

EVALUATION OF OPPORTUNITIES FOR THE APPLICATION OF NEW MECHANISMS TO PROMOTE BALANCED REGIONAL ECONOMIC DEVELOPMENT

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1. SUMMARY

In order to achieve sustainable economic development, it is important to ensure a balanced development of the regions. From this point of view, this policy paper examines the problems that lead to economic and social inequalities among regions and reviews policy alternatives that can be applied to eliminate these problems.

It has been established as a result of the research that there is a problem of inequality relating to participation in the formation of economic potential among regions and a number of other economic indicators. The key reason for this problem is the large dependence of the economy on the oil industry and the concentration of industrial enterprises mainly in Baku and the Absheron peninsula. Oil, oil products and natural gas account for about 90 percent of total exports. The research also shows that there are problems in the development of small and medium-sized businesses that play an important role in budget revenues and in the distribution of production and investments among regions. Although municipalities in many countries around the world have a say in state budget spending and solution of local problems, there are some shortcomings in this field in Azerbaijan. As a possible solution to the problem, it is suggested that incentives be used to expand the powers of local governments and stimulate economic activity on the ground. As a result of the research, three alternative policy mechanisms are proposed to reduce economic and social inequalities among regions:

- 1) **Establish a regional development fund with direct assistance from state and international financial institutions;**
- 2) Increase the impact of local governments on regional economic development decisions;
- 3) Application of differential incentives, depending on the socio-economic differences between regions

As a result of the research, this paper suggests creating favorable conditions for attracting investment and grant funds to increase the capacity and financial opportunities of municipalities.

2. INTRODUCTION

One of the most important elements of sustainable economic development is the development of the regions. From this perspective, one of the 17 Sustainable Development Goals reflected in the United Nations "Agenda for Sustainable Development until 2030" is to reduce inequality. An effective regional policy plays an important part in eliminating inequalities in income and living standards of citizens.

Various programs have been implemented in Azerbaijan in recent years to improve regional infrastructure and increase economic activity. Although regional development is one of the top economic priorities, statistics show that there are stark differences in economic and social performance of the capital and districts. According to the results of 2017, the value of the gross output of the country's economy was 77.6 billion manats, of which 55.4 billion manats, or 71.4 percent, falls on Baku.

There are many factors contributing to such differences in terms of economic productivity among regions of the country. Examples of this are problems with the diversification of the country's economy which is dependent on one resource, as well as the institutional barriers hindering business environment. Given these, this policy paper addresses the following questions:

- What are the reasons for inequality between regions in terms of economic value generation?
- What is the essence of the current policy on regional development?
- How can the development of regions be improved through investment and tax instruments?

The research consists of four stages. The first part, entitled "**Justification of the Problem**", examines the problems causing economic and social inequalities in the regions. The second part, called "**Alternatives**", proposes three alternatives we believe could stimulate economic life in the regions and reduce economic and social differences. This section also provides a detailed explanation of these options, the steps to be taken to implement them, the advantages and potential threats. The third part, called "**Assessment of Alternatives**", provides an assessment of these policy alternatives. Whether these alternatives meet the established criteria is assessed by a system of points and a superior alternative is selected as a result. Lastly, the "**Conclusions and Recommendations**" section sums up results of the research. At the same time, recommendations based on the results of the research are also provided.

3. JUSTIFICATION OF THE PROBLEM

Oil revenues that started flowing into the state budget in the mid-2000s, along with the improvement of many economic indicators, also led to inequalities in income and increased economic disparities between regions. For example, whereas in 2003 population incomes increased only by 14.3 percent to the previous year, this figure reached 42.7 percent in 2007. It should also be noted that whereas the volume of production in Baku constituted 20 billion 86 million manats in 2006, this indicator increased to 55 billion 411 million manats in 2017. In Ganja, the second biggest city of Azerbaijan 348 km from Baku, production amounted to 293,527,000 manats in 2006 and failed to cross the 1 billion manats threshold in the same period (989,100,000)¹.

The main criticism of the Azerbaijani economy by experts is that the economy is dependent on one resource². According to the law "On the State Budget for 2018",

¹ Data of the State Statistical Committee's table on overall production in the regions and population incomes - https://www.stat.gov.az/source/system_nat_accounts/

55.1 percent of budget revenues is made up by revenues from the oil sector³. If we look at the statistics of exports, we can see that top three most exported products are oil, oil products and natural gas. These products account for 87.62 percent of total exports⁴. Considering that 87 percent of the country's revenues comes from natural resources, it is clear why economic activity in Baku and surrounding cities is much higher due to their geographical proximity to oil and gas fields. From this point of view, one of the key reasons for economic inequality among regions boils down to geographical causes.

Poor development of business also results in higher levels of unemployment and lower tax revenues in the regions. It is no coincidence that only 4 percent of tax revenues came from 65 regions and cities of the country, while 96 percent was collected in Baku⁵ (for more on this, see Appendix 1).

According to official statistics, the number of individual entrepreneurs registered as of 1 July 2018 was about 815,000. Of these people, 30.1 percent work in Baku, 20.7 percent to Aran, 13.9 percent in Ganja-Gazakh and 10.0 percent in Lankaran economic regions⁶.

The "Small and Medium-sized Enterprise Research for Azerbaijan", published by the International Finance Corporation, identifies the following problems⁷ hindering the development of small and medium-sized enterprises, reduction of unemployment and increased tax collections in the regions:

- (a) limited competition and unfair treatment of certain businesses, such as giving systematic advantages to large or state-owned enterprises;
- (b) a tax system conducive to tax evasion, payment of much lower tax than necessary, other unlawful actions;
- (c) use of informal tools to solve problems.

The disruption of balance between regions can also be attributed to socio-cultural factors. From this point of view, we can, first of all, pay attention to the difference between the number of educated people and the quality of their education. Only five state-owned and two private universities are located outside of Baku⁸, which means that higher and specialized education is more accessible to the city population. By working in more profitable areas, qualified professionals boost the economic life of their own region.

Economic inequalities between the capital and the regions are also manifested in social and utility services. According to official statistics, 99 percent of all residential

² Economic and Social Development Center – “Use of oil revenue: efficiency and transparency principles”
www.cesd.az/documents/paper_az.doc

³ Law of the Republic of Azerbaijan “On state budget for 2018”
http://www.maliyye.gov.az/sites/default/files/Qanun_budce_2018_0.pdf

⁴ State Customs Committee
<http://customs.gov.az/az/faydali/gomruk-statistikasi/en-cox-ixrac-olunan-mallar/>

⁵ Rovshan Agayev – Anticipated budget revenue for 2017: key trends and problems
<http://freeeconomy.az/blog/2017-ci-ilin-gozlenilen-budce-gelirleri/?language=english>

⁶ State Statistical Committee
https://azertag.az/xeber/Ferdi_sahibkarlarin_sayi_815_mine_yaxinlasib-1180324

⁷ International Finance Corporation – research on small and medium-sized enterprise in Azerbaijan
https://www.ifc.org/wps/wcm/connect/2a254d004a1d4c9a8f939f02f96b8a3d/az_final.pdf?MOD=AJPERES

⁸ Ministry of Education http://edu.gov.az/az/page/339/613#move_top

areas in Baku are connected to the water network, 96.4 percent to the sewage network and 96.4 percent to the gas network. However, the level of gas supply in the regions varies around 45-95 percent. The level of centralized drinking water supply in the regions is very different. The lowest level is in the range of 2-10 percent. The availability of centralized sewage services in the regions is even worse. Official figures show that in 18 out more than 60 rural areas 18 the level of centralized sewage services is below 20 percent and in 32 districts less than 40 percent⁹.

The State Program on Socioeconomic Development of the Regions of the Republic of Azerbaijan has been adopted three times in the last 15 years to achieve sustainable development of Azerbaijani regions. The total investment channeled into the regions within the framework of these programs – the first covering 2004-2008, the second 2009-2013 and the third 2014-2018 – exceeded 60 billion manats¹⁰. Most of this money was spent on the creation of infrastructure.

Balanced development of the regions is also stated as one of the main goals of the "Azerbaijan 2020: Vision of the Future" concept. The key objectives set out in the concept for the balanced development of the regions are as follows:

- Taking into consideration regional development priorities, aligning state infrastructure and investment policies with investment strategies of the private sector and prioritizing cost effectiveness based on income and expenditure analyses;
- Eliminating the differences in the standard and quality of life, per capita production and investment, structure of commodity circulation in different economic regions, and reducing the differences between economic regions of the country;
- Increasing the impact of local governments on economic decision-making using a modern approach;
- Promoting balanced socioeconomic development of the regions through regional development centers, thus reducing regional inequalities and concentration of economic resources mainly in cities¹¹.

Another step towards resolving the problem is the "Investment Promotion Document". The purpose of this document is to encourage investment, improve the business environment, increase industrial production and, in accordance with paragraph 5.2 of the Action Plan on the implementation of the "State Program on Industrial Development of the Republic of Azerbaijan in 2015-2020", upgrade the investment promotion mechanism.

4. ALTERNATIVES

⁹ Baku Research Institute's economic group – Capital and provinces: key socioeconomic differences <https://bakuresearchinstitute.org/>

¹⁰ Baku Research Institute's economic group – Capital and provinces: key socioeconomic differences <https://bakuresearchinstitute.org/>

¹¹ "Azerbaijan 2020 – Vision for the Future" concept https://www.president.az/files/future_az.pdf

Based on the research conducted for this policy paper and consultations with experts, the following alternatives were identified:

4.1. Alternative 1: Establishment of a Regional Development Fund with direct support from state and international financial organizations

Investments are of great importance in terms of increasing the growth rate of both the country proper and its regions. From this point of view, we can say that investment is the locomotive of economic and social development. Therefore, regional development funds exist in a number of countries around and certain incentives and promotion mechanisms are applied to them.

The proposed alternative aims to establish a Regional Development Fund with direct support of the state and international financial institutions. Such a Fund supports development projects in the regions through loans and grants, in particular those implemented by municipalities and local governments. At the same time, the experience of other countries shows that effective operation of this alternative requires changes in the local self-governance structure. This primarily means providing greater powers to local governments to enable them to influence planning and economic development decisions.

When examining the experience of Regional Development Funds, we can see that there is a similar fund called "Municipal Development Fund" in Georgia. The Fund's charter indicates that its goals are to strengthen the institutional and financial capacity of local governments, improve economic and social services for local communities, develop renewable energy sources, improve the living conditions of the IDPs, restore irrigation and drainage systems, help eliminate the damage caused to the population and infrastructure by conflicts and natural disasters¹². The Fund's key donors are the World Bank, the European Bank for Reconstruction and Development, the Asian Development Bank, the German Development Bank, the European Commission, the US Agency for International Development (USAID), the Japan International Cooperation Bank, the Swedish International Development Agency, the Netherlands Government and the German Society for International Cooperation (GIZ)¹³.

Exact definition and explanation of the alternative. The essence of alternative to establish a Regional Development Fund with direct support of the state and international financial institutions to facilitate the implementation of development projects in the regions through loans and grants, in particular those implemented by municipalities and local governments, is that using the attracted resources the fund will contribute to the financing of the activities of local governments, to the development of regional infrastructure, to the creation of jobs and improvement of living conditions of the population and ultimately to the reduction of socioeconomic differences between the regions. Collaboration with international organizations will help to benefit from the experience of these institutions, increase transparency and accountability in local governance.

¹² Municipal Development Fund of Georgia <http://mdf.org.ge/?site-lang=en&site-path=fund/about/>

¹³ Elguja Khokrishvili - Municipal Development Fund of Georgia
<http://www.cmimarseille.org/sites/default/files/newsite/library/files/en/MDF%20Georgia%20presentation.pdf>

Application mechanism. The implementation of the proposed alternative requires certain changes to national legislation:

1. Activity areas and powers of municipalities should be expanded and their precise classification provided.

The law "On the Status of Municipalities" states that municipalities have three functions. These are "Local Social Protection and Social Development", "Local Economic Development" and "Local Environmental Issues". While the law specifies some powers of the municipalities on these functional areas, it does not define norms in relation to this issue. Another problem with the issue is that there is no clear division of responsibilities between state authorities and municipalities. There is no legal mechanism for municipalities to exercise their powers¹⁴.

2. The proposed alternative is to establish a Regional Development Fund and support the development projects in the regions both through loans and grants. However, following amendments to the "Law on Grants" introduced in 2014 and the "Procedure for Obtaining Grants from Foreign Donors on the Territory of the Republic of Azerbaijan" approved by the Cabinet of Ministers, it has become more difficult for local NGOs to receive grants. It should be noted that Article 1.2 of the "Law on Non-Governmental Organizations (Public Associations and Foundations)" states that "public associations and foundations are considered to be non-governmental organizations in this law."

In order to form the financial structure of the fund, the state should, in addition to public funds, attract the funds of international organizations, grants and loans. Reforms to meet the quality standards by these organizations may be seen as one of the most important ways of doing so. It is also possible to attract the State Oil Fund's resources to finance the fund in Azerbaijan. Considering that one of the Fund's main tasks is to work for the well-being of present and future generations in Azerbaijan, we can envisage the financing of the Fund's activities with the Oil Fund's resources.

This alternative has the following advantages:

- Financing sources for the implementation of municipal and local government projects will be expanded
- Additional funds will be attracted to local economy through grants and loans from international organizations
- Focus on local problems not by central government but local residents will create conditions for faster and more effective resolution of these problems.
- All this will allow the state to save administrative and financial resources

This alternative has the following drawbacks:

- Since the powers of local governments have so far been limited, it will take them a relatively long time to acquire the skills required for effective functioning

¹⁴ R. Agayev, A. Mehdiyev, A. Aslanov – Concept on Strengthening Municipalities in Azerbaijan
<http://sei.az/upload/files/consept-azeri.pdf>

- The dependence of the country's economy on one natural resource causes a considerable decline in revenues in the event of a global recession. Therefore, the state budget may always be in danger of failing to finance the fund. At the same time, donors of such funds finance projects that meet their targets, so the lack of donor funding creates a risk of financial deficits for such funds
- Transparency and accountability are the key conditions for the success of this alternative. Therefore, if local administrators are not selected through election and if transparency and accountability are at a low level, the successful application of this alternative becomes questionable.

4.2. Alternative 2: Stepping up the role of local governments in regional economic development decision-making

In theory, regional development undergoes two stages. These are the "traditional" regional development policy and the regional development policy within the framework of "new regional understanding". The "traditional" policy of regional development has been applied from the time of "Great Depression" in the United States until the "Energy Crisis" in the 1970s. Since Keynesian theory was more popular in this period, there was a great deal of policy-making by the central government and large-scale state interference in the economy. The domination of neoliberal theories in the 1970s also proved itself in regional policies. The most striking aspect of this regional development policy was the emergence of new players in the formation and implementation of policy mechanisms and the expanded role of local governments and non-governmental organizations. Therefore, the importance of domestic capacity in the new regional development policy increased and this policy became more inclusive¹⁵.

Factors such as the ability to adapt to changing globalization conditions, competition, human resources development, trends in global markets, elasticity and financial control in organizational structures were the key reasons for the transition from the "traditional" regional development policy to the policy within the framework of a "new regional understanding". From this perspective, the government no longer acts the single power center to achieve regional development. For this reason, the powers and responsibilities of the central government are shared with others. This is accomplished by expanding the powers of local governments.

Currently, most municipal budgets are formed by subsidies allocated from the state budget. According to the budget legislation, funds allocated to municipalities should be based on one principle – population size. However, experts believe that funds allocated to different municipalities with the same population may be several times different¹⁶.

Exact definition and explanation of the alternative. This alternative proposes to increase the effectiveness of local governments in the preparation of regional socioeconomic development activities and to expand the capacity of municipalities in the context of local economic development. The successful implementation of this alternative requires a clear understanding of the local governance concept and

¹⁵ Battal Yılmaz – Historical development of the regional policy and development agencies as a new model

¹⁶ R. Agayev, A. Mehdiyev, A. Aslanov – Concept on Strengthening Municipalities in Azerbaijan
<http://sei.az/upload/files/consept-azeri.pdf>

expansion of the powers of local governments. In addition to reducing the political and legal dependence of local governments on the central government, the success of this alternative also requires the provision of local governments with financial freedom. Taking this into account, this alternative proposes to expand the powers of local governments in the context of economic development.

Application mechanism. The application of this alternative first requires a number of legislative changes. From this perspective, the principles of forming local governments should be clarified. While internationally the organization of municipalities mainly depends on the size of population or territory, in Azerbaijan there is uncertainty in this area. One of the key conditions for the effective operation of municipalities is the size of population and territorial boundaries. Since there are currently no restrictions in relation to population and territory in the national legislation, the number of small municipalities in Azerbaijan is much higher than in other countries. Another aspect that differentiates Azerbaijan from countries with a developed local government system is that no city, including even the capital, has a special status and authority¹⁷.

One of the most important components of the alternative application mechanism is the financial side. Since financial sources of municipalities are currently limited, they are financed by the state. In addition to making them dependent on the central government, this also prevents efficient and targeted expenditure of funds.

This alternative has the following advantages:

- Effectiveness of local governance will increase and local population will be provided with better quality services;
- Transparency and accountability in local budget expenditures will increase;
- Capacity and involvement of local people in the process will increase;
- Proper planning of development policies will be implemented;
- Public and human resources will be used more effectively;
- Local authorities will be able to effectively intervene in the processes because they will be closer to the local population both physically and morally.

This alternative has the following drawbacks:

- The transition process may prove challenging due to significant differences from the previous system;
- The transfer of administration to electoral rails complicates political viability of the issue;
- The application of the alternative requires major changes in the legislation and, in particular, the constitution, and preparation of these changes may prove difficult and lengthy;
- Removal of the negative image of local authorities requires a long time and major financial resources.

¹⁷ R. Agayev, S. Aliyev – Upgrading the mechanism for identifying the powers of municipalities in Azerbaijan

4.3. Alternative 3: "Application of differential incentives, depending on the socio-economic differences between regions"

With the influence of globalization and growing economic competition in the modern economic system, we can state that along with countries, cities and regions inside a country have also taken shape as competitive units. This factor requires countries to form their regional development policies in line with this. Looking at international experience, we see that in most of the countries that have covered a certain distance in terms of regional development, regional development programmes are being used, taking into account specific socio-economic and geographical characteristics of each economic-geographical region. However, development programmes prepared for each region do not go beyond the national development strategy adopted by the central government.

We can see that countries located in the same region as Azerbaijan have also benefited from this experience. Specifically, the creation of "Development Agencies" that specialize in different regions (cities and districts) in Turkey is very useful in terms of identifying problems in the regions and developing effective policies to address these problems. Regional Development Agencies promote coordination among different status organizations, which are established at the level of economic or administrative regions and encourage local people to use their potential, and are organizations that ensure effective use of resources in the region, increasing the region's project opportunities and providing partners with high-level services and ways of addressing problems. The Turkish law on Development Agencies defines development agencies as institutions formed to speed up regional development in line with the principles and policies envisaged by regional development plans and programmes, ensure their sustainability and reduce the development differences between and inside regions.¹⁸

Although several programmes have been implemented in Azerbaijan in recent years as one of the main goals of regional development, it is planned to apply the incentives and concessions offered in these programmes not in cities or regions, but throughout the country. Given this shortcoming, the alternative that is offered takes into account the socio-economic features of regions and suggests differential incentive mechanisms for regions that are grouped on a given set of criteria. Deeper analysis of the specific features, capacities and problems of each region in local development programmes can help to overcome these shortcomings and make better use of the potential available.

The exact expression and explanation of the alternative

Azerbaijan has no experience in developing programmes and strategies that take into account the specific geographical conditions and socio-economic characteristics of each region. The absence of these programmes and strategies also hinders the identification and assessment of the government's regional development policy objectives. Given these, the alternative suggests the development of specific regional development programmes in accordance with the specificities of regions.

If this alternative is enforced, companies will have the opportunity to work more effectively in their business spheres, and the concessions that will be applied to the regions will increase employment opportunities and economic activity in the regions,

¹⁸ Can Ergüder və Elşən Bağırzadə: Regional İnkişaf Siyasətinin həyata keçirilməsində İnkişaf Agentliklərinin rolu:Dünya təcrübəsi və istifadə imkanları. "İqtisad elmləri: Nəzəriyyə və praktika jurnalı" №3, 2010. S59-70

which will ultimately reduce the deep socio-economic differences between the regions and the capital city and help boost the sustainability of the country's economy.

When examining South Korea's experience in the issue, we can see that the Korean government has been implementing a step-by-step programme to equally distribute production across the country and reveal the internal potential of the regions. Initially, after measures to improve the infrastructure situation across the country in order to eliminate the difference in infrastructure between regions, the natural and geographical characteristics of regions were taken into account and measures were taken to ensure that they specialize in different production areas. For example, a proposal was made to finance the construction of new buildings and cover the transportation costs of companies engaged in food industry for relocation to well-developed agricultural regions as they have numerous sources of freshwater. This can be regarded as an attractive offer for companies, which believe that their closeness to raw material sources will reduce their transportation costs. Concessions and incentives for companies that manufacture mostly export products have allowed them to continue their production in cities that are close to ports and have good transport infrastructure. As a result of the measures taken in the 1990s, the population of the capital Seoul dropped from 13.5 million to 9 million. The share of the region where the capital is situated in GDP dropped from 44% to 33%.¹⁹

Turkey's 2012 Investment Support Decision states that the country is divided into six regions based on the socioeconomic development level, and the incentives offered by the state are envisaged at different levels for each region. Along with the development of special development programmes for regions within the framework of the national regional development strategy, another highlight of Turkey's experience is that separate plans and programme on rural development were drafted in order to increase attention to the development of villages and increase the quality of the activities of the institutions operating in these areas.²⁰

When we look at the regional development policy in Georgia, another country in the same region as Azerbaijan, we see that the government policy here was prepared for each region, considering the resources available to that region. A separate development strategy was mapped out for each region of the country which consists of 9 regions. For example, along with information about the existing situation and infrastructure in the region, the Kakheti Region's regional development strategy for 2014-2021 shows the region's economic development potential and advantages, presents priority development spheres and provides a clear picture for people and companies that want to invest in the region. The document is based on the analysis of the strengths and weaknesses of the region, its opportunities and risks.²¹

As we mentioned above, all these programmes do not go beyond the framework of the national development strategy adopted by the central government in the countries where separate programmes are developed for each region based on the specific features of regional development. In this regard, one of the first steps to be taken in terms of the application of the proposed alternative could be the preparation of a strategy expressing the government's regional development policy, in which the

¹⁹ Dennis Rondinelli – Land Development Policy in South Korea

²⁰ <http://bolgesel.kalkinma.gov.tr/bolgesel-gelisme-ulusal-stratejisi/>

²¹ Rövşən Ağayev - 2013-2016-cı illərdə regionların tarazlı inkişafına yönəlik tədbirlərin əsas nəticələrinə dair Qiymətləndirmə Hesabatı

government should define the goals and objectives of the regional development policy it wants to pursue. Later, within the framework of this document, separate development programmes should be developed taking into account the specificities of each region. These programmes should be based on analysis of the strengths and weaknesses of the region, its opportunities and risks. This process also requires the strengthening of institutional potential for regional development. In this regard, it may be expedient to establish a separate central executive body responsible for the preparation and implementation of regional development policies. In international practice, these types of organizations operate separately in the form of a Ministry of Development or as a separate structural unit subordinate to an agency or the Ministry of Economy.

One of the most important steps in terms of implementing the alternative is the selection of criteria to be used to group the regions. In terms of selecting these criteria, the alternative proposes three options:

1. Per capital production in the regions. Based on this criterion, we can divide the regions into regions where per capita production is up to 30%, 30-50%, 50-70% and 70% of national production;
2. Share of industrial output in total output. According to this criterion, we can group the regions into regions where the share of the industry in total output is up to 20%, in the range of 20-40% and more than 40%;
3. Per capital consumption of communal services. One of the indicators of the economic situation in regions is the level of utilization of public services. Based on the criterion of the population's use of public utilities, the country can be divided into several regions.

Application mechanism of the alternative

The proposed alternative suggests incentives in the following areas:

- Tax payments;
- Custom duties;
- Loans;
- Land provision;
- Technical support (consultations, legal advice, etc.).

Although the alternative stresses that incentives in different areas are applied differently depending on the level of regional development, it is also possible to apply some incentive mechanisms to all regions at the same time. Such incentives can include the exemption of components of products manufactured by enterprises and the importation of means of production from VAT and customs duties and the allocation of land by the state to individuals who are willing to make an investment and open new enterprises.

Tax incentives can be applied in several tax types. If we divide regions based on different criteria into "weak", "average" and "high" regions by their level of development, then it is possible to apply concessions of up to 20% on the profit tax in the regions included in the "high" group, from 20% to 40% in the regions included in the "average" group and from 40% to 100% in the regions included in the "weak" group. The state could compensate for the payments made to the Social Security

Fund by enterprises in the same way. These tax incentives can be applied to the same groups for up to 2 years, from 2 to 5 years, and from 5 to 10 years.

In addition to the exemption of equipment imported by enterprises from customs duties, we can also indicate concessions on customs duties on products exported by the enterprises operating in those regions. This mechanism will provide companies with certain advantages in terms of their competitiveness on foreign markets.

One of the most important factors in local enterprises starting and continuing their operations is financing mechanisms where credit resources play an important role. The proposed alternative suggests that regions classified as "weak", "average" and "high", depending on the socio-economic development level, should get a discount of 0-20%, 20-40% and 40-100% on proposed business loan interest rates or the state should pay for these parts of interest payments. Concerning investments in the regions included in the "low" development group, the state could provide some of the necessary funding.

Providing land for newly-opened businesses is also one of the steps that will encourage investors to make a decision to invest. It is possible to apply these incentive mechanisms throughout the country. In addition to land allocation, the state could also cover the cost of constructing administrative buildings and production facilities, transporting production equipment and insuring enterprises against possible natural disasters in the area.

State-supported technical assistance includes legal assistance to enterprises in the process of their establishment and operation, business and marketing advice for business development and courses to improve the professional skills of employees in the new area of operation.

Proposed incentive mechanism	Exemption from customs duties	Concession on profit tax	Concession on social payments	Duration of tax concessions	Land allocation	Reduced interest on loans	State financial share in investment (free of charge)	Technical support
"Highly developed regions"	Yes	0-20%	0-20%	Up to 2 years	Yes	0-20%	No	Yes
"Average" regions	Yes	20-40%	20-40%	From 2 to 5 years	Yes	20-40%	No	Yes
"Weak" regions	Yes	40-100%	40-100%	From 5 to 10 years	Yes	40-100%	Yes	Yes

Advantages and disadvantages of the application of the alternative

The implementation of the alternative has the following advantages:

- More effective use of regional resources;
- Increasing the number of jobs and revitalization of economic activity in the regions;
- Expanding company operations and revenues;
- Reduced demographic and environmental problems due to the reduced concentration of production activity.

The application of the alternative has the following drawbacks:

- Hesitations to invest in regions with more unfavourable geographical and socio-economic characteristics than other regions

5. EVALUATION OF ALTERNATIVES

Specific criteria have been developed to evaluating the proposed alternatives and choose the most favorable one.

5.1. Evaluation methodology

The evaluation methodology is based on the assessment of alternatives using the existing criteria. During the assessment of alternatives, criteria were determined to reduce interregional economic and social inequalities.

The purpose of these criteria is to measure development differences between regions by expanding economic activity on the ground. Each proposed alternative was evaluated on the basis of a scoring system. The alternative with the highest score was defined as being more appropriate. It should be noted that the assessment is the subjective assessment of the author of this policy paper.

The following criteria were set to evaluate the proposed policy alternatives:

- *Increased volume of gross output in the regions*
- *Increased number of enterprises operating in the regions*
- *Reduction in the level of unemployment in the regions*
- *Increased level of investment in regions*
- *Increased level of tax collection in the regions*
- *Increased accessibility of social services and their improved quality*
- *Level of compliance with current legislation*
- *Viability of financial resources necessary for implementation*

Explanation of criteria:

- Increased volume of gross output in the regions. This means an increase in the regions' share in gross output;
- Increased number of enterprises operating in the regions. This means the opening of enterprises in the regions and increase in the number of companies moving outside of Baku;
- Reduced level of unemployment in the regions. This means better employment opportunities in the regions and reduction in the number of unemployed;
- Increased level of investment in regions. This means an increase in the number of projects financed by the private sector, the state and international organizations;
- Increased level of tax collection in the regions. This means an increase in the collection of tax in the regions;
- Increased accessibility of social services and their improved quality. This means an increase in the number and improvement of the quality of social services provided to the population in the regions;
- Level of compliance with current legislation. This means whether or not the proposed policy alternative complies with applicable legislation;
- Viability of financial resources necessary for implementation. This shows whether or not the resources required for the implementation of proposed alternatives will create difficulties for the existing economic realities.

Explanation of evaluation scores. "Low", "Medium" and "High" levels have been identified to evaluate the proposed policy alternatives, and these levels have been rated as 1, 2 and 3. It should be noted that since some statistical data could not be obtained, the evaluation is mainly based on comparative analysis and hypotheses.

Alternatives:

- **Alternative 1: Establish a regional development fund with direct assistance from state and international financial institutions;**
- **Alternative 2: Increase the impact of local governments on regional economic development decisions;**
- **Alternative 3: Application of differential incentive mechanisms, depending on the socio-economic differences between regions**

	ALTERNATIVE 1	ALTERNATIVE 2	ALTERNATIVE 3
Increased volume of gross output in the regions	2	3	3
Increased number of enterprises operating in the regions	2	3	3
Reduced level of	3	2	3

unemployment in the regions			
Increased level of investment in regions	3	3	3
Increased level of tax collection in the regions	2	3	3
Increased accessibility of social services and their improved quality	3	1	1
Level of compliance with current legislation	2	1	1
Viability of financial resources necessary for implementation	3	2	2
Total score	20	18	19

After the policy alternatives were evaluated based on the criteria that had been determined and points were collected, it became clear that although the points gained by all alternatives were close to one another, the first alternative, "Creating a Regional Development Fund with the support of state and international financial institutions" had gained 20 points and was regarded as more expedient than the others.

6. CONCLUSIONS AND RECOMMENDATIONS

One of the biggest obstacles hampering sustainable development of the Azerbaijani economy is economic and social inequality among the regions. Even the regions with developed infrastructure and economic activity seem too small compared to the capital Baku. The fact that regions remain passive in creating economic value and face difficulties in financing their costs results in the central budget being forced to allocate more resources to them. Another cause of the problem is the accumulation of many regional governance mechanisms in the central government. This eventually leads to the problems mentioned above, which, in turn, paved the way to serious differences in the living standards of the population.

As a result of the research carried out during the preparation of this policy paper, the following conclusions have been reached:

1. No industrial sector in the regions is as developed as the oil industry in terms of revenues. The lack of business opportunities creates inevitable economic and social differences between the regions;
2. Overall revenues of the regions are very small. In particular, the absence of tax revenues at the desired level makes local budgets dependent on the central one. One of the key reasons for the lack of tax revenues is the small number of businesses in the regions;

3. The regions are heavily dependent on the central government also in administrative terms. The lack of financial capacity of local governments deprives regions of the opportunity to address their problems in a more flexible manner;
4. The fact that regions lag behind the capital in terms of investment attraction further deepens the existing socioeconomic differences. Attraction of involvement to the regions through structural reforms and incentives can help address problems on the ground;
5. As is the case with economic indicators, there are differences in social performance among regions. In particular, the level of public services, education and health services leads to further stratification and problems such as migration and abandonment of villages.

International experience shows that the following should first be identified for a successful regional policy and development programs:

1. Preparation of mechanisms to determine the economic potential of the regions. This includes production opportunities, trade potential, supply of natural resources and so on. The identification of such indicators enables to measure the competitiveness of regions compared to others. This also allows the opportunity to identify what industrial enterprises would be more appropriate in a particular region;
2. Preparation of indicators to identify problematic regions with unfavorable natural and geographical conditions. This would make it possible to identify difficult situation regions and carry out favorable tax and investment policies in them;
3. Development of overall mechanisms and principles for the preparation of effective development programs for each economic region. Considering the specific capacities and conditions of each region, such development programs can lead to effective development of that region;
4. Preparation of clear prospects for those transferring their business to or investing in the regions. First of all, analyses and plans for future development of each region should be prepared and investment and tax incentives applied to them should be reflected in the legislation;
5. Criteria should be developed to assess the effectiveness of development policies being implemented. Accurate assessments through initial and subsequent reports can help to establish whether the activity is effective and to further improve its implementation mechanism. It should also be noted that one of the important conditions for both assessment and the implementation mechanism is to have accurate statistics.

It was established at the stage of assessment of alternatives that preference is given to the alternative on “establishing a regional development fund with direct assistance from state and international financial institutions” to reduce economic and social differences between regions. It is deemed important to take the following steps to implement this alternative:

1. The powers of municipalities should be expanded. It is critical for local governments to have more powers to function more efficiently. This should first of all mean the expansion of the legal status of municipalities. At the same

time, in order to eliminate parallelism in local governance it is appropriate to specify the division of powers between the executive authority and municipalities;

2. Financial capacity of municipalities should be expanded. The experience of developed countries shows that most of the state budget is consumed through municipalities. In some countries, the share of municipalities in total investment is over 80 percent. Since municipalities are well aware of problems, they are more likely to address them more efficiently and qualitatively;
3. The process of attracting grants and investment from international organizations and foreign markets should be simplified.

The acquisition of grants from international organizations is crucial both for enhancing financial resources and benefiting from the experience of these institutions. For this reason, it is very important to liberalize procedures for the acquisition of grants. It is also important to establish a strong judicial system to attract investment to the regions and adopt laws to protect investment and instill confidence in foreign investors.

The proposed alternatives generally aim to diversify the economy and increase business opportunities and investment in the regions. At the same time, we should also say that even if all of the proposed alternatives are applied, it will be impossible to eliminate inequalities between the regions overnight because the process of upgrading the regional self-governance system and the application of new economic mechanisms may take a long time. The establishment of a regional development organization, for example, the Ministry of Regional Development, could accelerate the process and ensure prompt interventions.