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WHAT ARE THE EXPEDIENT LIMITS OF BUSINESS INSPECTIONS?

Abil BAYRAMOV

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Author of Policy Paper:

Abil BAYRAMOV

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SUMMARY

This study focuses on the analysis of the legislation reflecting a new system of business inspections. It was not possible to evaluate the practice of applying the new legislation, and the analysis, based on positive international experience, primarily covers the legal provisions that reflect a new approach to inspections. A comparative analysis of international and national experience in the area of business inspections made it possible to arrive at some interesting conclusions.

Experience shows a system of government control is directly dependent on the state regulatory policies. The control should be organized in a way that allows inspections not only identifying wrongdoings and taking according measures, but also serves to encourage the behavior of complying with the law. Adopted in recent years with a view to streamline business inspections, the legislative acts are expected to establish essentially a new and more advanced system of government control over the activity of businesses in Azerbaijan.

Analysis of the legislation reflecting the new approach to inspections shows that its provisions are based on the positive experience of foreign countries. Due to incomplete application of the new system for inspections, and suspension of business inspections by law, it is difficult to predict to what extent the new system comes up to expectations.

The study highlights positives of the existing inspection system, identifies areas for further improvement and offers proposals for their improvement. Many of the proposals entail the alternative options:

- Improve the structure of inspection agencies:
 - *Alternative 1. Set up a centralized agency responsible for organizing and conducting business inspections in all areas;*

- *Alternative 2. Consolidate controlling agencies responsible for various inspection areas;*
- Improve the governance of controlling authorities:
 - *Alternative 1. Subordinate controlling bodies to a special inspection council instead of the relevant state authorities that exercise supervision over their inspection areas;*
 - *Alternative 2. Controlling bodies must be accountable to a special inspection council rather than the relevant ministries that exercise supervision over their inspection areas;*
- Improve frequency of conducting inspections on the basis of risk assessment:
 - *Alternative 1. Define the frequency of planned inspections as follows:*
 - in relation to high-risk businesses - not more than once a year;
 - in relation to medium-risk businesses - not more than once every three years;
 - in relation to low-risk businesses - not more than once every five years;
 - *Alternative 2. Scrap requirements for assigning inspections, while retaining frequency as prescribed by the law;*
- Specify competency standards for inspectors;
- Ensure effective handling of complaints;
- Speed up the process of developing a list of inspection agencies and their inspection areas;
- Develop incentive mechanisms for inspectors based on the results of evaluating the effectiveness of inspections.

INTRODUCTION

The critical situation that unfolded as a result of sharp drop in oil prices in global markets has shown that urgent measures should be taken to reduce economic dependence on the oil sector, develop non-oil sector and improve the business environment in Azerbaijan. To this end, the government has taken a number of important steps in these directions in recent years.

Streamlining business inspections was one of the important steps taken to develop entrepreneurship and improve business environment. Back in 2010, the President of the Republic of Azerbaijan signed a decree “on measures aimed to regulate business inspections and ensure protection of consumer rights.” The decree commissioned the Cabinet of Ministers to develop and submit to the President within a two-month period a single order of checks organized to protect consumer rights as well as form and order of single information register, run by the Ministry of Justice, allowing to receive information about frequency of business checks. Meantime, the decree introduced a norm that binds to conduct a business check only after its registration in the register.

Dated 15 February 2011, the President of the Republic of Azerbaijan signed a decree on the approval of “Statute on single information registry form and rules of implementation of business inspections.” The statute defines single information registry form as well as rules of implementation of business inspection and data protection.

On 28 September 2012, the Board of the Ministry of Justice adopted a resolution on approval of “administrative procedures for obtaining information about business inspections from single information registry.” According to these procedures, single information registry provides inspected subjects with information on audit results.

The Law “on regulation of business inspections and protection of entrepreneurs’ interests” was adopted on July 2, 2013. The law es-

establishes purposes, principles and rules of organizing and conducting business inspections, rights and obligations of inspectors and inspection agencies during audits, as well as requirements for protecting rights and interests of businesses. According to Article 63 of the Law, a list of inspection agencies and scope of their authority are defined by a relevant executive authority (the Cabinet of Ministers). The Cabinet of Minister was commissioned to take necessary measures for enforcing the law within a two-month period. Though the law was adopted more than three years ago, list of inspection agencies and scope of their authority have not been defined yet.

On 12 May 2014, the Cabinet of Ministers passed resolutions on approval of “form of a list of questions and rules of implementation of business inspection” as well as “rules and terms for reimbursing of expenses by businesses to controlling authority incurred in product sampling.” The purpose of implementing the list of question is to simplify inspection process and ensure systematic order, efficiency and transparency while gathering information about businesses as well as analysing and evaluating inspection results. Several ministries had already devised list of questions for inspections, which are available on their webpages (for example, list of questions for inspections conducted by the State Control Service for Technical Regulation and Standardization under the State Committee for Standardization, Metrology and Patent of the Republic of Azerbaijan, list of questions for inspections conducted by structural units and subordinated bodies of Transport Ministry, etc.).

On 20 October 2015, the Law “on suspension of business inspections” was adopted. This law stipulates suspension of business inspections for the period of two years starting from November 1, 2015.

As indicated above, a number of important legislative acts pertaining to business inspections were adopted in recent years. The legislative

changes are expected to considerably affect groundless, unexpected and disorderly conducted inspections that stifle the entrepreneurial development. As suspended inspections will remain in force till 1 November 2017, it is impossible to assess implications of the Law “on regulation of business inspections and protection of entrepreneurs’ interests” on the development of entrepreneurship. In this regard, the study will focus on the provisions of the law with regard to inspections in the context of national experience and international best practices.

1. EXPERIENCE OF FOREIGN COUNTRIES IN THE AREA OF BUSINESS INSPECTIONS

The institutional structure of various countries significantly differs due to legal, cultural, economic and other specific reasons. This difference can be seen in the structure of any organization and inspection system responsible for monitoring of businesses. Control over economic activity existed even before modern inspection agencies were established. They were mainly set up as a result of quality and safety concerns or served to protect business activity from competition. This kind of inspection activities was derived from self-regulation or control exercised by local authorities. A new mechanism for checks was later put in practice, which envisioned participation of inspectors appointed by central government. For example, safety in production industry was incorporated into the state control system in the 19th century. During the past years, a whole range of agencies exercising supervision and control over economic activity, in particular activity of business subjects, started to operate in various countries. However, there has always been much debate about optimality of these agencies and employed system of control, and different countries initiated reforms to apply a risk-based approach to streamline inspections and enhance effectiveness of controlling authorities. Having looked at the reform initiatives undertaken by

several member states of the Council of Europe, it is possible to see useful points on the example of each.¹

1.1. Italy

In 2011, Italy started to review and reform inspection system that was based on the findings of diagnostic analysis. The reform aimed to ensure full compliance of inspection system with risk-based target, improve coordination between inspection authorities and streamline bureaucracy. At first, Article 14 of the Law stipulates streamlining and coordinating system of inspections over business subjects with a view to simplify inspection activities and ensure their compliance with risk-based targeting.² To this end, the Law authorized the government to enact regulations for planning and coordination of inspections so as to reduce the burden on businesses as well as prevent duplication partially and completely.

The Chair of the Council of Ministers adopted guiding principles that will help to improve inspection procedures and practices for national, regional and local authorities in line with Article 14 given the following specific recommendations.³

Transparency in regulation. State authorities should inform business subjects about their obligations and the requirements set by the regulations, ensure greater awareness among persons subject to

¹Technical Paper on Regulatory and Supervisory Authorities in Council of Europe Member States Responsible for Inspections and Control of Activities in the Economic Sphere – structures, practices and examples, developed by Florentin Blanc and Giuseppa Ottimofiore, was used in this section.

²http://www.oecd-ilibrary.org/governance/better-regulation-in-europe-italy-2012_9789264204454-en

³Technical Paper on regulatory and supervisory authorities responsible for inspections and control of activities in economic sphere - structures, practices and examples' was used.

³Act of the Conference, dated 24 January 2013. www.arca.regione.lombardia.it

inspections and respond to queries in a timely manner. In particular, guiding principles call for development and use of inspection checklists. Checklists help to make requirements more transparent and clearer as well as harmonize practices of various structures.

Proportionality to risk. Control measures should be planned on the basis of the risks posed by each activity. Initial risk assessment has to be based on data and findings, that is, in addition to probability of risks, immediate/actual risks should also be taken into account when implementing regulatory requirements.

Cooperation strategy for relations with business subjects. Inspectors must establish constructive relationship with inspected subject. Thus, they need to consider that inspection activities are aimed to ensure effective protection of legal interests. In this sense, the guidelines recommend development of checklists of planned inspections, providing notice of planned inspection as early as possible, establishment of database and elaboration of mechanisms of promoting compliance with regulatory requirements.

Training and re-training of personnel. Inspectors need to be trained in order to fully comprehend the new approach. The courses emphasize cooperation with businesses, acting in a transparent manner, collaborative action with other government agencies, and promoting compliance with regulatory requirements.

Disclosure of information and transparency of inspection results. The guidelines entail establishing incentive mechanisms through disclosure of inspection results and creation of unified data bank.

In Italy, inspection activities are coordinated at the regional level. In this perspective, the Unified Inspections Registry (RUC - Registro Unico dei Controlli) is considered as the promising initiative. Currently, the registry includes a number of regional agriculture and food industry enterprises. In order to avoid duplication of checks and enhance effectiveness of inspection authorities, it is envisioned

to create such unified information systems in all inspection authorities at the national level.⁴

1.2. Lithuania

The reform process of 2009 that started following the global financial crisis and the election victory of a new coalition, introduced a new approach to business inspections and applied new mechanisms and tools to streamline its implementation. Accession to the European Union enabled assessing outcomes of the new inspection system in terms of social welfare. The assessments showed the reform had positive results especially with regard to food safety.

Considered as primary legal basis for initial inspections internationally, the Law on public administration had incorporated a comprehensive section on supervision, which is innovative in terms of setting forth guidelines and advice for businesses.⁵ The law defines supervision not only as consisting of checks, but also as a measure that entails advice and consultation for businesses, data analysis, and ensures compliance with regulatory requirements. The law also proposes a number of principles, such as burden reduction, proportionality of inspections and other control measures, risk assessment as a basis for conducting inspections, obligation to provide assistance to businesses, functional separation between inspections, and penalties in order to reduce the cases of abuse of power. The new legal framework, in addition, provides for a number of significant changes as regards sanctions: first, it cannot be decided to suspend

⁴http://www.oecd-ilibrary.org/governance/better-regulation-in-europe-italy-2012_9789264204454-en

⁵OECD (2015)? Regulatory Policy in Lithuania^ Focusing on the Delivery Side? OCDE Reviews of Regulatory Reform, OECD Publishing.

activity of business subject in the first year of operation; second, number of imposed sanctions can not be used as an indicator of performance for inspection; third, fines cannot be imposed in case of minor violation of legal norms.

According to the law on public administration, providing guidance to businesses is priority of inspection system. It is compulsory to comply with advice officially provided to businesses. Businesses can not be subject to sanctions, even if advice they comply with turn out to be incorrect. Under the provisions on 'Authentic advice,' call centers were created in the inspectorates, whose aim is to provide advice of consistent quality.

Over the first years following the beginning of the reforms in 2013, Lithuania demonstrated its ability to achieve significant results in several directions. These include development and application of checklists for all major inspection authorities, introduction of risk-based planning programs for the most important inspections, creation of call centers in a number of major inspectorates, development of on-line services in the tax inspectorate as well as adoption of criteria for assessing performance of inspection bodies.

1.3. Bosnia and Herzegovina

The experience of Bosnia and Herzegovina is of particular interest in terms of complex nature of undertaken reforms, and introducing management of information system for inspections.

Within the frame of "merging inspections model" that took hold in 2004, Bosnia and Herzegovina instituted a state inspectorate responsible for conducting all inspections (except tax audits and inspections that fall within the scope of state services and structures). Given institutional complexity of the country, two autonomous structures – one for the Republic of Serbia, and the other for the Federation of Bosnia and Herzegovina, controlling authorities at the regional level were established. Head of the state inspectorate is

determined by and accountable to the Council of Ministers in the Republic of Serbia. Thus, the state inspectorate escaped the influence of separate ministries by gaining reputation and a certain status.

The reform was not limited to consolidation of inspection structures, and covered the entire system of planning and conducting inspections. In particular, personnel were partially replaced and the law on inspections of each entity was adopted. Scope of authority and powers of the state inspectorate were specified in the legislation, which meantime defines new internal standard procedures. In addition, the law on inspections stipulates risk-based planning of inspections and binds all inspectors to compulsorily use checklists.

The law on inspections also provided for creation of a single information system. It is often referred as an example of good practice, because of being a fully integrated system with complete functionality. The system employs more complex approach to a risk-based planning of inspections. And its introduction was a logical conclusion in consolidation of control functions within the single inspection and supervisory structures. The reform of information and planning system helped to reduce duplication both partially and completely.

1.4. Slovenia

The reforms carried out in Slovenia are one of the examples of good practice (in particular, consolidation of the inspection system and its functions as well as coordination of procedures). In 1995, the first changes to the system divided public administration functions between the state authorities and municipalities. Meantime, inspectorates were consolidated as independent bodies, which enabled them to benefit from relative autonomy. Inspectors were given the authority to make independent decisions. The systematic reforms of 2002 introduced significant changes, such as creation of an inter-

ministerial coordination body (inspection council) in charge of ensuring cooperation and coordination between various inspection authorities, organizing joint inspections, continuously promoting information exchange and legal aid. Inspection authorities are now separate and autonomous institutions (in terms of budget, human resources and specialization).

The law on inspections instituted creation of an inspection council in charge of coordinating inspection agencies and their activities. The inspection council coordinates activity of inspection agencies in charge of auditing directly the private sector (such as financial administration, health inspectorate, market inspectorate, administration for food safety, veterinary and plant protection), inspection bodies with limited coverage of the public sector (nuclear security administration or the inspectorate for internal affairs) as well as inspectorates that solely deal with the public sector (such as inspectorate for defense and inspectorate to the public sector). The council is a permanent body, which is represented by heads of the state inspectorates. Since 2005, the council has had an authority to investigate minor offenses, which previously fell within the scope of the courts.

Further reforms resulted in an in-depth coordination of inspections. The changes in 2007 ensured regional coordination among inspectors. In overall, the reforms brought about reducing number of inspections and increasing number of business entities (from 155.000 in 2007 to 187.000 in 2012).

1.5. Great Britain

A business operating in Britain across the boundaries of more than one council is entitled to create partnership with only one local authority for the purposes of regulatory compliance. If the Better Regulation Delivery Office (BRDO) approves primary authority partnership, it is then recognized by all local regulators. By working

closely with such a business, the primary authority can supervise regulatory compliance as well as provide detailed and reliable advice. The advice provided by the primary authority is then respected by all local regulators. This enables the business to operate with confidence since the primary authority has validated its internal procedures, methods, etc. from the viewpoint of compliance with the relevant regulatory acts. This system also ensures regulatory compliance, since internal rules, compared to external regulations, are better understood and in practice guided by employees. The primary authority often develops a national inspection plan, which enables to avoid duplications and ensure adequate exchange of information. When problems arise, the primary authority can recover extra costs incurred as a result of thorough examination of the company's processes by giving advice and guidance. Thus, the system is partly financed by businesses themselves.

Introduction of "Safer Food, Better Business" (SFBB) toolkit, earmarked for catering, restaurants and other small businesses that prepare and serve food, is an excellent example of how the public authorities support a business to deal with complex regulations by making them clear. In most cases, small and medium enterprises consider particularly difficult to comply with food security requirements. SFBB toolkit is not just a comprehensible guidebook, it meantime articulates the regulatory requirements, and lets the businesses know that the guidebook is binding for inspectors (at least in practice). The guide specifies a series of steps that correspond to EU requirements on food safety. If a business follows the guide, it consequently abides by the EU legislation.

The inspections carried out by the Health and Safety Executive (HSE) serve a valuable example of employing risk-based approach. In fact, HSE inspects high-risk entities and entities with a clear record of hazardous non-compliance. The sectors, such as the construction sector, which involve most of the cases leading to deaths

or injuries, are specially included in inspection plans. In this regard, HSE mainly focuses its concentration on minimizing the risks rather than controlling compliance. Risk-based approach to planning as well as preventive measures has contributed to a decline in death and injury rates. In addition, the number of inspections carried out by HSE in recent years has significantly reduced.⁶

2. OVERVIEW OF THE CURRENT SITUATION IN THE AREA OF BUSINESS INSPECTIONS

2.1. A quick look at previous mechanisms of business inspections

Since the Law “on regulation of business inspections and protection of entrepreneurs’ interests” was adopted on July 2, 2013, businesses had experienced groundless inspections, inadequate penalties and unofficial payments following the chaotic state in regulation of inspections. The study findings of the International Finance Corporation show that an average number of annual inspections per business amounted to twelve in 2012. Based on comparisons, an average number of inspections per business equaled eleven in 2012, whereas the same indicator constituted one in Georgia, four in Ukraine, and five in Belarus respectively. High rate (61%) of inspections that resulted in no consequences offers evidence that state control over businesses had been excessive since suspension of inspections. International experience shows the effectiveness of state control is not measured by the number and scope of inspections. Transparency and proper planning make inspections efficient

⁶Florentin Blanc and Giuseppa Ottimofiore. Regulatory and Supervisory Authorities in Council of Europe Member States Responsible for Inspections and Control of Activities in the Economic Sphere – structures, practices and examples. ECCU-PRECOP-TP-6/2015

in countries, where an effective model of state control is implemented.

Since introduction of a single information registry for business inspections as well as adoption of the law on regulation of inspections, there had been no mechanism of control over the number and scope of checks carried out by the controlling authorities. A controlling body had the right to inspect any business. Inspections were conducted with no frequency. By acting as a controlling body, a state authority was able to conduct inspection at any time. Purpose of the inspection was defined by a controlling body. There was no limit as to the number of inspections. A controlling body thus defined the number of annual inspections in a business entity given the fact that the previous inspections detected no violation. In addition to official inspections, a state authority was able to visit a business in order to ensure compliance.

In the light of unlimited inspections carried by out controlling bodies, a business faced anxiety about being prepared for inspections that it could not predict. So, a business was not provided with a timely notice of upcoming inspection. A business faced difficulty in establishing the reason and legitimacy of the inspection. Businesses had to be ready for the visit of representatives of controlling bodies at any time, even after the inspection. In addition, it was possible to undergo inspections by a number of government authorities at quarter or year-end. An inspected subject had to provide necessary resources to facilitate on-site inspection.

Since rules and regulations on fire safety, occupational safety and health, sanitation, environmental protection were inaccessible, inspectors and representatives of controlling bodies usually referred to various laws, regulations, in some cases even internal instructions of their authorities at a time of inspection.

In the absence of clear planning system, low-risk businesses underwent inspections more frequently than others. For example, trade

and public catering (86%) were more exposed to inspections than construction sector (80%).⁷

A lack of control mechanisms on the scope and number of inspections as well as employing of non-transparent and unenforceable standards paved the way for “informal relationship” between entrepreneurs and the inspector. According to the study results of the International Finance Corporation, entrepreneurs preferred to come to informal agreement with the inspector in nearly half of inspection cases.

2.2. Suspension of business inspections and its implications

As mentioned above, the Law “on suspension of business inspections” was adopted on 20 October 2015. This law stipulates suspension of business inspections for the period of two years starting from November 1, 2015. The restrictions don’t apply to tax audits, and inspections can be executed in circumstances when human life and health, the state’s economic interests and security are concerned. According to the law, the legal provisions on the investigation of corruption offences are no longer a subject of inspection carried out by the General Prosecutor’s Office.

Results of the face-to-face survey conducted among 1,000 small businesses in the Republic of Azerbaijan under the Micro Enterprise Support Project (5 September - 10 October, 2016) have revealed that suspension of inspections significantly reduced their number, however cases of checks are still existent. Thus, responses given by the surveyed respondents to a question “Did state authorities often visit your office in the last one year period for the purpose of inspection?” confirm this finding. The given responses revealed that the

⁷<http://www.biznesinfo.az/businesspractice/finance/params/ln/az/article/34159>

police top the list of controlling bodies that the respondents were visited at least once a week. In overall, the survey required respondents to select an answer from a set of 13 choices, and a following list provides the names of the state authorities that most frequently inspected the respondents:

- 1) at least once a week by the police (14 out of 42 respondents, 33.3 percent);
- 2) at least once a month by the police - (548 out of 1,803 respondents, 30.4 percent);
- 3) at least once half a year by the Ministry of Taxes - (512 out of 2,601 respondents, 19.7 percent);
- 4) at least once a year by the Ministry of Economy - (476 out of 2,173 respondents, 21.9 percent);
- 5) not subject to inspection by the Ministry of National Security yet - (952 out of 2,386 respondents, 39.9 percent).

Responses to the question enabled to draw another conclusion. Results have revealed that the following government agencies did not visit the respondents for the purpose of inspection:

- 1) Ministry of National Security (952 respondents, 95.2 percent);
- 2) Ministry of Ecology and Natural Resources (931 respondents, 93.1 percent);
- 3) State Committee for Standardization, Metrology and Patent (171 respondents, 17.1 percent);
- 4) Sanitary-Epidemiology Service (154 respondents, 15.4 percent);
- 5) Local executive powers (89 respondents, 8.9 percent);
- 6) Ministry of Economy (43 respondents, 4.3 percent);
- 7) Police (25 respondents, 2.5 percent);

- 8) Ministry of Emergency Situations (21 respondents, 2.1 per cent);
- 9) Ministry of Taxes (0 respondent, 0.0 percent).

Respondents' answers to a question "Why do you think you were visited by inspectors in the last one-year period?" are of interest. 419 respondents (41.9 percent) said that they were subject to legitimate inspections. However, 130 respondents (13.0 percent) stated that they were visited by the inspector for unofficial monthly or annual payments. The rate of official checks constituted 41.9 percent in 2016 compared to 36.3 percent in 2013. Demand for informal monthly and annual payments has been reduced, that is, the rate dropped from 40.4 percent to 13 percent. Suspension of business inspections undoubtedly resulted in the positive trend.

The suspension of inspections had significant impact on businesses. While addressing the conference titled "Non-oil Export: Today's Challenges and Opportunities" held in Baku 19 October 2016, Economy Minister Shahin Mustafayev noted that the number of business inspections amounted to 50,000 during the first nine months of 2015, whereas there were 50 cases of checks compared to the same period of 2016.⁸ It shows that the number of inspections significantly dropped after the law was adopted.

As was mentioned earlier, the suspension of inspections is not applicable to tax audits. Consequently, there has been no significant reduction in the number of tax inspections. This trend can also be observed in the annual reports of the Ministry of Taxes on the on-site tax audits. According to the report for 2015, annual number of on-site inspections was 12,219, including 6,338 planned, 5,881 unplanned ones.⁹ The indicators for 2016 showed a decline to a certain

⁸<http://www.1news.az/az/iqtisadiyyat/20161019113826131.html>

⁹http://taxes.gov.az/uploads/info/2015/2015_seyyar.pdf

extent. According to the report, there were 7088 on-site inspections in 2016, including 1661 planned and 5427 unplanned checks.¹⁰ Interestingly, the number of unplanned inspections dramatically increased in 2016 compared to a preceding year. Estimated extra funds surpassed the amount of sanctions imposed as a result of inspections and control measures, and this can be explained by an increased number of special inspections. In 2016, AZN484436.1 out of estimated AZN628454.2 thus fell to the share of special inspections.

3. NEW APPROACH TO BUSINESS INSPECTIONS

3.1. Introducing a single information registry

Introduction of a single information registry for business inspections, and adoption of the law establishing the main principles of state control in the area of business inspections, common rules of organizing and conducting business inspections as well as defining rights and obligations of inspectors and controlling agencies took entirely a new approach to inspections.

A single information register is an online system that allows registering information about inspections that businesses undergo. The information register enables businesses to be provided with timely notice of planned inspections and require the registration of inspections in the register. The mechanism of registering inspection works as follows:

- 1) Controlling body reports its planned inspection of a business entity concerned to the single information registry under the Ministry of the Justice at least one day before an audit;

¹⁰<http://taxes.gov.az/uploads/info/2016/2016.pdf>

- 2) Planned inspection is recorded in the register within one working day;
- 3) On the day of inspection controlling body receives online an excerpt from the registry;
- 4) Prior to a check, inspector presents an excerpt from the registry to a business concerned;
- 5) Inspection is carried out within a time frame indicated in the extract;
- 6) Upon completion of the inspection, information on its results is included in the register within five working days.

If worked properly, this mechanism will enable to observe actual number of inspections as well as make a comparative analysis of the number and results of inspections. The register will also provide businesses with information about planned inspections. Meantime, it will promote regulatory compliance of businesses as well as reduce the number of groundless checks (raids, inspections, etc.).

The existing mechanism allows a controlling body to conduct inspection only after it is registered in the registry, and an internal instruction no longer serves as a basis to execute inspection. In addition, the new mechanism does not provide for any specific time frame for conducting inspections. That is, a controlling body may carry out inspection on the time indicated in the register. According to the new mechanism checks may not be conducted without registration in the registry, and an entrepreneur reserves the right to require the inspector an extract from the registry.

A presidential decree of 16 March 2017 prescribes a number of significant changes to “Statute on single information registry form and rules of implementation of business inspections.”¹¹ Under the changes, inspection is not registered in the registry if the inspector

¹¹<http://e-qanun.az/framework/35137>

visits a business upon the request of its owner to provide methodical aid and advice as well as assess the situation. A business entity may not be held liable for the facts obtained as a result of such activities. This provision allows businesses to unhesitatingly apply to controlling body for methodical aid and advice as well as assessment of the situation. Based on other amendments, Clause 7.1 of the Statute is edited as follows: “Officials of controlling bodies shall be held liable for conducting inspection without its registration in the registry as well as failing to provide information on the registered audit in the manner prescribed by the Code of Administrative Offenses.” The afore-said provision is of importance in terms of specifying responsibility of inspectors of controlling bodies.

It should be noted that there was no restriction in the registry as to the number of inspections until they were suspended. The system allows tracking all the inspections, and this data makes it possible to prepare analytical reports on the outcome of activity undertaken by various government agencies in the area of inspections.

3.2. Regulating business inspections: a new law and expected results of its enforcement

As mentioned above, the law “on regulation of business inspections and protection of entrepreneurs’ interests” was adopted on July 2, 2013. Considered as an important reform initiative geared to improve control mechanisms, the law introduces a new approach to the regulation of business inspections. The law establishes purposes, principles and rules of organizing and conducting business inspections, rights and obligations of inspectors and inspection agencies during audits, as well as requirements for protecting rights and interests of businesses that are based on best practices of the countries with advanced mechanisms of control. Though the new legislation provides for advanced inspection mechanisms, there still remains a need to further improve them.

According to Article 63 of the Law, list of inspection agencies and scope of their authority are defined by a relevant executive authority (the Cabinet of Ministers of the Republic of Azerbaijan). The Cabinet of Minister was commissioned to take necessary measures for enforcing the law within a two-month period. Though the law was adopted more than three years ago, list of inspection agencies and scope of their authority have not been defined yet. The state of affairs differs when it comes to tax audits. Since the law “on regulation of business inspections and protection of entrepreneurs’ interests” (with the exception of Articles 3.2, 7.1-7.3, 7.5-7.10, 8, 11.1, 12, 13 and 34.1) is not applicable to tax audits, they are regulated by the Tax Code and regulations of the Ministry of Taxes. These regulations include “Rules on conducting desk tax audits of tax returns,” “Rules on conducting on-site tax audits,” “Rules on determining bona fide taxpayers and granting them privileges,” “Rules on conducting of electronic audit,” “Rules on informing taxpayers by the Tax Ministry’s Call Center” (Outbound Call Centre), “Methodology for assessing the risk of business subjects and activities,” “Rules on identification of risk groups on indebted taxpayers, and raising awareness of taxpayers about repayment of sanctions and interests to the budget” and others.

3.2.1. Purpose and principles of inspections.

The law “on regulation of business inspections and protection of entrepreneurs’ interests” is a legal framework that enshrines common approach and principles with regard to organizing and conducting inspections. To this end, the law unifies inspection procedures for various controlling authorities and establishes basic principles of ensuring the rights of economic subjects that undergo inspection. The law stipulates that all inspections aim to maintain regulatory compliance of businesses, and a controlling authority protects human life or health, the environment and security of the public

property interests by means of providing assistance to businesses in the given area.

As indicated, the law stipulates regulatory compliance of businesses by means of providing assistance to entrepreneurs. This is one of the key components of the new approach to inspections.

The new approach defines the principles an inspection is based on. Many of the principles prescribed in Azerbaijan's legislation are also laid down, with slight differences, in the legislation of the countries, including Russia and Kazakhstan that have undertaken reforms in the area of business inspection in recent years (e.g., Kazakhstan's legislation in the area of inspections enshrines a principle such as "incentivizing of inspected honest businesses"). It can easily be found in the following principles of the existing legislation:

- inspection falls within the competence of controlling authority;
- business is not simultaneously subject to inspection by several controlling body;
- business's accessibility to regulatory documents and other pertinent information on organizing and conducting inspection;
- responsibility of controlling body and its representative for the damage caused to business subject as a result of violating normative legal acts during inspections;
- advantage of preventing violations without punishment;
- controlling body dafrays expenses incurred as a result of inspection;
- inspector is highly competent to undertake inspection;
- risk assessment system and checklist are used when conducting inspection;

- supervision over the activity of controlling bodies (including internal audit) is ensured;
- inspection is corrective and preventive action and aims to promote regulatory compliance of businesses;
- rights and legitimate interests of all inspected businesses are equal.

Indeed, application of these principles is dependent to a great extent on the regulation of rules on organizing and conducting of inspections.

3.2.2. Controlling bodies and scope of their authority.

As mentioned above, the new law is a legal framework that enshrines common approach and principles with regard to organizing and conducting inspections. In this regard, classification of controlling bodies and scope of their authority is not prescribed by the law. The Cabinet of Ministers was commissioned to define controlling bodies and scope of their authority. From the taken common approach, it can be concluded that inspection functions will be divided between various controlling bodies. In this case, inaccurate determination of the scope of authority can lead to duplication and overlap of inspections.

In some countries, various controlling bodies are merged or combined under a single authority. It enables to keep specialised departments within a single agency that ensures a unified management. In most cases, each single authority deals with one risk function. Radical consolidation has occurred in the Netherlands (with the number of national inspectorates decreasing from 25 to 10) and in Slovenia (with a similar decrease). In Bosnia and Herzegovina the government established a single state inspectorate responsible for conducting out all inspections (except fiscal and state services and structures inspections). In Great Britain, where most inspections

are conducted locally, inspectors are grouped into few large groups: trading standards, food safety, environmental health, etc.

There is no centralized body to oversee execution of inspections. A centralized authority in charge of control over regulatory compliance can fulfil all or some inspection functions. The model allows combining procedures, types of sanctions, data management system under a single authority. Such a model was successfully put in practice in Croatia, Bosnia and Herzegovina and other countries. List of controlling bodies is not determined yet, and it makes difficult to reason prospects of their consolidation.

Governance of inspection authorities was one of the main priority issues for a number of countries willing to reform it. The general approach is that direct or indirect subordination of controlling bodies to the ministries may affect inspection priorities of inspectorates. To this end, a number of measures were undertaken to ensure a greater independence of controlling authorities from political impact. For example, inspectorates report to Parliament in the Netherlands, but they remain subordinated to ministers.

3.2.3. Scope of inspection and authority of controlling bodies.

A number of state authorities ensure compliance of businesses with regulatory requirements. These include the Ministry of Taxes, the Ministry of Emergency Situations, the Ministry of Health, the Ministry of Economy, the Ministry of Labor and Social Protection of Population, the Ministry of Ecology and Natural Resources, the State Committee for Standardization, Metrology and Patent, local executive authorities, etc. Areas of inspection of these agencies remain undetermined, and it paves the way for corruption with respect to business entities.

Developed by the Organization for Economic Cooperation and Development (OECD) in 2014, the report Regulatory Enforcement

and Inspections: Best Practice Principles for Regulatory Policy recommends compliance with the following fundamental regulatory enforcement functions related to private business activities:¹²

- food safety;
- non-food products safety and consumer protection;
- technical and infrastructure/construction safety;
- public health, medicines and health care;
- occupational safety and health;
- environmental protection;
- state revenues (in many cases, it was excluded from other inspected areas);
- transportation safety;
- banking, insurance and financial services supervision;
- nuclear safety.

Indeed, policy priorities of different countries may vary in terms of regional or national specifics. However, it is worth to note OECD enforcement functions can be used for analysis, evaluation and review of existing institutional systems. In this regard, it would be appropriate to consider possibility of employing the OECD approach when determining inspection areas of the controlling bodies in Azerbaijan.

The Law “on regulation of business inspections and protection of entrepreneurs’ interests” takes completely a new approach with respect to inspector’s powers and regulatory requirements. According to the law, inspector’s authority is limited to the authority of controlling body. With exception of conducting checks, inspectors have no authority to restrict operation of the business, handle inspection

¹²<http://www.oecd.org/gov/regulatory-policy/enforcement-inspections.htm>

materials, make decision based on its results, apply measures of responsibility and levy penalties. Meantime, inspector is not entitled to inspect issues that are beyond the scope of his/her controlling body.

The other important issue is to ensure professionalism of inspectors. Under the law, a newly hired inspector needs to be trained by a controlling body on inspection procedures before conducting checks. Training is organized at least once a year by a controlling body with a view to enhance professionalism of inspectors. The provisions on competency requirements for inspectors is limited to what is mentioned above, and the question remains as to what competency requirements are and what criteria they are based on. The answer necessitates establishing an appropriate regulatory framework.

The new legislation is based on best practices of the countries that have examples of successful reforms in the area of assessing the effectiveness of inspections. Under the law, the number of violations identified during inspections and consequently application of measures of responsibility, the amount of penalties and other financial sanctions may not serve as a criterion for assessing effectiveness of the controlling body, inspector and other officials. This is a very important principle and geared to avoid unwarranted inspections.

3.2.4. Applying a risk-based approach to inspections.

One of the key elements of the new approach to inspections, prescribed by the law, is the introduction of risk assessment. Based on coherent principles, this approach is used in many countries with advanced experience in the given area. For example, according to a number of documents adopted in the United Kingdom, such as recommendations on Reducing Administrative Burdens: Effective Inspection and Enforcement - the Hampton Review (2005); recommendations on enhancing the efficiency of sanctions for non-

compliance - the Macrory Review (2006); principles of applying a risk-based approach to regulatory inspection and enforcement - the Regulators Compliance Code (2007); the Regulatory Enforcement and sanctions Act (2008), etc. the risk-based approach to inspections should be guided by the following principles:

- Regulators should recognise that a key element of their activity will be to allow, or even encourage, economic progress and only to intervene when there is a clear case for protection;
- Regulators should concentrate resources in the areas that need them most;
- Regulators should provide authoritative, accessible advice easily and cheaply;
- No inspection should take place without a reason;
- Businesses should not have to give unnecessary information or give the same piece of information twice;
- Businesses that persistently break regulations should face proportionate and meaningful sanctions;
- Regulators should be accountable for the efficiency and effectiveness of their activities, while remaining independent in the decisions they take.¹³

Similar principles are prescribed by the legislation of other countries with best practices. In particular, the European Union adopted numerous acts that determine necessity of applying the risk-based approach in many areas (such as occupational safety, food safety, control over industrial emissions, etc.).

¹³REGULATORS' COMPLIANCE CODE. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/301133/file45019.pdf

The legislative acts recently adopted in the area of inspections in Azerbaijan entail important provisions with regard to the above principles. In this sense, categorizing of businesses on the basis of risk assessment is of particular importance. The Law “on regulation of business inspections and protection of entrepreneurs’ interests” stipulates that quantitative and/or quality indicators of business activity are used when determining risk assessment criteria. In this case, the following factors are taken into account:

- scope of business activity;
- period within which the business has been active;
- specifics of the product produced (work carried out, services rendered);
- various statistical data (such as occurrence of adverse complications, violation of mandatory legal requirements in the past);
- results of previous audits;
- discrepancies and contradictions in mandatory reporting.

The law sets out common criteria, but it is possible to define a wide range of criteria for various inspection areas. In this respect, the law provides for development of criteria for determining risk groups by a controlling body within the scope of its inspection area. As specified in the new law, list of controlling bodies and scope of their inspection areas have not determined yet, it makes difficult to assess the state of developing criteria for determining risk groups in separate areas.

However, it is worth to note that there exist many examples of international best practice as to criteria for identification of risk groups and use of risk-based approach in various areas. For example, a risk-based approach to environmental protection has been introduced in the United Kingdom since 2002, in Ireland since 2007, in Portu-

gal since 2009. Risk assessment approach used in all three countries is the following: the level risk and the possibility of risk analysis for each risk group. The general criteria for identification of risk categories (risk groups) in all three countries are the following: type of activity, level of waste and pollution, location, efficiency of management. Additional criteria may include rating of regulatory compliance for the United Kingdom, date of violation occurrence for Ireland and Portugal. A scoring system is used in the United Kingdom with regard to risk categories. In Ireland, there remain three categories ranging from A (high risk) to C, and each category is divided into sub-categories (A1-A3, B1-B3, C1-C3). Portugal has identified three risk categories (such as high, medium and low).

There are specific criteria for risk categories in the area of food safety. A risk-based approach to food safety has been introduced in the United Kingdom since 1995, in Ireland since 2000. The general criteria for identification of risk groups in the United Kingdom are the following: potential hazards (product type, number of consumers, etc.), the level of regulatory compliance in the current period, internal control procedures, assessment of contamination risk by various microorganisms. When it comes to Ireland, the following criteria are concerned: the scope of activity; product type; processing/re-processing type; characteristics of the premises (building); internal control procedures. In the United Kingdom, there remain five categories ranging from A (high risk) to E in the area of food safety, while Ireland has identified three risk categories (high, medium and low).

For various countries, characteristics of risk-based approach are apparently common in a similar area, though elements differ. This distinction is evident and stems from constitutional, cultural, economic and other peculiarities. Given this factor, criteria for identification of risk groups for different areas can be developed on the basis of international best practice in Azerbaijan. Developing these criteria

are necessary. According to the law, a controlling body is not entitled to exercise (planned) inspection if criteria are not determined for identification of risk groups within the scope of its inspection area.

Identification of risk groups is also important for determining the frequency of inspections. According to law, the frequency of planned inspections depends on the risk group a business falls into. With the exception of certain areas, planned inspections are carried out at the following frequency:

- in relation to high-risk businesses - not more than once a year;
- in relation to medium-risk businesses - not more than once every two years;
- in relation to low-risk businesses - not more than once every three years.

Exceptions include inspecting the safety of food products. Planned inspections in this particular area are carried out at the following frequency:

- in relation to high-risk businesses - not more than once every six months;
- in relation to medium-risk businesses - not more than once a year;
- in relation to low-risk businesses - not more than once every two years.

The law apparently provides for conducting inspections with regard to all risk groups at a relative frequency. The inspection frequency may be increased only in one circumstance. Under the law, if two recent inspections result in violation of no mandatory requirements or identify violations that cause no direct and substantial damage to human life or health, the environment and the state's property interests, a planned (next) inspection is assigned to a business by in-

creasing the frequency 1.5 times for the risk group it belongs to. In other words, the cases of assigning planned inspections are not commonly prescribed by the legislation. According to the legal requirements of several countries, planned inspection is not however assigned under certain conditions. For example, the minimum inspection frequency for high-risk businesses is one year in the Republic of Belarus, a two-year frequency is applied when an inspection results in no consequences. The minimum inspection frequency for medium-risk businesses is three years, a five-year frequency is applied when an inspection results in no consequences. The minimum inspection frequency for low-risk businesses is five years. However, the legislation of Belarus provides for certain exceptions. In case of positive audit opinion, a further planned inspection may not be assigned to a medium-risk business. In this case, no inspection is assigned to low-risk businesses. It would be appropriate to apply similar exceptions in Azerbaijan so as to ensure effectiveness of inspections and promote regulatory compliance of businesses.

Experience shows there are a number of advantages of applying a risk-based approach to business inspections. These advantages can be classified as follows:

- focusing inspection activities mainly on high-risk businesses;
- lack of planned checks for low-risk businesses (or at a high frequency), and reducing the frequency of inspections for honest businesses;
- reducing unnecessary administrative costs;
- enhancing effectiveness of regulatory enforcement and improving performance indicators (reducing the number of deaths, fires and accidents, etc.);

- enhancing efficiency in the use of material, financial and human resources;
- improving current state of government control and reducing the number of inspections.

3.2.5. Inspection rules and complaints procedures: what does a new approach entail?

Introduction of the Law “on regulation of business inspections and protection of entrepreneurs’ interests” can significantly change the previous chaotic state of organizing and conducting inspections. This can be explained by the principles and rules of procedure that the law sets forth for all controlling bodies. What do the innovations mainly entail?

One of the important innovations includes providing an entrepreneur with a timely notice of upcoming check as well as dealing with the duration of inspection. According to the law, a controlling body hands to the entrepreneur a copy of the decision on conducting an audit at least five working days before the start of the planned inspection as well as explanation of rights and obligations of the entrepreneur and inspector during the inspection. The duration of planned (regular) inspections should not exceed ten working days for large enterprises, and five working days for medium and small businesses. The duration of unplanned (extraordinary) inspections must not exceed five working days for large enterprises, and three working days for medium and small businesses.

The requirement for inspection checklist is also important from the prism of entrepreneurial interest. According to the legal requirements, an inspection aims to verify the implementation status of mandatory requirements included in the checklist only. However, issues that are beyond inspection area of the controlling body can not be included in the checklist.

The law also implies the rights that allow an entrepreneur refusing to a controlling body to conduct inspection. Prior to inspection, inspector presents service card, copy of the decision on conducting the inspection and extract from the single information registry on registration of the inspection to the entrepreneur or his/her authorized representative as well as provides information about the legal basis, subject, duration of the inspection as well as rights and obligations of the parties.

The entrepreneur may refuse to the inspector to execute the inspection, when the latter fails to present the afore-said documents or comply with the time frame indicated in the extract from the single information registry for conducting the inspection.

The new legislation entails a number of provisions that aim to ensure the effectiveness of complaints mechanism. According to the law, if the decisions and actions (inaction) of the controlling authority (inspector) result in violation of the entrepreneur's rights and legal interests or inspection results does not satisfy the entrepreneur, he/she may file a complaint with a higher state authority, relevant executive powers or the court. A complaint lodged against a decision of the controlling body is reviewed by the higher state authority within fifteen working days. It would be appropriate to reduce this period to seven days, because the entrepreneurial interests may suffer damage within the period specified for consideration of complaints.

The rules of inspection, embedded in the legislation, other pertinent regulations as well as complaints procedures play an important role in preventing unwarranted inspections. In this sense, the effectiveness of state control over business entities will considerably depend on the level of compliance with these rules and procedures.

4. DIRECTIONS OF IMPROVING EXISTING SYSTEM OF BUSINESS INSPECTIONS

4.1. Improving the organizational structure of controlling authorities.

Business inspections are executed by multiple state authorities. Best practice of several countries shows the consolidation of inspection bodies and resources are effective in terms of enhancing the efficiency of inspections and saving on resources. Possible reforms in this direction can be implemented in Azerbaijan. Various reform options exist:

- **Alternative 1. *Set up a centralized agency responsible for organizing and conducting business inspections in all areas.*** The model allows combine procedures, the types of sanctions, data management system under a single authority. A similar model was successfully implemented in countries like Croatia, Bosnia and Herzegovina
- **Alternative 2. *Consolidate controlling agencies responsible for various inspection areas.*** This will reduce the number of controlling authorities, help to avoid duplication and overlap, apply a holistic approach and principles to inspections. This model is being implemented in the United Kingdom, where inspections are organized in areas such as trading standards, food safety, environmental hygiene, etc.

4.2. Improve the governance of controlling authorities.

Currently, inspectors work for various executive authorities and ministries, and remain accountable directly to these agencies. A number of countries poised to improve the inspection system are interested in removing or reducing this dependence. Possible reforms in this direction can be implemented in Azerbaijan. Various

reform options exist.

- **Alternativ 1. Subordinate controlling bodies to a special inspection council instead of the relevant state authorities that exercise supervision over their inspection areas.** In this case, all issues related to organizing and conducting inspections are decided by the inspection council. The proposed model guarantees the independence of controlling bodies.
- **Alternative 2. Controlling bodies are accountable to a special inspection council rather than the relevant ministries that exercise supervision over their inspection areas.** In this case, controlling bodies remain subordinated to the relevant ministries, but annually report to the inspection council. This model allows monitoring the activity of all controlling bodies from a single authority and employing a database necessary to improve the inspection system. The model also provides for creating an administrative structure with a view to ensure coordination of controlling bodies, coherence of their activities and promote information exchange, avoid duplicated and overlapping inspections, and harmonize practices. Examples include the Inspectorate Coordination Council established in Latvia in 2000 or the Inspection Council in Slovenia starting in 2002.

4.3. Improve frequency of conducting inspections on the basis of risk assessment.

The existing legislation provides for assigning the inspection frequency determined for risk groups. Evidently, the new approach to inspections meets the interests of business entities as well as paves the way for the rational use of public resources. It is however desirable to increase the frequency of planned inspections determined for the risk groups under the law. This can be done as follows.

➤ **Alternative 1. Define the frequency of planned inspections as follows:**

- in relation to high-risk businesses - not more than once a year;
- in relation to medium-risk businesses - not more than once every three years;
- in relation to low-risk businesses - not more than once every five years.

The proposed frequency allows enhancing the effectiveness of inspections and saving on existing resources.

➤ **Alternative 2. Scrap requirements for assigning inspections, while retaining frequency as prescribed by the law.** The existing legislation does not envision the cases of assigning planned inspections at all. In particular, certain conditions such as identification of no violation as a result of previous inspections, positive audit report, etc may be specified to exempt medium and low-risk businesses from inspections. Such an approach would be appropriate in terms of ensuring the effectiveness of inspections and promoting regulatory compliance of businesses.

4.4. Specify competency standards for inspectors.

Under the law, a newly hired inspector needs to be trained by a controlling body on inspection procedures before conducting checks. Training is organized at least once a year by a controlling body with a view to enhance professionalism of inspectors. The provisions on competency requirements of inspectors is limited to what is mentioned above, and the question remains as to what competency requirements are and what criteria they are based on. There is a need to establish an appropriate regulatory framework that specifies competency requirements for inspectors.

4.5. Speed up the process of developing list of inspection agencies and their inspection areas.

According to the Law “on regulation of business inspections and protection of entrepreneurs’ interests”, list of inspection agencies and scope of their authority are defined by a relevant executive authority (the Cabinet of Ministers of the Republic of Azerbaijan). The Cabinet of Minister was commissioned to take necessary measures for enforcing the law within a two-month period. Though the law was adopted more than three years ago, list of inspection agencies and scope of their authority have not been defined yet.

4.6. Develop performance incentive mechanisms for inspectors based on the results of assessing the effectiveness of inspections.

The law specifies inspection as corrective and preventive action that aims to promote regulatory compliance of businesses. In this regard, the effectiveness of inspections is measured by the level of business compliance with the mandatory requirements, the number and costs of inspections can be lowered as a result. Achieving this outcome is considerably dependent on the inspector’s performance, his/her approach to the economic subject. Therefore, it would be appropriate to develop performance incentive mechanisms for inspectors.

4.7. Ensure effective handling of complaints.

Under the law, a complaint lodged against a decision of the controlling body is reviewed by the higher state authority within fifteen working days. It would be appropriate to reduce this period to seven days, because the entrepreneurial interests may suffer damage within the period specified for consideration of complaints.

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