the rest (11%) came from regions[17]. Undoubtedly, if this principle were accepted as an absolute condition, municipalities in Baku would get significant part of the State transfers (at least 50-60%). Nevertheless, only 13 % of the total financial aids were appropriated to these municipalities. As it is shown in the Table (in Appendix), although Lenkaran and Gence paid the same funds to State Budget, the difference between transfers allocated to their municipalities is three times. The same is observed in statistics on Barda and Zagatala or Kurdemir and Bilasuvar.

Briefly, in case of Azerbaijani intergovernmental transfers, it is possible to observe some drawbacks of ad-hoc distribution of transfers, which are suggested by Bahl: such as, non-transparency, political manipulation, uncertainties concerning the amount of funds to be received by local governments, consideration of local governments as a lower priority issue by the central government and therefore a possibility of reducing the amount of transfers, local officials indifference towards spending these funds and less control over their budget due to absence of specific expenditure targets (2000). In short, this ad-hoc approach more resembles a centralizing approach rather than decentralizing.

[17] *Source: State Statistics Committee 2004. Revenues and Expenditures of Local Self-Governments.pp. 14*

3.8.6 Administrative Incapability

The issue of administrative capacity is also necessary under local revenue autonomy for revenue collection. The low level of local revenue mobilization in Azerbaijan is also explained—by the weak administration. An absence of political will for enforcement (as was mentioned above), combined with weak administration, can explain a low performance of local revenue mobilization. Accordingly, the issue of improving the territorial foundations of municipalities is also of special importance. A number of municipalities have a very small population. At the same time, the powers given to the municipalities are big. Even in the best conditions, there is little hope that municipalities with such a small population and revenue sources will be able to fulfill their duties. In this situation, the only way out is *to reduce the number of municipalities by merging small municipalities.*

Finally, under these circumstances, municipalities become very desperate. Most of the law defined local revenues are formal and municipalities do not possess *stable* tax revenues, property to be privatized or rented or profitably functioning enterprises.

Summary of the basic findings

Based on review of documents and conducted interviews, the findings of the research can be outlined as follows:

Although there are laws regulating financial activities of local self-government bodies, the local financial-economic position appears weak. Since municipalities do not have enough resources, it is impossible to talk about their total independence in solving local issues. Local tax payments and fees continually make up a small part of the overall revenues of municipal budgets and do not cover the expenses of the municipalities in full. The local budget system is characterized by a number of negative aspects. First of all, despite the allocation of some taxes to municipalities, it is difficult to collect them. It requires considerable organizationallegal efforts to calculate and collect them. The land and property taxes is of special importance for local budgets. That is why *the payment of the land tax not only by private individuals, but also by legal entities located on the territory of the municipality* would considerably improve the income base of local budgets.

In particular, other critical research findings can be summed up as follows:

- No full allocation of land and property taxes to local government, despite the general agreement among the interviewees of municipalities that they have big potential for more local revenues—from *land and property taxes*.
- No concrete registration system and incorrect calculation of properties;
- The inefficient tax collection performed by weak local governments
- Low administrative capacity and absence of legal enforcement and the issue of inequity;
- Recently limited local fees;
- No specified rules or formulas for distribution of state transfers, and thus an ad-hoc distribution of subsidies and subventions;
- Poitical manipulation of these state transfers by the regional branches of state administration (local excoms) concerned;
- The overlapping and unclear division of the responsibilities and tasks of local governments and local excoms.
- Problem with the allocation of fiscal powers between local excoms and municipalities;
- Widespread parallel decision-making by local branches of state administration and local governments.

The elimination of the increasingly low fiscal capacity of SNGs and also other noted problems can be achieved via tax-sharing transfers. Let's have a look at possible outcomes from this instrument.

Application of tax-sharing to Azerbaijan

The application of tax-sharing would first eliminate the basic disincentive of central government in tax collection. There must be some incentives both for the central and local governments in administering and collecting some of the taxes. The current situation has driven the central government indifferent towards the collection of local taxes and other revenues by local jurisdictions, since these revenues go directly to municipal budgets. As a result the collection rates appear very low.

However, the initiative of tax-sharing would improve the situation to a certain extent increasing the material interest of both central and local governments. For example, from the perspective of municipalities, tax-sharing will promote a connection between the economic power of the region and the revenues earned from shared taxes making them more interested in ensuring local economic development. That is, if the tax-sharing is properly designed and municipalities achieve some discretion in tax collection, it will not be so much time and work consuming to think about particular incentive components to stimulate additional local tax effort. Local governments will themselves be more tempted to be involved in new economic projects (creating new jobs, providing relevant conditions for medium and small enterprises). In a word, they will treat their actions in a more creative way for their revenues to increase.

From the viewpoint of proper fiscal planning, most of the interviewed local government councillars in general supported the idea of distributing general purpose transfers from the total pool in a stable manner (e.g. as a share of central taxes). In this regard, the application of tax-sharing system would provide municipalities with more certainity and stability in terms of revenue flows enabling them to organize their budget planning more accurately and easily.

Another justification for the introduction of tax-sharing is concerned with administrative incapability, as seen from the Azeri case. Municipalities are not as much administratively capable, and most part of revenues is spent on administrative issues. That is why, the application of tax-sharing can solve this issue by letting the collection of some taxes by the central government thus decreasing administrative costs. These funds would instead be spent on more important purposes, such as road maintenance, debt recovery etc. By allowing centrally administered tax collection local governments can benefit from economies of scale advantage of tax-sharing.

However, it does not mean that tax-sharing should also cover land and property taxes. In case of these taxes, local governments should be supported to improve their tax base identification, valuation and assessment systems and mechanisms. This would enhance tax collection and create more revenues.

Tax-sharing can also be a good political key for localities in the sense that the flexibility of central government will be restricted in making ad-hoc changes in the amounts of these transfers, which is the case with the present transfers system. It can help eradicate the concern of intervention by local excoms.

Tax-sharing can also induce local governments to use their funds efficiently and more responsibly. They will also be more accountable than they are now to their local citizens through the raised question of monitoring by the residents.

Finally, via the employment of tax-sharing under the below-specified conditions or guidelines, the Azerbaijani government will make a real commitment to fiscal decentralization and complete its promise in practice too as it did in the legislation.

Recommendations on application of tax-sharing to Azerbaijan

There should be a strategic approach to achieve the successful operation of tax-sharing. Therefore, as the shift to tax-sharing will bring about certain changes in tax administration practices, as well as, in revenue flows, the introduction of tax-sharing will undoubtedly require certain preparatory stages. The paper proposes the following steps:

In phase 1, rules and some other enforcement tools will be developed and adapted to a new system of tax-sharing transfers. The theory warns against less accountability of local governments in case of tax-sharing (Bird & Wallich 1995). It is therefore necessary to build up mechanisms to maximum maintain the accountability of local authorities. In addition, during this phase:

- The budgeting system of local governments should be updated.
- Some legal tools for revenue collection should be allocated to give local governments the power to collect their property and land taxes.
- It is also vital to work out simple, yet effective, administrative procedures realizable at the local level. These administrative procedures must encompass all revenue administration functions—such as, tax base identification and information database management, assessment of liabilities etc.
- It is impossible to strengthen and develop the local self-government's accountability without mechanisms of overseeing their activities by the public. Special attention should be paid to *the population's involvement in the monitoring of work carried out by municipalities.* The accountability is a sensitive issue in case of tax-sharing. That is

why, while the mechanisms of public supervision over the activities of municipalities have not been set in motion in their full capacity, it would not be wise to start this initiative. Local governments should be audited publicly. They should make information on local finances publicly available.

Phase 2 will then open to tax-sharing. For the beginning, the relevant tax-sharing system should entail very easily administered tax option. This is very important remark in the case of Azerbaijan. The second remark has to do with the distribution approach of this tax. It is advisable to use the derivation-based mode. The reason is that under the current circumstances, when Azeri municipalities are administratively weak, it could be hard to use any other method such as formulas. This would require a lot of administrative costs to determine elements or indicators of formulas. However, I do not mean that this is the best approach. This method seems as the most appropriate at least for the present time. New other methods can be topic of future discussions.

The taxes should also be shared via uniformity principle i.e. rates should be set the same across jurisdictions to avoid negative aspect of tax-sharing such as, tax wars. Assuming the fact that the practice of shared taxes has never been tried in Azerbaijan, it is recommended to start with the easiest one. Besides, this tax is also expected to convert local government officials into more accountable and responsible clerks, by internalizing costs and benefits related with this tax. For the above mentioned reasons, I propose revenues being accrued to municipalities from sharing of *Personal Income tax*.

The percentage of tax shares to be accrued to local jurisdictions should be fixed over a long run, say, 3 years for the sake of stability and certainty and to ease local budgeting process. The shares should not undergo frequent changes.

CONCLUSION

As a matter of fact, the regional and local governments in transition countries have a revenue structure skewed toward external revenue sources, such as shared taxes and governmental grants (Bird, Ebel, and Wallich 1995). One of the key elements in subnational financing which most transition countries make use of is tax-sharing. Taxes are collected by the central government and distributed among local governments.

Despite the great importance of this method, Azerbaijan's legislation does not forsee any tax-sharing instrument as a source for municipal financing. The main goal of the paper was therefore to introduce the tax-sharing practice into the intergovernmental fiscal transfers system in Azerbaijan. The paper argued that tax sharing would complete the revenue sources of local governments for their improved fiscal position. This was done first on the basis of conceptual framework of fiscal decentralization. Arguments with regard to tax-sharing transfers were analyzed on the basis of this conceptual background.

Later in the empirical part, the research highlighted the issue of low fiscal capacity of Azeri local governments and showed that they have been assigned inadequate revenue base to cover their expenditure functions. In addition to lack of necessary revenue sources, there are several other key factors which do not allow stable revenue inflows. These critical problems undermine efficiency of the fiscal decentralization in Azerbaijan were specified. For the solution of these concerns, the paper discovered the need for an additional method of municipal financing and eventually stressed the inevitability of establishing a new system of transfers with the participation of tax-sharing.

Moreover, the research proposal of tax-sharing will have future implications in the improvement of local governance system in Azerbaijan. The application of tax-sharing can be a very helpful transitory instrument in switching to the system of surtaxes (or surcharges) in the future, which theoretically appears the most decentralizing approach by allowing local jurisdictions to set their rates on the nationally administered taxes. The surtaxes provide local governments with higher revenue autonomy[18].

In the end, it should be noted that the issue of the intergovernmental transfers is surfacing along the *ongoing* process of fiscal decentralization. Hence, the area of research is still young in the case of Azerbaijan and needs further investigation in the future.

[18] Table 2: Classification of surtaxes as the one granting more revenue autonomy can be found in OECD Report 7, 2002

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GLOSSARY

Specal technical terms

Fiscal decentralization – a transfer of fiscal, political, and administrative responsibilities to local tiers of government.

Fiscal Federalism – fiscal decisions are made at different tiers of a government. The economic theory of fiscal federalism describes how the different economic functions of government are matched with the level of government best equipped to carry them out efficiently.

Intergovernmental transfers – transfers between different levels of government which involve grants and *revenue sharing*.

Conditional grants – grants with stipulations imposed by grantor governments on how revenues are to be spent by the recipient governments.

Unconditional grants – grants carrying no restrictions on the ways in which revenues are to be spent by recipient governments.

Horizontal imbalance – a situation when own taxing resources of various subnational levels of governments of the same level differ.

Local budgets – budgets of subnational governments.

Local public good – public good locally provided for the benefit of a local community and financed largely out of local taxation; a spatially limited public good

Public good – a commodity or service which is available to everyone in a particular area, cannot be withheld from non-payers and is "non-rival", i.e. one person's consumption does not diminish that of others (Rutherford, 1995).

Tax sharing – *sharing of revenues* created by a certain tax (or taxes) among different levels of government.

VAT – Value Added Tax

Vertical imbalance – a situation when own revenue falls short of spending at a particular level – or unit – of government.

Subnational surcharges (or surtax) - a higher level of government defines the tax base and collects both its own tax and surcharges set by subnational governments.