



**SUPPORT FOR ECONOMIC INITIATIVES**

**Strengthening Financial Capacity of  
Azerbaijan's Municipalities:**  
*Improving the taxable base of physical entity property tax*

**BAKU – 2011**



*This policy paper has been developed in the framework of the project titled "Strengthening municipal capacity and citizens' engagement in local governance and development in Central Azerbaijan".*

*The project has been implemented with joint funding of Oxfam (Great Britain) and The Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH.*

**Authors:**

**Azer MEHTIYEV  
Rovshen AGAYEV  
Samir ALIYEV**

**Expert:**

**Rashad ALIYEV**

**21 Zulfi Adigozelov Street, AZ1009, Baku**

**Tel: (99412) 5964459**

**Fax: (99412) 5964978**

**E-mail: [sei@azeronline.com](mailto:sei@azeronline.com)**

**Web: [www.sei.az](http://www.sei.az)**

# TABLE OF CONTENTS

<b>1. Project overview</b>	<b>4</b>
<b>2. Introduction</b>	<b>5</b>
<b>3. Problem statement</b>	<b>7</b>
<b>4. Policy options</b>	<b>14</b>
4.1. Organizing overall inventory of physical entity property	14
4.2. Implementing the physical entity property tax based on the property's market value	17
4.3. Implementing the physical entity property tax based on the size of the property	23
<b>5. Assessment of alternatives</b>	<b>26</b>
5.1. Assessment methodology	26
5.2. Assessment of alternatives by criteria	27
<b>6. Conclusions and recommendations</b>	<b>32</b>
<b>7. Annexes</b>	<b>36</b>
7.1. <b>Annex 1.</b> The level of physical entity property tax as of 2010 (by regions)	36
7.2. <b>Annex 2.</b> Extract from the Tax Code of the Republic of Azerbaijan	38
<b>8. References</b>	<b>39</b>

## PROJECT OVERVIEW

*One of the key factors for effective exercise of basic powers and responsibilities at local level is to provide local authorities with adequate financial resources. This policy paper indicates legislative improvements to address and prevent problems arising during the collection of revenue raised by taxation, which is one of the largest sources of the local budget income.*

*The research revealed that there are significant problems over the collection of the physical entity property tax, which is an earner of local budgets. The main reason for this is the lack of inventoried/inventory value of the real estate subject to taxation. This practice is mostly common in rural communities, where more than 90 percent of real estate have no inventoried/inventory value. Moreover, there are also problems over the taxation of property with inventoried value. The taxable base for property tax applied in about 130 countries across the world is a property's market value.*

*To solve the problem, it is recommended to improve tax legislation. As the outcome of the research, the policy paper suggests three alternative mechanisms: 1) Organizing overall inventory of physical entity property; 2) Implementing the physical entity property tax based on the property's market value; 3) Implementing the physical entity property tax based on the size of the property. Each alternative is analyzed and assessed.*

*The policy paper also suggests and recommends calculating legal entity property tax as local tax instead of state tax, as well as applying the mechanism to levy property tax based on the market cost/value of buildings and property.*

# INTRODUCTION

According to article 9 paragraph 1 of the European Charter of Local Self-Government (Council of Europe, 1985), "local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers". In this view one of the pacing factors for effective exercise of basic powers and responsibilities at local level in a country is to allocate adequate financial resources to local authorities. A central authority shall ensure local authorities' access to the financial resources within the limits of the law.

Under the law of the Azerbaijan Republic, several taxable and non-taxable incomes coming from local taxes constitute the revenue available to Azerbaijan's municipalities. The research showed that in Azerbaijan, municipalities' access to substantial financial resources allocated to them is very limited. One of the sources of income unavailable to municipalities is the property tax levied from physical entities. The reality is that the property tax coming to municipalities is at a low level. According to statistical data, the collection rate did not go beyond 70 percent in 2010 across the country. Even this figure is 2-3 percent in some municipalities. Worse still, in practice, some municipalities have no access to this kind of tax.

There are multiple reasons giving birth to problems over the collection of physical entity property tax, mostly stemming from legislative gaps and poor organization of municipal activity, including but not limited to, the lack of inventoried value of physical entity property (buildings) in particular. Under the law, physical entity property tax shall be levied from the inventory value of real property. The lack of inventoried value of most houses in the country, in rural areas particularly, impedes collection of property income.

While preparing this policy paper, the case study sought to focus on the questions below:

- *What are the reasons for the low level of physical entity property tax collection in the country?*
- *What is the extent of municipalities' liability due to the low level of physical entity property tax collection?*
- *What steps must be taken towards improving the taxable base for physical entity property tax as well as stimulating taxation as a whole?*

To this end, experiences from other Former Soviet Union (FSU)-countries have been studied: they showed that law in these countries previously envisaged calculation of physical entity property tax based on the inventoried value of real estate. However, some of these countries further amended their legislative framework. For example, tax is collected through the method based on market value in Georgia, while on the assessment value in Moldova, on the property size in Ukraine. In the other FSU-countries, including in Azerbaijan, the tax assessment based on inventoried value of real estate still remains in force. Russia is set to impose a unified real estate tax from 2013 by replacing existing land and property taxes.

As part of the case study, 40 municipalities in Barda, Tartar, Agjabadi and Yevlakh, located in the so-called Central Aran (the central region of Azerbaijan) were surveyed. The poll aimed to reveal problems hampering the collection of physical entity property tax, as well as learn municipalities' opinions for decision-making. Research results showed that only 4% of houses on average located at the area of the municipality have inventoried value. The municipal officials said the lack of inventoried/inventory value of real estate impedes the tax collection, and underlined the necessity for taking inventory of all houses.

Independent experts were also interviewed during the survey. They were asked to name problems over the tax collection and voice concrete offers for decision-making.

Besides, focus group discussions, private meetings and public debates arranged as part of preparation of a different policy paper facilitated the survey process.

According to the Republic of Azerbaijan's Tax Code, property tax shall be levied from both legal and natural persons. However, the property tax levied from legal entities is calculated through a quit different mechanism and paid to the state budget, while property tax levied from physical entities is paid to the local (municipal) budget. This document only sees into the property tax levied from and transferred to local budgets by physical entities.

The policy paper mainly consists of four parts. Part 1 – **“Problem statement”** highlights problems facing the physical entity property tax collection in Azerbaijan's municipalities. Part 2 - **“Policy options”** provides three policy options/alternatives developed by SEI experts aimed to stimulate tax collection, as well as reflects their definition, probability of their implementation, advantages and disadvantages. Part 4 - **“Assessment of alternatives”** contains detailed assessment of the three policy options. To this end, assessment criteria are defined and each alternative are assessed based on these criteria. In the end, the best policy option is defined. The part **“Conclusions and recommendations”** summarizes the study outcomes and lists certain recommendations for decision-makers.

The aim of this policy paper developed in framework of the project titled **“Increasing municipal capacity and citizens' engagement in local governance and development in Central Azerbaijan with joint funding from Oxfam (Great Britain) and The Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH** is to assist Azerbaijan's municipalities to strengthen their financial capacity.

The authors believe that the adoption of this policy paper by the government and use of the recommendations in decision-making will help municipalities increase the local budget incomes, stimulate them to duly carry out their responsibilities and contribute to shaping tax-paying culture among the population.

## PROBLEM STATEMENT

Strengthening the financial capacity is vital for municipalities to carry out activity. The lack of sufficient financial resources impedes local governments to duly perform their responsibilities. Consequently, this situation shatters public confidence in municipalities tuning public opinion to their valuelessness.

A variety of international institutions [9] and independent experts [14] in Azerbaijan do recommend entrusting additional powers and financial resources to municipalities to reform the local government system. Moreover, government officials claim that municipalities enjoy full powers and have sufficient financial resources. The result is that municipalities still fail to pay off as local authorities in the country.

Recent studies [14] have found that municipalities cannot use financial resources entrusted to them. However, the government's opposite argument against the recommendations voiced by the international organizations and independent experts is that municipalities are unable to adequately benefit from responsibilities and financial resources given to them and additional powers and financial resources to be given will not change anything. In fact, the problem roots from legislative gaps which are unrelated with the municipalities.

One of the problems facing municipalities is the low level of the physical entity property tax collection. Studies show that some municipalities even cannot collect this tax at all. Globally, the property tax (which includes legal entities as a rule – **author**) is a major source of municipal/local budget revenues. Nevertheless, the share of the income coming from the property tax is insignificant in municipal/local budget revenues.

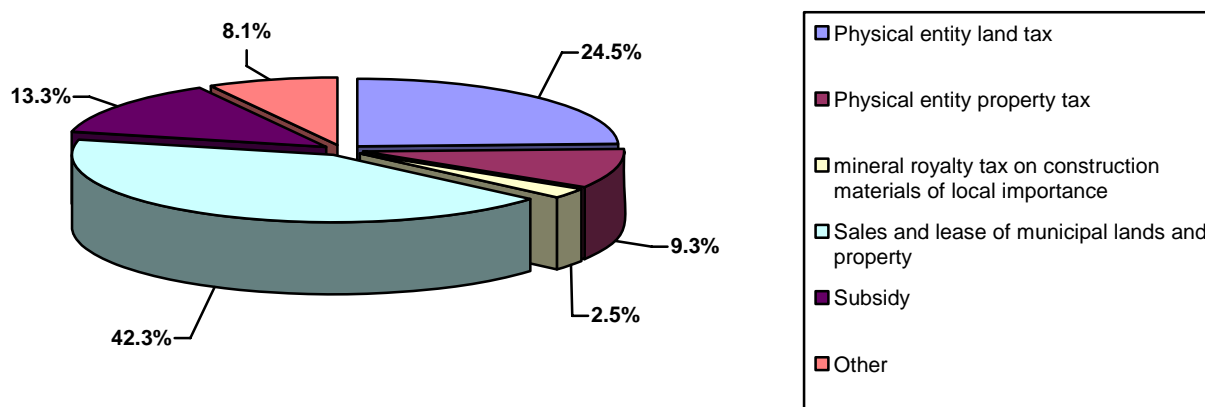
Local governments are financed out of local budget revenues. According to statistical data, non-tax receipts prevail in local budget revenues. The substantial proportion of budget revenues accounted for incomes from privatization and lease of lands in the municipal ownership. For example, the incomes from this source comprised 42.3% in 2010, whereas more than 70% in previous years.

Tax receipts are the second supplier of local budgets. According to the tax Code [2] and Law on Municipalities [5] of the Azerbaijan Republic, following are the local (municipal) taxes:

- *land use tax levied from natural persons;*
- *property tax levied from natural persons;*
- *mineral royalty tax on construction materials of local importance;*
- *profit tax of enterprises and organizations that are the property of municipalities.*

Local taxes are applied under municipal decisions and paid in municipal areas.

Tax receipts basically come from the physical entity land and property taxes (land use/property tax levied from natural persons) accounting nearly 90% of total revenues. The physical entity property tax/ property tax levied from natural persons is the second source of taxes. Last year, its shares in local budget and tax revenues, respectively, were 9.3% and 24.5%. [16]



**Chart 1. Local budget sources (2010)**

The share of physical entity property tax incomes in local budgets by years have been significantly changed, not exceeding 10% on average. The highest figure was (9.3%) was observed in 2010. In 2005 and 2007 the share of property tax averaged 2%, which is the lowest figure. (Table 1)

*Table 1*

**Local budget revenue and share of tax income by country**

Years	Budget revenue, in mln manats	Tax income, in mln manats	Share of tax income in budget revenue, (%)	Income from physical entity property tax, in thsd. manats	Share in budget revenue, (%)
2002	12828,4	4979,92	38,82	840,96	6,56
2003	11100,0	5397,16	48,62	942,72	8,49
2004	17547,14	5694,66	32,45	1118,6	6,37
2005	24327,3	6239,8	25,65	566,5	2,33
2006	33000,0	6870,6	20,82	685,8	2,08
2007	50000,0	8943,5	17,89	967,3	1,94
2008	43077,3	11546,7	26,80	2778,2	6,45
2009	26697,9	9895,0	37,06	1666,4	6,24
2010	28873,0	11235,5	38,91	2675,9	9,27

Source: State Statistics Committee

The highest pace of property tax growth was achieved in 2008, when tax receipts saw a 187% increase despite the fact that there was a 13.85% decrease in the budget revenue at that time. The significant increase in property tax was due to the change of the mechanism for sales of lands in the municipal ownership. Since December 2007, local governments have been banned to sell lands until new regulations are endorsed and this restriction that lasted till April 2009 resulted in the loss of income source of the budget. Since the share of income from privatization of municipal lands in the budget revenues averaged 40-70% by years. The sharp decrease in the income from the major source stimulated municipals to focus on tax collection. As a result, tax receipts were about 30% up in a year. In that same timeframe property tax incomes rose three-fold to 2.8 million manats from 967,300 manats. (Table 1)

There is a significant difference between local budget revenues and physical entity property tax incomes. In most cases, property tax increases when budget revenues drop. Property tax decreased by 50% in 2005 and 40% in 2009. (Table 2)

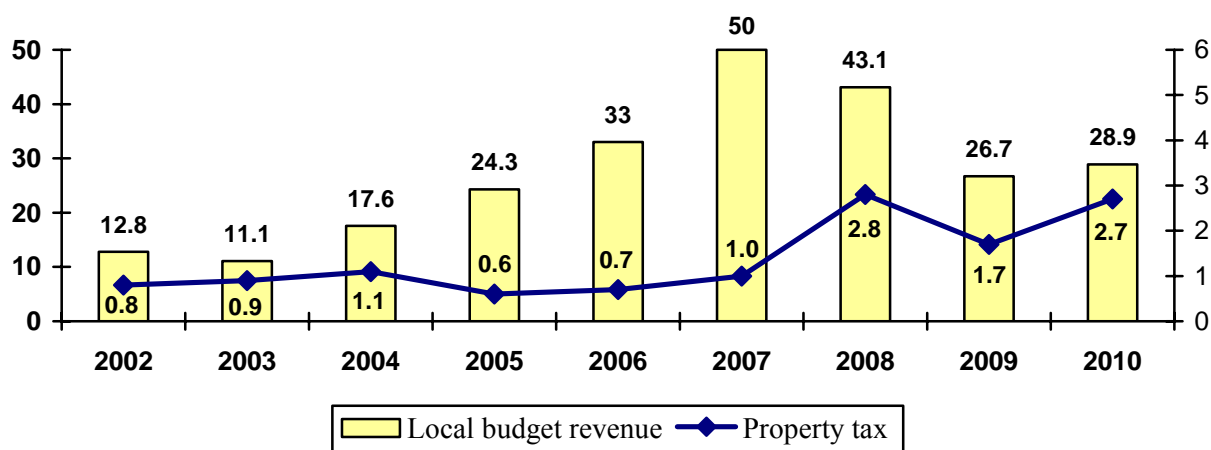
*Table 2*

**Pace of budget revenue and physical entity property tax income growth**

Years	Budget revenue, in mln manats	Pace of budget revenue growth, (%)	Income from physical entity property tax, In thsd. manats	Pace of physical entity property tax income growth, (%)
2003	11100,00	-13,47	942,72	12,10
2004	17547,14	58,08	1118,6	18,66
2005	24327,3	38,64	566,5	-49,36
2006	33000,00	35,65	685,8	21,06
2007	50000,0	51,52	967,3	41,05
2008	43077,3	-13,85	2778,2	187,21
2009	26697,9	-38,02	1666,4	-40,02
2010	28873,0	8,15	2675,9	60,58

**Source: State Statistics Committee**

In 2009 there have been decreases in the volume of budget revenue and property tax income, respective decreases of 38% and 40% (Table 2). This drop can be explained with the impact of global financial turbulences on Azerbaijan's economy. Because the volume of money sent from Russia, which is the main source of earning in regions, in rural areas particularly, narrowed to 30% in 2009 [17]. Besides, slightly worsening of macro-economic state and decline in the economic activity had brought to a higher unemployment rate in the country at that time. For example, according to the State Statistics Committee, in 2009 the number of employees by economic activities dropped by 25,000 compared to 2008.



**Chart 2. Flow of total budget revenue and property tax income by years, in mln manats**

The growth in the local budget revenue does not always depend on the property tax income hike. Although the property tax income increased in 2003 and 2008, there had been decreases in the budget revenue. Alternatively, in 2005 the budget revenue had increased despite the tax income drop. **(Chart 2)**

Although municipalities are legally entitled to collect local taxes, including physical entity property tax, municipal enterprises cannot completely perform this function. In fact, they face a pile of problems in collecting the property tax, the implementation of which is compulsory for local governments. These problems can be systemized as the following:

Azerbaijanis pay their lowest level of the physical entity property tax. According to statistical data, this tax payment was 68% executed in 2010. Municipalities could collect AZN 2.7 million versus the planned target – AZN 3.9 million. In 2009 and 2008, the level of collection was 48% and 92% accordingly. The payments have varied in regions: municipalities in Yevlakh və Beylagan outstripped the target, with property tax collection rates at 135.3% and 121.4% accordingly. In Khachmaz, Guba, Lenkaran regions the target was over 90% over fulfilled. The lowest rates were found in Astara, Gobustan, Saatlı and Gadabay regions, fulfilling the target at 1.6%, 2.2%, 3% and 3.3%. *(for more details, see: ANNEX 1)*

**Some municipalities have never levied the property tax.** Sometimes, municipal enterprises think that physical entity property tax collection is not their responsibility, but their right granted to them. Fearing to loose voters during next municipal elections, local government authorities prefer not to collect taxes in order to gain more prestige among the people. Even some municipal candidates stress refusal of taxes in their platforms. The surveys showed that some municipalities cannot cope with their responsibilities failing to collect property tax as envisaged by the law. In 2010, no property tax was levied in six regions (Naftalan, Dashkasan, Imishli, Mingechevir, Agdam and Fuzuli), where 126

municipalities function. It shows that 7.3% of the municipalities across the country do not levy physical entity property tax. (ANNEX 1)

The survey conducted among 40 municipalities in Central Azerbaijan (Barda, Tartar, Agdjabedi, Yevlakh) has also revealed a similar case: 77.5% of local government authorities do not levy the property tax at all [15].

**Lack of inventory value of buildings makes it impossible to levy property tax.** Under article 198 of the Tax Code, “physical persons shall pay the property tax from the inventoried value of the building in their ownership”. So, the inventoried value of the building is significant to levy the property tax. Otherwise, the building cannot be subject to tax. However, studies have shown that most of the taxable buildings have no inventoried value, mostly in rural areas (90% of property), thus causing problems to levy property tax. Given that over 80% of municipalities function in rural areas, most of them have been impacted by the collection problems. The survey conducted among municipalities also proves this fact. 25% of municipalities surveyed said the premises located at their municipality of the area have no inventoried value. On average 4% of buildings located at the municipality of the area have their inventoried value [15].

**Legislative discrepancies and gaps cast doubt on municipal decisions concerning the appraisal.** Under article 200 paragraph 1 of the Tax Code, “the property tax shall be calculated on a building according to the inventory value placed by local government authorities to that building as of January 1 of each year”. So, local government authorities calculate the annual tax amount and send notifications to the taxpayers at the municipality of the area they are located. However, failure to place the inventory value causes problems with tax collection. To solve the problem, local government authorities in most cases make decisions about the premises with no inventory value. As a basis, local government authorities maintain that they are guided by the law on local taxes and payments [6]. Under article 5 paragraph 3 of this law, “for the purposes of calculating physical entity property tax, local government authorities adopt decisions on assessment of buildings and property located at the municipality of the area every 3-5 years”. The local government authorities that refer to this law or independent appraisers place the inventory value on the premises, thus contradicting the law. The inventory value of real property is placed under the Regulations titled “Rules to calculate the inventory value of buildings owned by natural persons” approved by the Cabinet’s Resolution No 110 (June 28, 1999). Under article 1 paragraph 1 of the Rules, the inventory value placement of buildings owned by natural persons is based on their technical inventory. This process is documented by the State Property Register Service at the State Committee for Property Affairs of the Azerbaijan Republic and the papers on physical stocktaking are submitted to tax agencies. Under article 9 paragraph 24 of the Regulations of the State Property Register Service, “the Service shall carry out inventory of structures, including buildings, fittings, residential or non-residential spaces, private and vacation houses” [7]. According to article 9 paragraph 25 of the Regulations, “the Service shall draw up all necessary technical documents required for the state registration of property ownership and prepare the plan and size of

land plots based on inventory taking". The section "Formalization of assessments" of the Regulations titled "Rules to calculate the inventory value of buildings owned by natural persons" states that "the State Property Register Service is the executing body to place the inventory value of real property".

All this shows that the State Property Register Service at the State Committee for Property Affairs of the Azerbaijan Republic is the sole agency to place the inventory value of real property. The inventory value placed by other agencies, including appraisers is illegal.

In some cases the premises that have no inventoried value are appraised by the municipalities themselves, applying an approximate tax amount. Such initiative by the municipalities contradicts the Tax Code in fact. Some municipalities have taken more illegal actions over legislative gaps, involving other bodies in the tax collection process, including signing of agreements with local building-utilities administrator offices, known as ZhEK, with a view to levy taxes<sup>1</sup>. This case is mostly found in Baku municipalities. Under the Tax Code, building-utilities administrator offices or relevant departments exercise no right to levy taxes.

**Municipalities fail to use necessary workings to levy taxes.** Unlike government taxes, taxpayers show no interest in local tax payments. Because unauthorized municipalities cannot handle local problems and therefore they have not gained public confidence, on one hand. And municipalities have no leverage to collect fines on the other hand. Unlike electricity, gas, water and other utility fees, municipalities can force the people to pay taxes through court decisions only. But this process takes a long time and as the court expenses are higher than tax payments, municipalities seek no efforts to initiate this step. If local building-utilities administrator offices apply leverages, such as refuse to issue reports to those citizens that pay no utility fees, municipalities have no such workings.

**Municipalities with higher non-taxable incomes levy property tax at low level.** Recent studies and statistical analyses have found that the municipalities with higher non-taxable incomes show no interest in tax collection. Especially, when the proceeds from the land sales supply the largest portion of budget revenues, municipalities do not address other sources. For instance, according to the 2010 statistical information, in the Absheron region, where the proceeds from the land sales comprised 67% of budget revenues, the property tax share was 2.3%. In Akstafa municipalities, this the property tax supplied 1.7% of budget revenues, while 1.5% in Goygol, 0.3% Masally, 0.1% in Shabran, 1% in Shirvan. The share of non-taxable incomes in the municipalities was 73.2%, 77.2%, 85.7%, 95.3% and 91.1% respectively. But no property tax is levied in Fuzuli, Mingchevir and Dashkasan where tax receipts constitute 86.6%, 88.6% and 86.3%. [16]

In 2007 the land sales supplied more than 70% of municipal budgets. Local government revenues hit 50 million manats in 2007 - the biggest budget they had ever collected in their

---

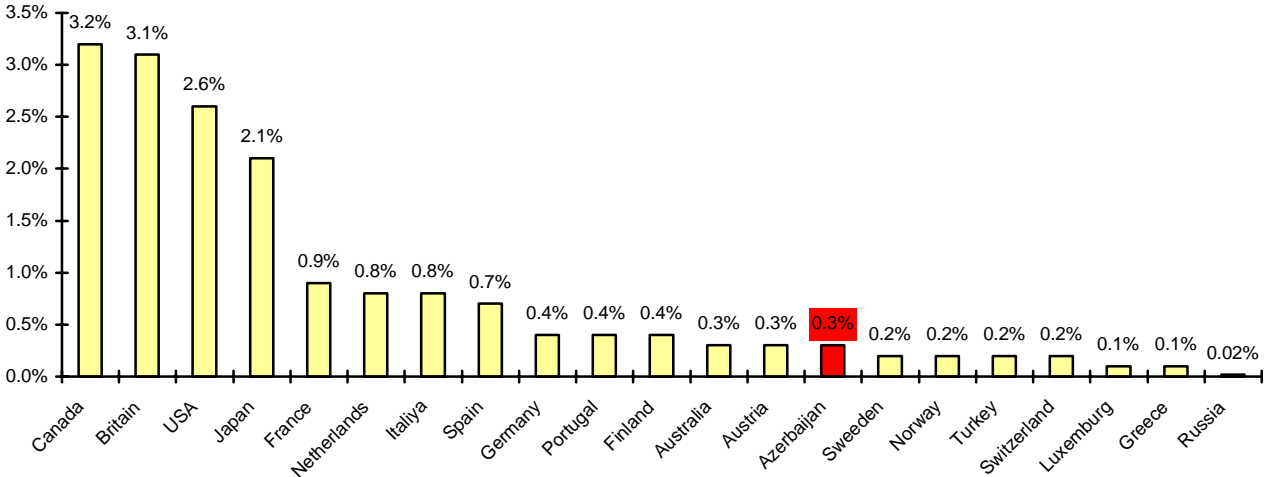
<sup>1</sup> Baku's Hatai, Nizami and Yasamal municipalities have made such initiatives.

history. Just then, the share of property tax receipts was below 2% in the budget revenues. (Table 1)

The insufficient public awareness negatively affects tax collection. About 18% of the respondents interviewed among municipalities said there is a need to raise public awareness about the tax collection. Some citizens consider that the tax implementation depends on municipalities. According to them, municipalities may refuse from the taxes collection taking into account the citizens’ request.

One of the reasons for the decline in tax receipts is the tax exemption applied to the persons enjoying the right to privilege. Under article 199 paragraph 3 of the Tax Code, “the amount of property tax that shall be paid by disabled people who were war participants, persons who received the status of war veterans in accordance with legislation, as well as people on pension or obligatory military service, their family members for the period of such service shall be reduced for the amount of 30 manats, with exception of cases of their leasing, rent or use for entrepreneurial or other commercial activity. If we take the reduced 30 manats from the amount, there is nothing left. The inventory value of the most houses in rural areas is much lower than 30,000 manats.

The physical entity property tax applied in about 130 countries across the world. In most countries, property tax receipts/payments constitute 1-3% of budget revenues. This indicator is 9% in the United States, while 1-4% in some developed countries, such as in Canada, Great Britain, Japan, and France. In Azerbaijan, the physical and legal entity property tax receipts supply 0.3% of total GDP, which is similar that in Australia and Austria. (Chart 3)



**Chart 3. Share of property tax payments in GDP by different countries [19]**

In international practices, the property tax is unexceptionally included in local taxes. As a rule, legal entity property tax receipts are also supplied to local budgets. In some countries even land and property are taxable within a unified tax system.

## ALTERNATIVES

As a result of the studies, surveys and expert debates within the preparation of this policy paper, three alternatives and/or policy options below have been defined:

1. *Organizing overall inventory of physical entity property (premises);*
2. *Implementing the physical entity property tax based on the property's market value;*
3. *Implementing the physical entity property tax based on the size of the property.*

Below is the detailed analysis of each alternative.

### **Alternative 1: Organizing overall inventory of physical entity property (buildings)**

Under article 198 of the Tax Code, “physical persons shall pay the property tax from the inventoried value of the building in their ownership”. The property tax from the inventoried value of the building in their ownership is placed through defining its technical inventory. The inventoried value of the buildings is calculated on the real value by deducting the amortization cost available at the time of appraisal.

According to municipal law [6] , the inventoried value of buildings is placed by the Cabinet of Ministers' decision 110 of June 28 1999 on “**the approval of calculation guidelines for inventoried value of real estate owned by physical persons**”. According to this decision, the inventoried value of real estate owned by natural persons shall be placed taking into consideration ratios and existing index (inflation rate).

This value placed is documented by the State Property Register Service at the State Committee for Property Affairs of the Azerbaijan Republic and the papers on physical stocktaking are submitted to tax agencies.

The property tax levied on buildings owned by natural persons is calculated by the local government authorities of the municipality of the area they are located at. The calculation is guided by the Cabinet's decision #46 “**Rules for calculation of property tax levied on buildings**” dated 23 February 2001. The inventoried value of the taxable real property is required to calculate the tax.

Otherwise, it cannot be subject to tax. Because the Tax Code states that “physical persons shall pay the property tax from the inventoried value of the building in their ownership”. However, studies have shown that most of the taxable buildings have no inventoried value, mostly in rural areas, thus **causing problems to levy property tax**. The survey conducted among municipalities in Central Azerbaijan proves this fact. The municipalities

---

<sup>2</sup> Under the rules, buildings mean private houses, apartments, vacation houses, garages, other facilities and their permanent structures owned by physical persons

surveyed said 85% of the premises located at their municipality of the area have no inventoried value. On average 4% of buildings located at the municipality of the area have their inventoried value. This indicator is 100% in Tartar, Agdjabadi and Yevlakh regions. 97.5% of the municipalities point out that the main cause of the problem is the lack of inventoried value of buildings [15].

*The solution of the problem concerning the inventoried value of real property does not smooth the performance in the property tax collection.* Because local government authorities even cannot levy property tax from the buildings that already have their inventoried value, in particular in regions. Although municipalities in cities can rather cope with the collection, municipalities in Mingechevir and Naftalan never levy property tax [16].

Survey answers have shown that 61.3% of municipalities cannot levy property tax from the inventoried buildings, with the collection not touching 100% at those municipalities collecting this tax. For example, 80% of inventoried buildings in II Hacallı are subject to tax, while 63% in Körpüqıran, 54% in I Qarademirçi, 70% in Seydimli, 75% in Aşağı Qarxun (75%), 30% in Alaçadırlı and 40% in Hacıqervend municipalities. [15]

Municipalities surveyed link the problem with legislative gaps (82.5%), low-earning capacity of the population (77.5%) and poor public awareness (17.5%) [15].

Also the law includes an item entrusting local government authorities to pass decisions on property appraisal, this right contradicts other legislative acts. *Firstly*, under article 5 paragraph 3 of the law on local taxes and payments, “for the purposes of calculating physical entity property tax, local government authorities adopt decisions on assessment of buildings and property located at the municipality of the area within a period not exceeding every 3-5 years”. *Secondly*, the value placed by an independent appraiser has no legal base. Because the State Property Register Service is held responsible to carry out such assessment by the law.

The lack of inventoried value of the building and legislative gaps restrict municipalities’ right to tax collection, thus forcing them to break the law. Below are some of the wrongdoings committed by local government authorities:

- Buildings without their inventoried value are subject to property tax;
- Buildings without their inventoried value are assessed by local government authorities thus fixing an approximate tax amount;
- Property tax is collected by local building-utilities administrator offices under the agreement signed with the municipalities.

The studies, surveys and group discussions showed that there are considerable disadvantages in the physical entity property tax collection and it is necessary to take prompt measures in order to improve this mechanism.

*The essence of the alternative is that the government should immediately start to carry out overall inventory of real property (buildings) owned by physical persons.*

### **Definition of the alternative**

To implement this mechanism, it is proposed to the government to initiate the measures below:

The overall inventory of buildings starts. The government passes a decision on overall inventory of buildings owned by physical persons to launch the process immediately, which is carried out by the State Property Register Service at the State Committee for Property Affairs of the Azerbaijan Republic. Given additional costs, it is proposed to allocate funds to the Register Service from the state budget.

After placing the overall inventoried value of buildings, the database is submitted to relevant municipalities, which in turn calculate the property tax amount on each building and send notifications to the taxpayers at the municipality of the area they are located.

Surveys in Central Azerbaijan have revealed that the volume of property tax levy is likely to significantly increase in case of placing inventoried value of all buildings at there. According to the answers provided during the survey, the property tax levy could advance by 23-fold if the inventory process is launched [16].

### **Advantages and disadvantages of the alternative option**

**Below are the major advantages of this alternative option:**

- The buildings that are registered with the State Registry of Property, also have inventoried value placed by the State Property Register Service at the State Committee for Property Affairs of the Azerbaijan Republic. In this case, local government authorities will be relieved from unnecessary expenses.
- Local budget revenues, as well as physical entity property tax incomes significantly increase thus promoting local government authorities to enhance their financial capacity.
- The inventoried value secures lower tax rate levied on physical entity buildings, thus reducing the tax burden of taxpayers, especially rural citizens and low-income section of the population.

*The following are the disadvantages of this alternative option:*

- The property tax collection mechanism based on its inventoried value contradicts the principle of fair tax collection. The same tax rate applied on buildings located in the capital city and a remote village decimates taxpayers in terms of social equality.
- As the inventoried value of buildings is low, the amount of tax collection is insignificant.
- There is no dependence between the inflation level and inventoried value. Increased cost of building materials, devaluation of national currency are not reflected in this value.

**Alternative 2. Implementing the physical entity property tax based on the property's market value**

In Azerbaijan, one of the most serious problems facing physical entity property taxation is that there is no link between the tax base and the market value of real property. This policy option therefore proposes to assess the buildings and property owned by physical persons on the basis of their market value. **The market value for the purpose of taxation** is the real price of taxable facility under fair sales conditions in a competitive and open market environment. Here the term «fair sales conditions» mean the sales value is not impacted by non-market factors, as well as both seller and buyer are similarly briefed about the market value of property. For example, in Lithuania, the term «market value of property» is applied. Under the law on property tax adopted 7 June 2005, “the average market value of real property is considered its taxable value (tax base)”. Under article 6 of the law, “the tax base is 1% of taxable value”, while article 9 states that “physical entity property is taxable to levy by classifying according to two groups: commercial facilities and housing funds [13].

Foreign experiences have shown that physical entity property tax based on its market value calls for shaping of mechanisms below:

**1) Fiscal cadastre (it is also called property registry).** It sets out to levy taxes and carry out registry of property. The property registry is the collection of data on the technical, economic and legal characteristics of real property and contains the following as a rule:

- *Types of property;*
- *Physical characteristics of property;*
- *Actual state of use of property;*
- *Data on the value of property.*

To process all these data, it is necessary to open a cadastral number and all the information should be included in this number.

**2) Legal and applied mechanism shall be shaped to assess property.** In international practices, real property, including building and its permanent structures are appraised according to two methods – overall and individual assessment. As a rule, overall assessment is applied for the purpose of taxation. It is a systematic appraisal process based on statistical data, standard procedures and analyses, encompassing standard appraisal of facilities included in the same group or type and calling for classification and statistics if taxable facilities. During overall assessment three various methods are used in different countries. According to *Cost Approach*, property assessment is conducted based on current expenses for restoration and replacement of the property under assessment taking into consideration its physical aging. This approach is mostly used for assessment of upper constructions. According to *Capitalization of Profits*, property is assessed according to forecast profits. **Finally**, the widely applicable approach is the assessment based on **comparative sales**. This time the value of the property being assessed is defined according the information on the sales and proposals for the similar facilities available at the market. Nevertheless, it is important to obtain correct and transparent database about the market. This approach is considered the most adequate one, as the market price is the most reliable source to assess the market value of the property.

In international practices, the application of comparative sales method is based on certain procedures. *First*, premises that are similar to the property under assessment are investigated according to diverse markets. Some professional appraisers maintain that selecting at least 4 analogues for the property would increase the reliability of assessment outcomes. *On the other hand*, once the facilities chosen as analogues are analyzed and compared, the correction ratio must be applied on the property under assessment. According to international standards, the right of surrender of real property, sale conditions (on cash, credit, etc), expenditures to be incurred after sale, market or sale conditions (prompt sale, etc), property location and other characteristics can be the elements of comparison.

**3) The liability of relevant agencies responsible for the application of the physical entity property tax based on the market value of the property and their interrelations must be legally determined.** It's clear that the rules to determine tax collection and calculation, property registry for the purposes of taxation, property assessment, control over the conformance of tax calculation, the regular monitoring for tax collection and tax mechanism application are implemented by a variety of agencies. In this regard, the liability of each agency and their interrelations must be regulated in a way that no problem could arise in the timely and full payment of physical entity property tax to the local budgets and all property owners could be impacted by the tax system.

### **Definition of the alternative**

The second alternative proposed for taxation of buildings and structures owned by physical persons can be defined as the following: **Rejecting the current taxation rules**

**based on the inventoried/inventory value of the property (see: Alternative 1) and implementing the taxation mechanism based on the market value of the property.**

As is seen, should this alternative be introduced, the practice of performing inventory value of taxable property (premises and structures) owned by physical entities will be quitted and this property will be appraised and subject to tax based on its market value in conformity with the legal mechanisms as stipulated by the law.

### **Range of use of the mechanism to implement the property tax based on its market value**

This mechanism extends to the physical entity property below:

- *Living property, which includes private houses with and without land plots, living premises in multistoried/apartment buildings and vacation houses;*
- *Garages;*
- *Social and public service facilities;*
- *Retail facilities;*
- *Commercial facilities;*
- *Facilities other than the above-mentioned classification groups.*

### **Mechanism of use of the alternative**

To implement this alternative, first, there is a need to include the following mechanisms in the **tax law**:

- (i) Taxable property in the form of buildings and structures owned by physical persons must be thoroughly classified;
- (ii) The tax rates base must be amended. Under article 198 paragraph 1 of the Tax Code, “physical persons shall pay the property tax from the inventoried value of the building in their ownership”. In accordance with the alternative proposed, the term “inventoried value” must be replaced by the term “market value”.
- (iii) In accordance with the property classification to be envisaged by the Tax Code, the tax rates below may be set for physical entity property based on the current market value:
  - *For living buildings and structures – up to 0.1% of the market value for the property;*

- For garages – **up to 0.5% of the market value for the property;**
- For social and public service facilities – **up to 1.0% of the market value for the property;**
- For retail facilities – **up to 1.5% of the market value for the property;**
- For commercial facilities as well as facilities other than the classification groups above – **up to 2% of the market value for the property and tax is allocated to local budgets.**

**Note:** The physical entity property tax applied in about 130 countries across the world. In the countries, where the market value is applied, a maximum of 1% is set for the physical entity property tax based on the cost/value of buildings and property. But this rate is higher in some countries. For example, 9.15% in the USA, 4.63% in Australia, 10.43% in Great Britain, 8.16% in Canada, 5.7% in Japan, 2.17% in France. [18].

It appears probable that the tax rate can constitute 50-60% of the market value of the property by the law. This case can be found in foreign practices and experts claim that the taxable value of the property must be equal to 50% of its market value assessed for the purpose of sales [20].

- (iv) Article 200 paragraph 1 of the effective Tax Code of the Azerbaijan Republic is replaced by the following: **“The property (real estate) tax shall be calculated on the buildings and structures owned by physical persons according to the cadastral number of each property based on the market cost/value available at the State Register Service”.**

For the purpose of effective realization of this alternative, it is proposed to establish a **unified electronic tax e-tax register**, which is one of the important mechanisms, in order to levy property tax from physical persons. Each property will have a cadastral number and a data catalog to be created in accordance with the cadastral number will include detailed information about the property type (whether it is residential or non-residential house; if a living residence, whether it is a multistoried building, private house, or vacation house, the number of rooms, which floor is located on; if a non-residential facility, its exact type), property ownership (if more than one owner, their full names), right to use it (whether the owner uses or has leased the property), the state of use (whether its working life is suitable or expired), property size, its location (city, region, settlement (village), street (corner), etc), its market value determined from the last appraisal based on comparative sale method, etc. Presently, the low probability to get documents confirming the property on ground of the availability of numerous illegal constructions in the ownership of physical persons in Azerbaijan as well as part of their con-conformity to building norms is still a major challenge to establish the register. Nevertheless, it would be more expedient, at least, to complete the property registration process in accordance with urban development rules, and if necessary, to introduce state tax exemption for the registration of the population within the tax concession period of

one year. All citizens should have a full access to the register so that property owners could obtain detailed information about their property through including their cadastral number.

Finally, one of the legislative reforms to apply this alternative is to create **overall assessment/appraisal mechanism**, which is a well-developed legal base as a popular method to calculate the market value of physical entity property. In case all parameters are exactly chosen, overall assessment enables to appraise the market value of property (housing fund in particular) at 5-10% deviation [21]. Here, parameters are different according to property intended for housing fund and commercial purposes, as well as according to multistoried and private houses, vacation houses within the housing fund. For example, overall assessment for multistoried houses/ apartment buildings may include the following parameters:

- *Building model;*
- *Number of floors the apartment is located on;*
- *Floor where the apartment is located;*
- *Number of rooms;*
- *Floor area of rooms;*
- *Living space;*
- *Kitchen space;*
- *Type of the wall material;*
- *Year of construction of the building;*
- *Availability of balcony and their number;*
- *Proximity to transport means (metro, railway, railless line);*
- *Location of city (region, settlement, village).*
- *Terrain (mountainous, lowland, etc.)*
- *Telephone line, etc.*

For private houses with courtyard, the size of the courtyard, the type material used for roofs, thickness of side walls, the state of infrastructure and etc parameters are taken into consideration in addition to the above parameters ( number of rooms, living space, total area, proximity to transport means, etc).

One of the key issues in overall assessment is to collect regular and much information on purchase/sale bargains for the purpose of assessment based on comparative sales. To collect and data and process them as electronic data, a property appraisal/assessment commission can be created at the State Property Register Service. Commission will include representatives from the ministries of taxes, finance and justice, as well as municipality associations. The commission will also update database at the Register Service doing research on the real estate market at least once every three years. And the commission may collect paid monthly information through concluding agreements with notaries (notarial offices) and real estate dealers operating in different areas throughout the country with a view to increasing efficiency and reliability of data.

What is key for overall assessment is to correctly choose the appraisal parameters and take into consideration all possible ones that may affect the price. Based on these parameters, it will not be complicated to shape an electronic data and calculation base. For example, it may be proposed to create a classification code with a view to determining/fixing the market value of buildings and property. In turn, each region is divided into regional centers, villages and settlements, and each can be separately assessed in accordance with the parameters above. Concerning Baku, it would be more appropriate to divide the buildings according a number of classification groups (architectural buildings built in the 1920s, buildings of «Stalin», «Khrushov», «Leningrad» and «Kiev» style built during the Soviet period, newly-built buildings and under construction, private houses).

As to determination of land prices, the current classification of regions would be satisfactory. Since Baku and other cities under supervision of the Republic are classified according to the standard land price and force of attraction, while villages and settlements are classified according to different criteria.

The last value of property is currently accepted as its market value across the world. However, this system cannot be justified when notarial services are not transparent.

### **Advantages and disadvantages of the alternative option**

**Below are the major advantages of this alternative option:**

- The system is fair from an economic point of view. Each property is subject to tax levied on expensive premises at a higher rate, on cheap premises at a lower rate;
- The system is dynamic and changes in the property value at the market immediately affect the tax size. When the property value increases or decreases at the market, the paid tax amount also increase or decreases accordingly;
- The system is not linked with subjective approaches, but with processes set in the market. In this respect, it is a mechanism securing a more effective transparency.

*The following are the disadvantages of this alternative option:*

- It requires serious amendments to the law, which is time consuming;
- It calls for establishment of new institutions, which is a complicated process that will take up a long time;
- It is challenging to manage the system, thus requiring to regularly trace the markets, collecting and analyzing multiple information;

- It demands unnecessary costs. It is necessary to establish contacts with market subjects and buy information from them for data collection and processing. It is a must to pay service fees to appraisers on regular basis;
- It fails to meet the interests of socially low-income families. The increase in the market value of real property does not always coincide with the increase of their profit. Under such conditions, the indexation of tax amount according to the market value of the property is considered unnecessary/surplus expenses for the poor.
- In villages, as well as in areas, which have no force of attraction for relocation and migration, it is difficult to determine the market value of the property based on the comparative method of sales. Because sometimes no property is sold in such areas for several years.

### ***Alternative 3. Implementing the physical entity property tax based on the size of the property***

Under this alternative, taxation of and/or implementing the physical entity property in the form of buildings and permanent structures is not based on the market, but on the size of the taxable property. Presently, this kind of tax collection levied on physical entity property is applied in a number of countries. Consider Poland: The tax rate is 0.14 USD per square metre of housing fund, while 4.2 USD per square meter of commercial facilities [22].

Among the CIS-member states, Ukraine has announced that from 1 January 2012 it will implement the physical entity property tax base on the size of the property. In the initial stage, this mechanism will be tested in the capital city of Kyiv as a pilot project. Under the amendments to the Tax Code, apartment living area of less than 120 square meters and houses ranging from less than 250 to 500 square meters will not be taxable. However, apartment living area of 120 to 240 square meters and houses ranging from 250 to 500 square meters will pay 1.2 USD per 1 sq. km. m, while 3.2\$ per 1 sq. km. m in apartment living area of above 240 square meters and houses of above 500 square meters [24].

In Czech Republic, a post-Soviet country, the physical entity property tax is taxable based on the size of the property. Under the existing law, tax rates are 0.06 USD per 1 sq. km. m in apartment buildings, 0.2 USD per 1 sq. km. m in vacation houses and private houses, and 0.25 USD per 1 sq. km. m in commercial facilities. Depending on the type of residential areas (village, city, etc), decreasing or increasing ratios are applied on the base tax amount. For example, this ratio is 0.3 in areas inhabited by about 300 residents, while 3.5 is multiplied for areas with more than 500 000 residents. The increasing ratio for the capital city Prague is 4.5. As can be seen, the ratio increase as the number of the population rises. Besides, the increasing ratio is also applied in resort and tourism cities under the law [25].

In Finland, the market value has no share in determining the real estate tax rates. All property owners pay one euro per square metre of their permanent residence [23].

### **Definition of the alternative**

The third alternative option offered to apply on physical entity property (buildings and permanent structure) tax can be defined as following: **Implementing the physical entity property in the form of buildings and permanent structures based on the size of the taxable property.**

In case of introducing this alternative option, the tax amount per square meter shall be fixed in the Tax Code, depending on the use of property and its location.

### **Range of use of the alternative option**

This mechanism extends to the physical entity property below:

- *Living property (private houses, living premises and vacation houses;*
- *Garages;*
- *Commercial facilities.*

### **Implementation mechanisms of the alternative option**

To implement this alternative option, first of all, there is a need to establish legal mechanisms. Since two mechanisms can be considered to levy tax on the size of physical entity property.

**In the first case**, in Azerbaijan's Tax Code the mechanism similar to that of physical entity lands occupied by non-agricultural sites (housing funds, industrial, trade, etc) is also used for buildings and structures. Under article 206 paragraph 3 of the Tax Code, for industrial, construction, transport, telecommunications, trade and utility services lands and other dedicated lands occupied by agricultural sites of housing funds and lands of citizens the tax shall be charged for each 100 sq. meters of the lands of housing funds, agricultural lands and lands occupied by citizens in accordance with these rates (in manats): in Baku - 0.6; in Ganja, Sumgayit and Absheron district - 0.5; in other towns (with exception of regional subordination towns), regional centers - 0.3; and in towns, settlements and villages of regional subordination (with exception of settlements and villages - 0.1. In international practice, per square meter of buildings and structures on average costs 3-4 times as much as the per square meter cost/value of the land they are located on. Based on this ratio, the property tax levied on buildings and structures can be fixed in the amount of 3-fold size of land tax per square meter according to a similar classification.

**In the second case**, by improving the classification of existing administrative-territorial zones and property facilities for the purposes of taxation, tax amount for each square

meter of the taxable facility may be determined in the Tax Code. To this end, it is proposed to apply the following mechanism:

- (v) To determine the property tax base in the amount of 0.5-2.0% of minimum salaries for each square meter depending on the use of the real property. For rural residential areas, this base amount will be 0.3%, while for settlements - 0.5%. The tax base in the amount of 1.0% can be used for regional centers, 1.2% for Mingechevir and Shirvan, 1.5% for Ganja. The increasing ratio can be applied in 12 zones of Baku City can ranging from 2.0 to 3.0.
- (vi) For favorable administrative units for tourism, recreation and resort zones, an increasing ratio can be applied. To that end, the Cabinet [of Ministers] can endorse the list of tourism and resort zone for the purposes of taxation.

In case of applying this alternative option, it is proposed to assign the Ministry of taxes for tax collection (*see: the first option*).

### **Advantages and disadvantages of the alternative option**

#### **Below are the major advantages of this alternative option:**

- No serious amendments to the law are required;
- There is no need to establish new institutions;
- The system is simple, the tax administration is easily organized;
- The information about the property (living premises) area is specified in the documents approving the property ownership;
- For low-income families, it is more favorable in social respect. This section of the population can pay for property tax tailored to their opportunity through building low-size premises.

#### ***The following are the disadvantages of this alternative option:***

- The real market value of real property is not taken into consideration;
- The system is not flexible, the price fluctuations in the real estate market do not affect the tax size;
- The impossibility to apply a differential tax amount within the same region results in unjust tax payments. For example, the villagers that are located in the high mountainous areas and well-fit for tourism in Shamakhy and Guba regions will have to pay the same amount paid by villagers located in Central Azerbaijan;
- Changes in the size of premises cannot be registered in an operative way.

## EVALUATION OF POLICY OPTIONS

In order to evaluate alternative policy options and choose the best one, the expert group has developed a special set of criteria and built their evaluation on these criteria.

**Methodology of Evaluation.** The methodology is experts' evaluation based upon the criteria. During the evaluation of alternatives, only those criteria were chosen that can actually raise the financial capacity of municipalities. The goal of choosing these criteria is to measure the increasing level of municipalities' fiscal capacity through enhancing their access to credit resources. The expert group evaluated all four alternatives based on point system by each of the criteria and finally points were added and the best alternative chosen.

The evaluation took account of the following criteria:

- Growth in the local budget revenues;*
- Growth in the local tax incomes;*
- Promoting local tax imposition;*
- Level of improving local tax base;*
- Lesser dependence of local budgets on state budget;*
- level of cooperation between municipalities and relevant state agencies;*
- Lesser dependence of municipalities on relevant state agencies;*
- Enhanced capacity to provide local public services;*
- Lowering of administrative costs;*
- Property tax level;*
- Tax evasion level;*
- Meeting costs associated with tax collection;*
- Level of improving tax services provided by municipalities;*

### Definition of the criteria:

**Growth in the local budget revenues** – indicates the growth level of local budget revenues through tax incomes.

**Growth in the local tax incomes** – indicates the growth level of local (municipal) tax incomes in local budget revenues.

**Promoting local tax imposition** – implies the level to what extent the tax-collecting body is interested in tax imposition/collection.

**Level of improving local tax base** – implies the level how to prevent factors impeding taxation of property in the tax law.

**Lesser dependence of local budgets on state budget** – indicates that how municipalities show insignificant interest in receiving financial resources from the state budget because of increase in the local budget revenues.

**Level of cooperation between municipalities and relevant state agencies** – indicates the level of cooperation between municipal enterprises and state agencies when collecting local taxes.

**Lesser dependence of municipalities on relevant state agencies** - shows municipalities’ decreasing dependence on the relevant state agencies during both processes - the property taxation and tax collection.

**Enhanced capacity to provide local social services** – shows how municipalities are promoted to provide social services through increasing their financial opportunities.

**Lowering of administrative costs** – shows lowering of the level of costs for maintaining a tax- collecting body within the municipal enterprise.

**Property tax level** – shows the tax level of living premises, buildings and other structures in the municipal area.

**Tax evasion level** – shows the decreased level of tax evasion by property owners through using various methods (decrease in the tax base, inclusion into the group enjoying tax privileges, no-tax payment, etc.).

**Meeting costs associated with tax collection** – shows the level how costs associated with tax collection are cleared.

**Level of improving tax services provided by municipalities** – shows the efficiency and flexibility level of tax services provided by municipalities.

### Explanation of evaluation points

Three levels are identified for the evaluation of alternatives – low, middle and high and each level is given a conditional point with low given 1, middle 2 and high 3. The evaluation is based on comparative analysis and assumptions. Due to the unavailability of necessary statistical data, it is more likely to be difficult to define the boundaries of changes that may occur in the implementation of alternatives. Therefore, the points given are based on the comparative view of alternatives and experts’ assumptions. (Table 3-5)

The policy implementation process and outcome evaluation of alternatives through the criteria is illustrated in Tables 3-5:

### Evaluation of alternatives through criteria

**Table 3.**

**Alternative 1:** *Organizing overall inventory of physical entity property and maintaining the existing state through improving the legislative framework*

Criteria	Level			P
	Low	Middle	High	
	1	2	3	
1. Growth in the local budget revenues		2		2

2. Growth in the local tax incomes		2		2
3. Promoting local tax imposition			3	3
4. Level of improving local tax base		2		2
5. Lesser dependence of local budgets on state budget		2		2
6. Level of cooperation between municipalities and relevant state agencies			3	3
7. Lesser dependence of municipalities on relevant state agencies	1			1
8. Enhanced capacity to provide local social services		2		2
9. Lowering of administrative costs			3	3
10. Property tax level		2		2
11. Tax evasion level		2		2
12. Meeting costs associated with tax collection		2		2
13. Level of improving tax services provided by municipalities	1			1
<b>Total points</b>				<b>27</b>

**Table 4.**

**Alternative 2: Implementing/Assessing the physical entity property tax based on the property's market value**

Criteria	Level			P
	Low	Mid dle	High	
	1	2	3	
1. Growth in the local budget revenues			3	3
2. Growth in the local tax incomes			3	3
3. Promoting local tax imposition		2		2
4. Level of improving local tax base			3	3
5. Lesser dependence of local budgets on state budget			3	3
6. Level of cooperation between municipalities and relevant state agencies		2		2
7. Lesser dependence of municipalities on relevant state agencies	1			1
8. Enhanced capacity to provide local social services			3	3
9. Lowering of administrative costs			3	3
10. Property tax level			3	3
11. Tax evasion level			3	3
12. Meeting costs associated with tax collection			3	3
13. Level of improving tax services provided by municipalities	1			1
<b>Total points</b>				<b>33</b>

**Table 5.****Alternative 3: Implementing the physical entity property tax based on the size of the property**

Criteria	Level			P
	Low	Mid dle	High	
	1	2	3	
1. Growth in the local budget revenues			3	3
2. Growth in the local tax incomes			3	3
3. Promoting local tax imposition		2		2
4. Level of improving local tax base			3	3
5. Lesser dependence of local budgets on state budget		2		2
6. Level of cooperation between municipalities and relevant state agencies			3	3
7. Lesser dependence of municipalities on relevant state agencies	1			1
8. Enhanced capacity to provide local social services			3	3
9. Lowering of administrative costs			3	3
10. Property tax level			3	3
11. Tax evasion level			3	3
12. Meeting costs associated with tax collection		3		2
13. Level of improving tax services provided by municipalities	1			1
<b>Total points</b>				<b>32</b>

Alternatives were evaluated through each of the criteria and given points for their results. The best option, as it comes out of the evaluation of experts (**Tables 3-5**), is the second alternative “Physical entity property’s assessment based on its market value”, which gained the highest points, 33, as compared to the other two options because it is worthwhile from the perspective of increasing financial capacity of municipalities and collecting property tax on market value basis in terms of social justice. The second preference of experts is Alternative 3, i.e. tax collection based on the physical entity property size, which gained the lower points, 32.

Now is the time for evaluating the impact of alternatives on the basis of multipurpose analysis. The analysis evaluates goals of the implementation of these alternatives and factors that influence them.

*Table 6.*

**Projected impacts of alternatives towards strengthening municipalities in Azerbaijan**

Goals	Impacts	Alternatives		
		Alternative 1	Alternative 2	Alternative 3
1. Raising financial capacity	1.1. Increase in budget revenues	Less increases	More increases	More increases
	1.2. Increase in local tax incomes	Less increases	More increases	More increases
	1.3. Increase in state financial assistance	No happens	No happens	No happens
	1.4. Increase in incomes from municipal land sales	Slightly increases	No happens	No happens
2. Raising tax-raising capacity of municipalities	2.1. Growth of property tax level	Middle	High	High
	2.2. Mitigation of tax evasion	Partly happens	Significantly happens	Significantly happens
	2.3. Increase in tax burden of the population	Less increases	More increases	More increases
	2.4. Improving tax law	Happens	Happens	Happens
3. Raising transparency and accountability of municipalities	3.1. Holding accountability vis-a-vis the government	Increases	Increases	Increases
	3.2. Holding accountability vis-a-vis the population	Increases	Increases	Increases
	3.3. Improving fiscal accounting	Significantly happens	Significantly happens	Significantly happens
4. Raising fiscal independence of municipalities	4.1. Municipalities' dependence on state budget	Decreases	More decreases	More decreases
	4.2. Promoting local tax collection	Happens	Happens	Happens
	4.3. Greater interest in the local delivery of public services	Increases	Increases	Increases
	4.4. Social and economic development of the municipal area	Increases	Significantly increases	Significantly increases
5. Enhancing management efficiency	5.1. Lowering of administrative costs	Partly decreases	Happens	Happens
	5.2. Increase in municipal incomes	No happens	Happens	Happens
	5.3. Enhancing the opportunity to employ additional personnel	Happens	Happens	Happens
	5.4. Increasing the satisfaction level of costs associated with tax collection	Less increases	Partly increases	Partly increases

The multipurpose analysis of the alternatives forwarded to increase tax incomes of municipalities showed that the second alternative is favorable in order to attain the set task. The tax rate assessment based on market value or property size can significantly strengthen the fiscal capacity of local government institutions. Moreover, the experts revealed a preference in favor of the second option - *Implementing the physical entity property tax based on the property's market value.*

## CONCLUSIONS AND RECOMMENDATIONS

Municipal taxes are the most non-performing and imperfect taxes in Azerbaijan's tax system. Model citizens even that pay state taxes in a timely manner, somewhat hesitate, or are uneager, to pay (local) municipal taxes for some reason. In most cases, municipal enterprises to calculate and collect local taxes display indifference, make no efforts to undertake their liabilities. Then, the tax-raising capacity of the municipal enterprises fails, as they are unable to secure fiscal revenue collection, making it even more challenging to carry out their responsibilities. Consequently, it negatively affects the expectations of citizens about municipalities, thus shaping it as an unnecessary enterprise.

The case study summarized the following consequences:

1. In municipal areas, particularly in rural areas, most residents have no inventory value of real property, thus disabling to collect property tax.
2. The physical entity property tax collection levels are real low. Some municipalities even have not collected physical entity property tax so far.
3. The applicable mechanism shaping the taxable base for the physical entity property tax fails to meet modern standards.
4. The improvement of legislative framework does not guarantee a municipality to fully levy property tax in the future.

The property tax applied in about 130 countries across the world. The application of property tax, which is accepted in international practice, is based on determination of the scope of taxpayers, the tax base and rates, as well as flexible collection of tax receipts under conditions of inflation. In most countries, property taxpayers are physical and legal entities which own the real property, while in some countries, taxpayers are tenants of property.

In developing countries, property tax collection is based on the principles below:

- The property tax a purely local tax and this tax receipts are transferred to local budgets;
- In most countries, real property owners pay for property tax, moreover tenants are also practiced to be taxpayers for real property;
- Tax is usually levied on buildings and permanent structures are usually (in the countires where the unified property tax is applied).
- When determining the property tax base, the cost/value which is approximate to the market value of taxable property is used. This value is calculated on comparative sales or capitalization of profits, or cost approach method.
- The value of real property is not determined through individual appraisal of each facility, but is based on overall assessment applying standard calculation procedures for the tax collection;

- In most countries where a property's assessment is based on its market value, the average annual tax rate does not exceed 1% real property value;
- Tax relieves are determined either according to categories of taxpayers (say, socially vulnerable taxpayers) or based on the family status, income level of taxpayers and the characteristics of their property.

In international practice, several mechanisms apply on the tax base for property tax, such as the cadastral value, inventoried/inventory value, size of property, etc. The inventoried value of property, which is currently effective in Azerbaijan, is mostly applied in the Former Soviet Union (FSU) countries. Some of these countries are already set to discontinue this form of valuation. In Baltic states, Georgia and Moldova, calculation is based on market or cadastral value, while in Ukraine, the taxation is based on property size. Russia has announced that from 2013 it will start calculating property tax based on market value.

Most countries, as a rule, apply the tax base calculated with the help of mechanism based on the market value of real estate. And in terms of social justice and economic efficiency, this base is the most successful mechanism.

The authors of this policy paper, as well as a number of municipal experts and representatives offer the shift to the method of calculating property tax based on market value. During the process of alternatives assessment the experts gave the preference over *the collection of physical entity property tax based on market value* among the three possible alternatives submitted to improve the taxable base for physical entity property tax.

The authors of this policy paper see it expedient to take the following steps towards realization of this alternative:

1. **Physical entity property tax base to be amended.** The practice of performing inventory value of taxable property (premises and structures) owned by physical entities shall be quitted and this property shall be appraised and go through tax collection based on the market value in conformity with the legal mechanisms guided by the property law. In accordance with the alternative proposed, article 198 paragraph 1 of Azerbaijan's Tax Code is amended and the term "inventoried value" is replaced by the term "market value".
2. **Taxable property to be classified.** Taxable property in the form of buildings and structures owned by physical persons is thoroughly classified. This classification will be grouped as following:
  - *Living property, which includes private houses with and without land plots, Living premises in multistoried buildings and vacation houses;*
  - *Garages;*
  - *Social and public service facilities;*

- *Retail facilities;*
- *Commercial facilities;*
- *Facilities other than the above-mentioned classification groups.*

3. **Existing tax rate ranges to be adjusted.** In accordance with the property classification to be envisaged by the Tax Code, the tax rates below will be set for physical entity property based on the current market value:

- *For living buildings and structures – up to 0.1% of the market value for the property;*
- *For garages – up to 0.5% of the market value for the property;*
- *For social and public service facilities – up to 1.0% of the market value for the property;*
- *For retail facilities – up to 1.5% of the market value for the property;*
- *For commercial facilities as well as facilities other than the classification groups above – up to 2% of the market value for the property and tax is allocated to local budgets.*

4. **Property tax base rate to be reduced.** The tax/taxable base rate may be reduced in order to prevent further increase in property tax burden and tax evasion, to collect tax from the greater part of the population, and to develop taxpaying culture. With this aim in view, 50%-60% of market value of real estate may constitute the property tax base by the law.

5. **Unified e-tax register to be established.** In order to collect property tax, a unified electronic tax (e-tax) register shall be established. Each property will have a cadastral number and a data catalog to be created in accordance with the cadastral number will include detailed information about the property type, property ownership, right to use it, the state of use, property size, its location, its market value determined from the last appraisal based on comparative sale method, etc.

Article 200 paragraph 1 of the effective Tax Code of the Azerbaijan Republic is replaced by the following: *“The property (real estate) tax shall be calculated on the buildings and structures owned by physical persons according to the cadastral number of each property based on the market cost/value available at the State Register Service”.*

6. **Legal bases for an overall appraisal mechanism to be created and the appraisal/assessment process to be launched.** The legal bases of overall appraisal shall be created through amending the Law on Assessment and the Tax Code. A property appraisal/assessment commission shall be created at the State Property Register Service. Commission will include representatives from the ministries of taxes, finance and justice, as well as municipality associations. Commission is to provide scrutiny over the overall assessment of entire property. Authorized appraisers firms to be appointed by Commission will implement the process. The

commission will also update database at the Register Service doing research on the real estate market at least once every three years. Finally, Commission will collect paid monthly information through concluding agreements with notaries (notarial offices) and real estate dealers operating in different areas throughout the country with a view to increasing efficiency and reliability of data.

7. **Property tax to be included in local taxes.** Legal entity property tax shall be excluded from state taxes and included in local taxes. In this case, the related articles of the Tax Code will be amended. The mechanism for the legal entity property tax base based on the market value will be imposed replacing the calculation based on average annual book value. The tax collected will be transferred to the local budget within the municipality of the area at which they [physical persons] are located.

The authors regard that the revenue of the local budgets may advance by nearly 20-30 times once a new mechanism is adopted. And such a mechanism will also pave the way for shaping tax-paying culture among the citizens.

The recommendations submitted to the government contain a set of mechanisms and tools to improve taxation. Nevertheless, the authors of the policy paper maintain that even the submission of the recommendations and introduction of the market value mechanism will not fully solve the problem over the collection of physical entity property tax. To this end, it's significant to improve current taxation mechanisms or develop a new one. According to them, one of such mechanisms is that the Ministry of Taxes be tasked for tax treatment in order to increase the collection of local taxes, including physical entity property tax.

**The level of physical entity  
property tax as of 2010 (by regions)**

Districts	Budget revenue, in thousand manat	Income from physical entity property tax, in thousand manat	Physical entity property tax collection level, %-lə	Share of the physical entity property tax in budget revenue, (%)
<b>In country, total</b>	<b>28873,0</b>	<b>2675,9</b>	<b>68,0</b>	<b>9,3</b>
Nakhchivan AR	442,4	44,7	54,2	10,1
Baku	5369,6	2023,6	88,7	37,7
<b>Absheron economic district</b>	<b>4375,6</b>	<b>104,0</b>	<b>40,2</b>	<b>2,4</b>
Sumgayit	737,0	21,2	57,6	2,9
Absheron district	3478,0	80,6	37,5	2,3
Khizi district	160,5	2,2	31,4	1,4
<b>Gandja-Kazax economic district</b>	<b>2963,6</b>	<b>94,1</b>	<b>24,1</b>	<b>3,2</b>
Gandja	194,2	36,4	56,1	18,7
Agstafa district	236,5	4,0	36,4	1,7
Dashkesen district	52,6	-	-	-
Gedebey district	210,8	2,8	3,3	1,3
Goranboy district	337,5	2,5	28,1	0,7
Goygol district	237,2	3,6	6,0	1,3
Kazax district	180,7	6,0	42,9	3,3
Naftalan city	17,9	-	-	-
Samux district	143,2	1,8	25,0	1,3
Shemkir district	1056,4	12,1	18,2	1,1
Tovuz district	260,7	24,9	35,4	9,6
<b>Sheki-Zakatala economic district</b>	<b>2961,3</b>	<b>62,6</b>	<b>35,9</b>	<b>2,1</b>
Balaken district	355,2	15,6	37,2	4,4
Gax district	527,4	12,1	31,2	2,3
Gabala district	227,6	0,5	5,1	0,2
Oguz district	306,5	1,8	31,6	0,6
Sheki district	829,3	13,9	34,8	1,7
Zakatala district	715,3	18,6	48,4	2,6
<b>Lenkaran economic district</b>	<b>1549,7</b>	<b>40,3</b>	<b>28,4</b>	<b>2,6</b>
Astara district	183,8	0,6	1,6	0,3
Jalilabad district	330,0	13,8	29,3	4,2
Lerik district	52,0	2,6	61,9	5,0
Lenkaran district	514,7	21,7	99,1	4,2
Masalli district	412,3	1,1	5,0	0,3
Yardimli district	57,0	0,5	6,0	0,9

<b>Guba-Khachmaz economic district</b>	<b>3704,1</b>	<b>152,3</b>	<b>81,3</b>	<b>4,1</b>
Shabran district	1353,0	1,8	78,3	0,1
Khachmaz district	626,2	68,8	93,6	11,0
Guba district	995,8	76,8	94,2	7,7
Gusar district	448,6	4,8	19,0	1,1
Siyazan district	280,5	0,2	4,0	0,1
<b>Aran economic district</b>	<b>6115,3</b>	<b>134,6</b>	<b>37,9</b>	<b>2,2</b>
Shirvan city	597,3	5,8	29,0	1,0
Mingechevir city	346,2	-	-	-
Agdash district	332,0	16,4	45,6	4,9
Agjabedi district	506,2	10,5	68,6	2,1
Beylegan district	404,1	1,7	121,4	0,4
Barda district	442,2	28,5	36,7	6,4
Bilasuvar district	425,2	0,6	5,0	0,1
Goychay district	350,4	7,6	43,7	2,2
Hajigabul district	113,8	1,6	15,4	1,4
İmişli district	206,8	-	-	-
Kurdemir district	260,1	6,0	53,1	2,3
Neftchala district	217,5	0,9	8,9	0,4
Saatli district	253,4	0,5	3,0	0,2
Sabirabad district	478,9	3,1	14,3	0,6
Salyan district	496,9	26,2	57,7	5,3
Ujar district	227,2	9,2	41,8	4,0
Yevlakh district	271,8	13,8	135,3	5,1
Zerdab district	185,3	2,1	10,3	1,1
<b>Yukhari Karabakh economic district</b>	<b>398,7</b>	<b>3,3</b>	<b>26,8</b>	<b>0,8</b>
Agdam district	95,6	-	-	-
Fuzuli district	58,3	-	-	-
Tartar district	244,8	3,3	27,7	1,3
<b>Daglıq-Shirvan economic district</b>	<b>992,8</b>	<b>16,4</b>	<b>32,7</b>	<b>1,7</b>
Agsu district	161,7	2,7	37,0	1,7
İsmayilli district	341,3	10,5	35,7	3,1
Gobustan district	193,9	0,1	2,2	0,1
Shamakhi district	295,9	2,9	32,6	1,0

Source: State Statistic Committee

## **EXTRACT**

### **from the Tax Code of the Republic of Azerbaijan**

#### **Article: 200. Procedure for the calculation and payment of the property tax of physical persons**

200.1. The property tax shall be calculated on a building according to the inventory value placed by local government authorities to that building.

*For premises owned by natural persons, the property tax shall be calculated by the municipality of the area at which they are located.*

200.2. Property tax on a building that has several owners shall be calculated, in accordance with the share of each owner in that building, on the basis of procedure established in Article 200.1. of this Code.

200.3. Tax authorities shall calculate tax on water and air transport facilities, as of January 1 of each year, on the basis of the relevant information submitted by authorities registering such facilities. In the absence of such registration the owner of this property each year before January 1 shall provide to relevant authorities documents that include all necessary data (year of manufacturing, price at the moment of purchasing and technical characteristics) on all water and air transport owned.

Tax on a water or air transport facility that has several owners shall be collected from the person who has registered such facility under his own name.

200.4. Municipalities shall submit tax payment notifications to taxpayers not later than August 1.

200.5. The annual tax amounts shall be paid, in equal portions, before September 15 and before November 15. If property tax was not paid by the previous owner of property it shall be paid by new owner within timeframes stipulated by this Article.

200.6. The tax on the property of natural persons shall be paid into local (municipal) budget.

## REFERENCES

1. European Charter of Local Self-Government.
2. The Tax Code of the Republic of Azerbaijan (Approved by the Law No.905-IG of the Azerbaijan Republic from 11 July, 2000).
3. The Law of Azerbaijan Republic on Budget System, July 2, 2002. # 358-IIQ.
4. The Law of Azerbaijan Republic on Status of Municipalities.
5. Law No. 772-IQ of the Azerbaijan Republic on Basis of Municipal Finance – 7 December 1999 (Municipal Finance Law).
6. Law of the Azerbaijan Republic No.244-IIQ On 21 December 2001 Local (Municipal) Taxes and Payments.
7. Regulations on State Property Register Service at the State Committee for Property Affairs of the Azerbaijan Republic, 24.06.2004.
8. Cabinet of Ministers' decision 110 of June 28 1999 on “the approval of calculation guidelines for inventoried value of real estate owned by physical persons.
9. The Congress of Local and Regional Authorities of Europe Recommendation 126 (2003) local and regional democracy in Azerbaijan.
10. Tax codes of different countries.
11. CLRAE Recommendation Rec (2000)14 of the Committee of Ministers to member states on local taxation, financial equalization and grants to local authorities.
12. CLRAE Recommendation 79 (2000) on the Financial resources of local authorities in relation to their responsibilities: a litmus test for subsidiarity.
13. Law No. x-233 of Lithuania’s Property Tax, 7 June 2005.
14. Opinion relating to the current state of municipalities in Azerbaijan. NGO Alliance for Municipalities’ Development. Baku, 2011.
15. Survey conducted over the collection of property tax in Central Aran (Azerbaijan’s central region). Support for Economic Initiatives Public Union, Baku, 2011.
16. Annual bulletins on performance of local (municipal) budgets, Azerbaijan’s State Statistics Committee.
17. Money transfers to Azerbaijan from Russia reduced. “Economic Forum” journal, 1 March, 2010
18. Physical entity property taxation, tax newsletter, 2004, N9.
19. S.L. Bondarchuk. On communication between the Register and Federal Tax Service of the Russian Federation at property tax assessment and collection. Moscow, 2010, All-Russian conference.
20. Methodology of assessment modeling and tax calculation function. Center for real estate market analysis. [www.crea.ru](http://www.crea.ru).
21. Tax reforms in Russia: problems and their solutions (Volume II). Institute of Transit Economy. Moscow, 2003.

22. "Principles of fiscal decentralization". Guide book for transit economy countries. Pavel Svyanevich.
23. Berezin M. Taxation on real estate - M.: Finances and Statistics, 2003.
24. "Kievan will pay property tax". Internet portal BUSINESS NEWS. July 1, 2011. [www.businessnews.com.ua](http://www.businessnews.com.ua).
25. Property Tax. All about real estate in the Czech Republic. Internet portal <http://ceska-nedvizimost.com>