

AMERICAN UNIVERSITY OF ARMENIA

**INTERGOVERNMENTAL TRANSFERS IN ARMENIA: IS THERE A NEED FOR
REVISION OF FINANCIAL EQUALIZATION MECHANISMS?**

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Abstract

Currently small and financially weak communities in Armenia continue to face growing difficulties. The aim of the study is to look at and analyze the system of intergovernmental transfers in Armenia, mainly to study the “Law on Financial Equalization” and the need for its revision. The study uses quantitative and qualitative methods. Tools for collecting data include secondary and legal document analysis, statistical data analysis, and in-depth interviews. The current paper studies the role of equalization subsidies on financial viability of communities in Armenia, whether the existing system allocates sufficient resources to the communities in financial need, and helps to address the lack of financial resources. In addition, it tries to identify the impact of equalization subsidies on recipient communities provided based on the acting law, and the impact of possible amendments to the law on the community life in Armenia. Main conclusion is that insufficient financing of municipalities remains an issue. Furthermore, the acting law does not ensure harmonized development of communities; rather it hardly covers mandated responsibilities. In addition, suggested changes in the acting law will help to mediate polarization between communities with various financial capacities in Armenia.

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1. Introduction

The issue of unequal distribution of financial resources among communities has been a concern for many countries for decades. It became part of discussions mainly because of the growing tendency of social problems connected with it. Many scholars have studied the issue, particularly paying attention to the role of governments in it. Some authors have underlined the importance of grant allocations by central governments while others have stressed development of the local governments' autonomy in the coping with the issue.

Intergovernmental transfers play an important role in the allocation of financial resources among different tiers of governments. As it will be discussed further in the paper, one government may transfer spending power to another via grants. Those grants can be earmarked (or conditional, targeted for special programs), as well as discretionary (or general purpose, when the recipient may spend financial resources at its discretion). Many countries have developed financial equalization mechanisms in order to make intergovernmental transfers efficient to the extent possible. Some countries were more successful in the implementation of the financial equalization procedures than others were, which will be discussed in detail in the following sections.

The current paper will study financial equalization mechanisms in Armenia. Firstly, it will provide a brief background to the issue of intergovernmental transfers and equalization mechanisms in Armenia. Secondly, it will present a review of the studied literature. Thirdly, it will explain the methodology of the study and discuss its limitations. Then, the findings of the analyzed documents, statistical data and interview results will be reviewed. Next, interpretations and discussions of those findings will be deliberated. Finally, the conclusions and recommendations will be made.

2. Background

The current paper aims to review and analyze intergovernmental (IG) transfer system in the Republic of Armenia. In particular, to analyze the “Law on Financial Equalization” and identify its drawbacks, to look at implementation policies, and amendments of the law that are currently in the active process of preparation by the government. In addition, the paper intends to compare the existing system of IG transfers in Armenia with those in the countries, which practice a system of financial equalization (such as countries of South East Europe, etc.).

The system of IG transfers is directly linked to the issues of fiscal decentralization. The issue of decentralization of power in Armenia became relevant after the Soviet Union collapsed and independent republic began its transition from centralized way of government to some extent decentralized. In 1995 the country introduced a new system of territorial administrative division, the first “Law of Local Self-government” was adopted in 1996, the “Law on Budgetary System” in 1997, and the “Law on Financial Equalization” enacted in 1998. Afterwards, these laws underwent numerous changes and amendments.

The system of IG transfers is extremely important for financial viability of local governments. The Central Governments of the Republic of Armenia provide three types of transfers to the municipalities: subventions, subsidies (equalization grants) and other subsidies. Subventions in Armenia are provided rarely and they are targeted, whereas equalization subsidies have no specific direction. The allocation of equalization subsidies, which are a central part of the study, is based on the “Law on Financial Equalization”. Many local and international organizations (such as, World Bank, United States Agency for International Development, United Nations Development Program, Communities Finance Officers Association) supported Ministry of Finance and Ministry of Territorial

Administration and Emergency Situations in their decentralization efforts and had been actively engaged in drafting and subsequently amending the aforementioned law.

According to the law, IG transfers are provided in the form of subsidies to the local governments, which can spend them at their discretion. The total amount of subsidies for a given fiscal year is defined by the “Law on Local Self-Government” (Article 58) and shall be no less than 4% of consolidated budget of the penultimate year. However, the financial equalization procedures need thorough study in order to understand weaknesses and strengths of the law and recommend whether there is a need for improvement.

3. Literature Review

As was mentioned above decentralization of power and IG transfers are interconnected. After the collapse of the Soviet Union, many countries started to move towards political and fiscal decentralization, transferring some of their powers to lower tiers of government. Many scholars have started to look at the issues of fiscal decentralization in developing countries and the use of IG transfers to achieve this objective (Bahl and Johannes 1994; Treisman 1996; Freinkman, Kholodilin, and Thießen 2011).

Treisman (1996) in his article looks at development of relationships between central and regional governments, in post-Soviet Russia. He stresses that during early 1990s period some regions has received large net transfers while others have to pay large net taxes (Treisman 1996). Freinkman, Kholodilin, and Thießen (2011) have studied IG transfers and have not found negative associations of federal transfers between central and regional units. Moreover, they pointed out that there is no major differences in provision of IG fiscal arrangements between donor and recipient regions (Freinkman, Kholodilin, and Thießen 2011).

The main way of implementing IG transfers is through providing government grants and other transfers, either targeted (conditional) or general purpose (discretionary). The main

objective of equalization grants is to provide for uniform quality of public services by recipient sub-national governments with different tax collection capacities. However, distribution is often based on indicators of actual spending and actual tax revenue (Bergvall et al. 2006). Some scholars discuss two ways of equalization: the central government allocates resources via horizontal and vertical grants. Combinations of both methods occur as well (Bergvall et al. 2006; Alm and Boex 2008).

Some authors investigate the rationales behind the system of equalization, the inefficiencies in the system of providing grants by central government to municipal governments. Many of them focus their attention on failure to achieve equitable resource allocation, because of such effects as negative externalities and asymmetry of information in providing grants (Alm and Boex 2008; Le Houerou and Rutkowski 1996; Greco 2008). While others, point out positive sides of the equalization reforms in many: mainly developing and post-soviet countries (Bucovetsky and Smart 2006; Freinkman, Kholodilin, and Thießen 2011).

According to Mikesell (2003) “grants transfer spending power from one government to another” (Mikesell 2003, 519). In the relationships between central and local governments, grants can reduce problem, which occur because of region’s economic decline, compensate governments in the case of benefit spillovers. Such grants help higher tiers of government with stronger revenue capacities to provide funds to lower tiers. Governments may use different types of grants, such as categorical and block grants. Categorical grants are designed to finance special purpose programs, and block grants usually are provided to general-purpose governments for spending in broader functional areas.

Many authors look at IG transfer system as a means to contribute the improvement of horizontal or vertical equity in such countries as Northeast Thailand, Canada, Australia (Wongpredee and Sudhipongpracha 2014; Boothe and Kryvoruchko 2004; Dahlby and Wilson

1994; Smart 2007). Wongpredee and Sudhipongpracha (2014) study the IG transfer system in Northeast Thailand. The authors use quantitative and qualitative evidence from Northeast Thailand provinces in order to show differences between theory and implementation of the law. The aim of their study is to evaluate IG grant allocation criteria since decentralization began. The panel data from 2009-2011 in the region has showed that IG transfers in the region has ended up increasing horizontal fiscal imbalances.

Boothe and Kryvoruchko (2004), Dahlby and Wilson (1994), Smart (2007) study Canadian IG transfer system. Boothe and Kryvoruchko (2004) observe the design of IG transfer system in Australia and Canada. In both countries, IG transfers are designed to address horizontal and vertical imbalances of subordinate regions. The effectiveness of equalization grants according to the authors depends on the design and specifics of conditions (for example macroeconomic) in the country.

Dahlby and Wilson (1994) study IG system in Canada and the optimization of equalization grant system in order to minimize social costs in the country. Smart (2007) also looks at equalization transfer system in Canada. He discusses horizontal equalization grants, and derives to a conclusion that these transfers create conflicts between efficiency and equity analogues, which exist in personal tax system. The formulas are commonly used in many countries, in order to reduce such incentive problems.

Many countries use formula-based grants in fiscal transfer system. Countries while moving towards decentralized fiscal policy create formulas based on several factors. Struyk (2000) and Romanik (1999) study different factors/components of such transfer formulas. Struyk (2000) discusses the case of allocation of financial transfers to Poland. The problem that he addresses concerns the use of formula in allocation process. The findings of the study suggest that investments are needed for more populated urban, urban-rural areas.

Romanik (1999) looks at equalization transfer system in Romania, and discusses the Law of 1999 on Local Public Finance. The author provides normative and empirical evaluation of the law. In order to evaluate the law, Romanik (1999) sample budget data from five countries (Poland, Hungary, Bulgaria, Slovak Republic, and the Czech Republic) and desirable ten criteria for a fiscal transfer system. In this study, the author simulates two alternative scenarios for equalization grants and two alternative scenarios for revenue sharing, and makes a number of recommendations based on the results of her findings. This include making more equitable revenue sharing system, improving targeting of equalization grants, ensuring implementation of equalization grants distribution according to law by county councils, creating regional assistance program, in order to adjust fiscal imbalances, reduce interjurisdictional externalities, enhancing of internal markets etc.

Levitas (2010), Hankla (2009), and Grazzini and Petretto (2006) acknowledge the political implications of equalization transfers in IG fiscal system. Levitas (2010) analyses decentralization process and IG fiscal system in Macedonia. The first goal of the study is to present IG transfer system evolution since 2005, during three years, the other goal is to provide some suggestions for improving the equity, efficiency and effectiveness of the IG system in the country. The author suggests based on the simulation model that in order to improve fiscal conditions of the subnational regions it would be better to raise the share of personal income tax of the region. In the case of equalization grants, the simulation model results have suggested that all local governments, which have weak tax bases will benefit from it.

Hankla (2009) studies whether fiscal decentralization is beneficial for government or not, and in what cases it may be beneficial. Based on the theory and experience of previous findings he discusses the effectiveness of decentralization. One of his findings is that steady and unconditional central financing is necessary for subnational governments. He states that

regardless of the type of transfer having fiscal resources to ensure implementation of policy responsibilities is significant for subnational governments. Grazzini and Petretto (2006) study equalization grants in connection to tax policies. The conclusion, which they derive, is that government needs to improve the degree of coordination between central and local public finance.

3.1 Fiscal Equalization by Countries: Albania, Bulgaria, Croatia, Georgia, Latvia, Lithuania, Macedonia, Moldova, Serbia, Slovenia, Romania

During last decade in many countries the importance of fiscal equalization increased due to a number of reforms. These reforms aimed to promote decentralization. National governments have aimed to reduce their role in managing specific problems on individual local level. Besides administrative logic, governments have intended to minimize the level of provisions of public services, thus, in the decision of IG fiscal relations to redesign the system, political pressure also had place. Because of easy management of fiscal equalization, such reforms in the process of decentralization were likely to gain political support more than, for example, increasing efficiency in providing services.

In IG relations, main objectives of fiscal equalization are to manage vertical and horizontal imbalances in expenditures and revenues between governments. Some factors play a crucial role during the development of fiscal equalization system. For example, the need for financial equalization in providing minimum level of mandatory public services should be based on the difference between functions and unit cost. In addition, the size of local governments is also very important, as smaller municipalities may need support. In some cases, central cities may provide services to neighboring municipalities, hence creating spillover effect, where equalization grants might be important in reducing external costs due to territorial fragmentation of local municipalities. Inequalities might arise also because of the ability/inability of revenue-raising capacity of the municipality. Nevertheless, fiscal

equalization scheme should not take into account such factors as costs originated due to inefficient service delivery or higher local demand (Péteri 2006).

All aforementioned countries have begun reforms towards decentralization mainly in last decade of the twentieth century. Some of them started the reform process already in the early years of the 1990s, while others turned to the implementation of reforms after a decade, in early 2000s. One of the main documents in this process is the European Charter of Local Self-Government. The following section will go through the reform process in many post-soviet countries one by one, and discuss main features and problems that countries face in the implementation processes.

3.2 Albania

Brahimi et al. (2013), Muollari and Katro (2012) Schroeder (2007), and Shehu (2006) discuss the equalization mechanisms in Albania. In addition, they look at the process of decentralization, under which modifications connected with financial equalization happened. The authors elaborate on how and when the changes in the system took place.

Schroeder (2007) discusses the IG transfer system in Albania. The government of Albania undertook several actions to move towards more decentralized fiscal policy. The Albanian government has developed unconditional transfers system, which is formula-based and transparent. The formula is based on four factors, which are equal shares, population size, comparative economic advantages, and the length of roads in the regions. The author has provided his evaluations chronicled.

Muollari and Katro (2012) argue that although the system of financial equalization is transparent, reasonably equitable and readily verifiable, it still unstable and unpredictable. Furthermore, Brahimi et al. (2013) accept the considerable move towards creation of core legal bases for fiscal decentralization in Albania. However, according to them further

specification of competencies, fragmentation, and fiscal decentralization need to be identified.

3.3 Bulgaria

Stoilova (2009) and Nenkova (2014) look at the changes in the IG relations in Bulgaria. The authors underline the role of financial equalization transfers in the decentralization process. Furthermore, although authors agree on considerable improvements in the system of IG transfers, they consider that it has to overcome challenges, such as decentralization of revenues for local authorities, and strengthening stability of the fiscal transfer system.

According to Stoilova (2009) IG transfers, which have three components (the general supplemental subsidy, the general equalization subsidy, and the capital investment subsidy) still play a dominant role in the financing process of the local governments. Moreover, Nenkova (2014) states that such grants constitute major part of the local governments budget. Thus, it makes local authorities highly dependent on central governments.

3.4 Croatia

Đulabić and Škarica (2012), Alibegovic, Slijepčević, and Kordej-De Villa (2014), and Bajo and Bronić (2007) study fiscal decentralization in Croatia. The authors state that since its independence (1991) Croatia has undertaken a number of reforms for achieving more decentralized and participatory fiscal system. However, it still needs to address vertical and horizontal disparities in mitigating fiscal imbalances.

Đulabić and Škarica (2012) and Bajo and Bronić (2007) discuss the local finance system and establishment of four special authorities areas (special national concern areas, hill and mountain areas, local units on the islands that have entered into agreements to finance capital projects and the so-called decentralization of the financing of local government units (Bajo and Bronić 2007)). Nevertheless, according to Bajo and Bronić (2007) clear

distribution of authorities and responsibilities for given functions financing, and revenue distribution still needs to be settled. Alibegovic, Slijepčević, and Kordej-De Villa (2014) in their study, emphasize the need for better solutions of the minimum financial standard, which is part of the financial equalization grant's volume calculations.

3.5 Georgia

Many authors, who have studied decentralization process in Georgia, consider that the process have started after 2000s (Murgulia, Gvelesiani, and Toklikishvili 2011; Boex, Martinez-Vazquez, and Schaeffer 2006; *Georgia - Public Expenditure and Financial Accountability (PEFA) Assessment 2012 2013*). They believe that crucial point in the process were 2005-2006 years, when the governments have enacted a number of important laws. They were designed for ensuring economic stability, institutional development and administrative-territorial development of local self-government.

According to Boex, Martinez-Vazquez, and Schaeffer (2006) changes in the “Law on Local Self-Government” have stressed the role of equalization transfers for reducing horizontal fiscal imbalances between communities. They discuss the gap-filling approach of the equalization transfer, as well as the system of grant allocation, as there are three levels of governments in Georgia (central, rayon and local). In their study, Murgulia, Gvelesiani, and Toklikishvili (2011) state that the provision of IG transfers remains unclear. They state that Georgian governments need to deliver more commitments, and ensure political level of decentralization process. It will aim at improving transparency, participation and accountability of Georgian public sector.

3.6 Latvia

Gross and Bruna (2012), and Pūle (2013) analyze the financial system of Latvian municipalities. They look at the local governments revenue resources. The authors agree that

one of the most important types of revenues in the reduction of fiscal imbalances between communities is the financial equalization mechanism.

Pūle (2013) in the course of examining inclusion of corporate income tax in the revenues of municipalities, refers to the equalization fund revenues. According to the author, equalization grant is implemented through the financial equalization fund of the local government, and it takes into account revenues from taxes and local needs that are based on the structure of the population. Such transfers contribute to the development of regions with lower level of index value (referring to the territorial development index). However, the author stresses the importance of achieving independence of local governments' budget, and that redistribution of finance via equalization mechanisms does not contribute to the strengthening of the community's financial stability. In their turn, Gross and Bruna (2012) believe that changes in the current equalization system, should be based on national priorities and development directions.

3.7 Lithuania

Mingelaite and Novikevicius (2010) and Davulis (2007) provide an analysis of the financial system in Lithuania. They study local-government finances and the decentralization process in the public economic sector. Authors also refer to the correspondence of the Lithuanian laws with the European Charter of Local Self-Government (1985).

According to Mingelaite and Novikevicius (2010) as substantial part of the municipal budget is formed based on the subsidy from the state budget, it is important to improve self-sufficiency of local budgets. Furthermore, Davulis (2007) states that despite the fact that Lithuanian legislation corresponds to the European Charter on Local Self-Government, it still needs to improve financial capacities of local governments. Author also points out that a certain share of the financial resource transfers is redistributed from the certain percentage of

the income tax from not all municipalities, but several, which are considered donor municipalities.

3.8 Macedonia

In analysis of local government finance system in Macedonia Rockel (2008) and Levitas (2010) discuss IG transfers system of the country. Both authors look at the grants from central to local budget and the composition of the local government revenue. They state that as such equalization system in Macedonia is relatively poor.

Levitas (2010) based on the statistical data, shows that there is a considerable difference in the revenues within and outside of Skopje and that equalization system does not mediate disparities between revenues of capital and other jurisdictions. Moreover, Rockel (2008) states that prior 2005, there were no any law regulating financial equalization of local governments. In addition, due to insufficient funds, it was difficult to create appropriately functioning financial equalization system. Thus, lack of objective and mismanagement may be followed in the equalization mechanisms of Macedonia.

3.9 Moldova

Casian and Busmachi (2007), and Manole (2014) study financial autonomy of local governments in Moldova. According to them main portion of local budget constitutes transfers from central government and Rayons. Besides, share in taxes represents smaller part and own revenues play no role.

Casian and Busmachi (2007) have considered that financial system in Moldova need improvements in order to increase efficiency in budget transfers, make finance flows transparent, improve reporting quality, and ensuring effective management. Whereas, Manole (2014) based on the assessments of the new funding system built on the new formula, which was introduced in 2014, states that it enhances autonomy of local governments and fosters financial decentralization.

3.10 Serbia

Brnjas and Dedeic (2011), and Monastiriotis (2011) examine IG transfer system of Serbia. The authors focus their attention on the fiscal decentralization of the country and analyze system of local-government finance. They conclude that further broadening and restoration of administrative and fiscal competences will lead to the sustainable development.

Monastiriotis (2011) states that in the process of decentralization it is important to admit importance of central government decision-making. The relatively weak local governments and institutions, which are still in the process of development, may hinder matching between local policies and fiscal capacities. In fact, financial inequalities in financial capacities require development of more equalization mechanisms. Brnjas and Dedeic (2011) also emphasizes the role of financial position of local government, and their level of (un)equalization.

3.11 Slovenia

Pevcin (2012), Oplotnik and Brezovnik 2004, and Oplotnik, Brezovnik, and Vojinovic (2012) in their researches focus on the local government finance system in Slovenia. They study to what extent the system complies with the European Charter of Local Self-Government, and to what extent the funding of local governments provides sources for covering their expenditures. The conclusion they arrive is that depending on the size of municipality the funds may be a smaller or extra amount.

Oplotnik and Brezovnik (2004) assess the situation in the country and provide comments and suggestions to the implementation of the system. The financial equalization in the country is used as a tool for keeping horizontal balance between municipalities. Their findings suggest that considerable amount of total revenue of small municipalities is based on equalization grants.

Pevcin (2012) discusses the issue of expenditure calculation and the financial equalization funds impact on the financial autonomy of municipalities. In order to achieve equalization, expenditure calculation equation included specific factors for addressing diversity in municipalities. However, because of equalization funds, financial autonomy of local-governments considerably reduced. Furthermore, according to Oplotnik, Brezovnik, and Vojinovic (2012) considerable amount of local government budget constitutes direct funding from the national level, by violating self-sufficiency of an individual municipality.

3.12 Romania

Gómez et al. (2007), Guess (2007), Gheorghe (2008), and Dragoman (2011) study Romanian fiscal decentralization process, particularly the role of financial equalization in that process. They analyze the extent to which changes in the administrative system and governmental mechanisms impact on reducing regional financial inequalities. The conclusion they derive is that despite considerable improvements in the IG transfers system, some problems remain.

Gheorghe (2008) argues that fiscal equalization system in Romania gradually has become more complex. The formula (which contains four variables) although has improved since its introduction by avoiding negative incentives in terms of revenue collecting, may undermine objectivity and transparency of the project. Moreover, according to Gómez et al. (2007) the equalization system in Romania emphasizes equalization within the county, rather than across counties, thus leaving similar (in terms of expenditure needs and fiscal capacities) local governments at different levels.

3.13 The “Law on Financial Equalization” in Armenia

In order to continue the study, it is useful to discuss the equalization law in Armenia, and provide information about its structure. In Armenia, the law was enacted in 1998. In 2008 the draft for a new law was prepared, however, it was not adopted by the parliament (passed

only one reading). After the first hearing in the National Assembly, a draft version of the new Law on Financial Equalization was postponed and then removed from the agenda and therefore the 1998 law is still in force. Recently the government undertook another attempt to bring the bill back and revive it. Currently there is a slightly revised version of the bill that was declined in 2008, which was reviewed by the Ministry of Finance and Ministry of Territorial Administration and Emergency Situations. Community Finance Officers Association, a non-governmental professional association is closely involved in the development of the bill.

The advantages of acting law is that it is simple, because it has only two factors, and it is transparent, which means all procedures can be followed easily, and there is no political factor in it. However, many analysts have identified a number of shortcomings. They notice that it does not serve its primary goal, which is to provide equitable resource allocation to the municipalities (Movsisyan 2007; Tumanyan et al. 2012). For example, big regions receive more equalization transfers, than the small ones, based on the number of population.

To summarize this section, in many countries financial equalization grants have been delivered in the scope of the financial decentralization process (such as Albania, Bulgaria, Croatia, Lithuania, Serbia, and Romania). The aim was to reduce existing inequalities in fiscal capacities between communities with different fiscal resources. Some countries have attained improvements in the system (for example Bulgaria, Moldova and Romania), while others need to improve fiscal autonomy of weak communities and reduce the role of central government.

Armenia, similar to those countries, also has undertaken reforms in the financial equalization mechanisms. The comparable issues connected with the mediation of fiscal imbalances between communities may be followed. In addition, the acting law provides financial resources to weak municipalities only for covering mandated responsibilities.

According to some authors, it is not enough for raising “harmonized development” of those communities in need stated in the law, which is an important requirement of the European Charter on Local Self-Government.

4. Methodology

This paper aims to study financial equalization procedures and discuss the current legislation of the Republic of Armenia regulating the allocation of subsidies from the central government to municipalities. The objective is to analyze the strengths and weaknesses of the acting law on equalization and expected outcomes of possible amendments, as well as to look at the extent of unequal distribution of finances mediation among bigger and smaller municipalities. Thus, it will be built on the following hypothesis:

Hypothesis: The amendments in current “Law on Financial Equalization” will help to reduce polarization between communities with various financial capacities in Armenia.

Research questions, which derive from abovementioned hypothesis, are the following:

RQ1: What are the main reasons for proposing changes in the “Law on Financial Equalization” in Armenia?

RQ2: How do financial equalization mechanisms affect fiscal capacities of communities in Armenia?

RQ3: What are the expected outcomes of suggested changes?

The research is conducted using both empirical and theoretical data. Quantitative as well as qualitative methods are used in order to study the financial equalization procedures in Armenia. The data collection tools include legal and secondary documents analysis, statistical data analyses, and in-depth interviews.

Legal and secondary documents analysis is based on the review and content analysis of the laws of Armenia on the “Financial Equalization”, on “Budgetary system” and on “Local Self-Government”, as well as it briefly discusses European Charter of Local Self-Government. In addition, it studies laws of eleven countries discussed in the Literature Review section and shows similarities/differences between legal procedures, in order to get understanding of the international experience in the development and implementation of

financial equalization. It also looks at the type of the legal document that controls financial transfers between central and lower level governments, as there is no particular law on the financial equalization in some countries.

Statistical data analysis includes analyses of the data on equalization subsidies, available on the web pages of the Ministry of Finance and Ministry of Territorial Administration and Emergency Situations of Armenia. In addition, figures from the Law of the Republic of Armenia on the State Budget of 2015 are discussed. The purpose is to show the current allocation of resources between communities based on the acting law.

Additionally, the present paper provides insight on the share of equalization subsidies in the state and local budgets during last five years. For that purpose, statistical data, available at the Ministry of Territorial Administration and Emergency Situations web page on the revenues of communities are used. The years studied include the period from 2010 to 2014, as the revenues for the year of 2015 are not available yet.

Eleven *in-depth interviews* were conducted. All interviews were semi-structured and lasted from 40 to 50 minutes. Interviewees included key contributors to the first draft law brought to National Assembly in 2008. One respondent was from the Community Finance Officers Association in Armenia (CFOA). The aim of the interview was getting full understanding of main components of the amendments in the law back then, in 2008 and nowadays, as well as to find out the respondents' position towards those changes. In addition, interviews were conducted with representatives of the Ministries of Finance, and Territorial Administration and Emergency Situations, in order to track the development of the process of preparation of amendments. In addition interviews pursued the goal of clarifying the position of government representatives towards effects that those changes may have on the communities and to find out their suggested possible solutions to the issue of financial

equalization in Armenia. Two representatives from the Ministry of Finance, and one from the Ministry of Territorial Administration and Emergency Situations were interviewed.

Further interviews were conducted with members of National Assembly, particularly with the two members of Standing Committee on Territorial Management and Local Self-Government. In addition, to have an understanding of the community representatives towards the issue of financial equalization and possible amendments to the law, interviews were organized with high-ranking officials from Yerevan municipality, town of Ashtarak, and village of Nor Erznka. Three representatives from Yerevan municipality included financial and legal departments' representatives: as a capital city, which receives the most of the equalization subsidy. Similarly, respondents were from Ashtarak, as an example of another, but a smaller city, and from Nor Erznka, as an example of a village. For last two interviews, field trips were organized. One interview also was organized with the representative of the Municipal Lawyers Association.

4.1 Limitations

Limitations of the study are connected with the postponement of submitting the amended law to the National Assembly. The process of preparation has started during 2014 by the Ministry of Territorial Administration and Emergency Situations and Ministry of Finance. Due to extended discussions, the draft law is still in the development process and although has a preliminary approval from the National Assembly, it is not available for public, yet. As a result it was not available for this study as well.

Another limitation is connected with limited time and resources, so only two communities outside Yerevan were possible to visit and conduct interviews with their representatives. For more inclusive understanding of the issue, it would have been useful to visit at least ten cities outside the capital and 20 villages. In addition, it would have been

useful to take into consideration social capacities of the communities and their disposition in relation to the capital during the selection process.

5. Findings

5.1 Legal document analysis

The following descriptors were identified for making analysis in the legal documents of countries discussed in the current paper: the type of the subsidy: whether it is horizontal or vertical or both; whether it is discretionary (unconditional) or earmarked (conditional), and on which factors the formula is based.

Table 1 summarizes findings of the paper concerning descriptors mentioned above.

Table 1: Types of equalization subsidies by countries

Country	Type	Vertical	Horizontal	Earmarked (conditional)	Discretionary (unconditional)	Formula
Albania		✓	✓	✓	✓	4 factors
Bulgaria		✓		✓	✓	differs
Croatia		✓	✓	✓	✓	No strict formula
Georgia		✓		✓	✓	4 factors
Latvia		✓	✓	✓	✓	No formula
Lithuania		✓	✓	✓	✓	No formula
Macedonia		✓		✓	✓	No formula
Moldova		✓		✓	✓	share
Serbia			✓	✓	✓	8 factors
Slovenia		✓	✓	✓	✓	2 criteria
Romania		✓	✓	✓	✓	4 variables
Armenia		✓		✓	✓	2 factors

The main picture of the Table 1 suggests that subsidies are mostly vertical, i.e. the governments provide them. Only some of the countries have a horizontal type of subsidies, where communities also provide grant allocations: most affluent communities are forced to allocate part of their revenues to the less affluent communities. In addition, all countries use both earmarked and discretionary types of subsidies. Besides, the formula differs from country to country. Some countries do not have a formula (such as Latvia and Lithuania, Macedonia), yet, some others have, but their formula is not efficient enough, so there is a room for improvements. Below, countries are presented one by one, as in the Literature Review section, and more detailed information is provided.

5.1.1. Albania: Under the implementation of the National Decentralization Strategy, Albania enacted the Law No. 8652 “On Organization and Functioning of Local Governments” in 2000. This law regulates financial equalization mechanisms in Albania. Based on the law, governments were divided into two groups: municipalities and communes, and regions.

Law on Local Governments has specified several types of transfers. Besides shared taxes, it also has introduced unconditional (general) transfers and conditional (earmarked) transfers. The aim of the introduction of unconditional transfers was to provide discretionary funding sources to local governments, in order to support autonomy objective (Shehu 2006).

5.1.2. Bulgaria: The main legal basis regulating IG relations in Bulgaria is the Constitution (last amended in 2007), and the Local Self Government and Local Administration Act (enacted in 1991, last amended in 2011). In Bulgaria, new equalization mechanisms also were introduced in the scope of the decentralization strategy in 2001-2002. Important components of the new system were two equalization mechanisms: the supplementary subsidy and the equalizing subsidy. Supplementary subsidies aimed to fund delegated services to local governments by the state and were a mix of a general grant and

shared taxes. Whereas, equalizing subsidies were designed to provide a minimum revenue level for local discretion services (Savov 2006).

5.1.3. Croatia: Local and regional self-government in Croatia is regulated by the Constitution of the Republic of Croatia (1990) and it has a two-tier system of subnational government. The Law on Local and Regional Self-government Financing regulates local government's finance system. One of the sources of the revenue for local governments is equalization transfers for decentralized functions. They are ensured to be financed from the state budget and designed to cover public expenses in the areas of primary, secondary education, healthcare, and social welfare. Such transfers, grants, and subventions are designed in the special way that they are used to fund only poor fiscal capacity self-government units.

In order to calculate grants for counties, the factors such as the number of inhabitants, the average revenue per capita and the average expenditure on capital programs are taken into consideration. For the calculation of grants for municipalities and cities to aforementioned factors central governments add additional factors. Those factors include the balance of material expenditure, the rationale for system function execution and the corrective variable, which occurs during the transition to the new model of calculation of grant. These grants aimed to fund obligatory expenditures outlined by the law (Alibegović 2006).

5.1.4. Georgia: According to the organic law, fiscal equalization mechanisms in Georgia are allocated based on the formula. This formula since its introduction in 2006 underwent several changes, mainly to improve objectivity and transparency in the horizontal allocation of grants among sub-national governments. For every municipality equalization transfer, its volume depends on the difference between potential expenditures and revenues (Tengiz Shergelashvili and Narmania 2006).

5.1.5. Latvia: Equalization mechanisms were introduced in Latvia already in 1992, taking as a base the experience of the Denmark. The Law on Municipality Finance Equalization was enacted in 1995 for the period of one year and was approved yearly for subsequent years. In 1998, a long-term Law on Equalization of Local Government Finances had been adopted.

According to the law, central governments by taking into consideration economic and social capacities of local governments should provide local governments with equal opportunities to perform their functions delegated to them by the legislation. In addition, finance equalization should anticipate partial equalization of the finances, in order to boost local government independence and initiative in forming their financial resources. In addition, it should provide protection to those financial resources (Gross and Bruna 2012).

5.1.6. Lithuania: In Lithuania, a considerable part of municipal budgets comes from the central budget in the form of subsidies. They have three types: general subsidies, compensation of general subsidies and special target subsidies. The calculation procedures, approval and the transfer of subsidies are presented in the Law on Methodology of Municipal Budget Revenue Estimation of the Republic of Lithuania. The size of the subsidy for the self-governing institution for a relevant financial year is approved by the Law on Approval of the Financial Indicators of the State Budget and Municipal Budgets.

Subsidies aim at firstly equalizing of the income formed from the taxes, the differences of the structure of expenses. Secondly, at carrying out state functions delegated to the self-governing institutions, general education functions (for children, youth and adults). Thirdly, at the implementation of Government and Seimas approved programs. Fourthly, at the compensation of the changes in the incomes and expenditures of municipal budgets, because of new decisions passed by the Government and Seimas (Davulis 2007).

5.1.7. Macedonia: Law on Local Self-government was enacted in 1995 in Macedonia. It underwent considerable amendments in 2002, which aimed mainly to correct financial deficiencies. In 2005, a special reform package was introduced aimed at improving three processes: transfers from central to the local level in the areas of competencies, civil servants, and other state employees, and funds.

Local self-government consists of three groups: city-municipalities, village-municipalities, and municipalities in the city of Skopje, and the city itself. The Constitution and the Laws on Local Self-Government, on Financing Units of Local Self-government, city of Skopje, and other similar laws control fiscal autonomies of municipalities. Central governments provide grants to local governments in the form of earmarked grants, block grants, capital grants, and grants for delegated competencies (Yusufi 2006).

5.1.8. Moldova: In Moldova, public administration has been divided into two levels: towns, communes and villages at the first level, and municipalities and ‘*rayons*’ at the second level. The law, which regulates the territorial administration of the country, is the Law nr. 764-XV of 2001. In addition, laws no. 397-IV of 2003 on Local Public Finance, and 1163-XIII of 1997 on Tax Code regulate equalization mechanisms in Moldova. The legislation provides a considerable autonomy (also fiscal autonomy) to the local authorities, which have been granted with delegated responsibilities in addition to a number of direct competencies.

In order to equalize local budgets, the Republic of Moldova started to use transfer mechanisms. These transfers were made based on a formula and central governments allocate grants to the second level of local government authorities, and they make financial provisions to the first level of local government authorities. They are also two types: general transfers, which are based on the difference between anticipated revenues and expenditure needs, and special allocations. In order to fulfill objectivity criteria, IG finance system in Moldova is incorporated in the formula (Veverita 2006).

5.1.9. Serbia: Local government finance system in Serbia has been developed since 1994. The aim was equalization of expenditures based on objectivity criteria. During 2005-2006, The Law on Local Government Financing was drafted, which aimed at increasing of transparency, stabilizing and increasing the predictability of the IG system. In addition, it was designed to improve horizontal equalization, improvement of institutional arrangements between central and local governments, as well as strengthening of the fiscal autonomy of local governments.

Three basic laws regulate local finances: Laws on Local Self-government, on Budgetary System, and on Public Revenues and Expenditures. Sources of revenues according to the Law on Local Government are three: own revenues, revenues from shared national taxes, and a share of revenues assigned to local governments, based on unique criteria (grant funds). The Republic transfers grants to the local governments via general grant funds (aimed at accomplishing horizontal and vertical balance objectives), and equalization grant funds (provided only to those municipalities that are below the average population density, as well as average level of development) 2 criteria: area & population density; level of development, 8 factors. (Stipanovic 2006).

5.1.10. Slovenia: The Law on Financing of Municipalities Act of 2007 (ZFO-1) regulates the local government financing on Slovenia. According to the law, municipalities receive funds based on the appropriate expenditure formula, which is aimed to cover municipality expenditures defined by the law. The underlying idea is that resource proportionality to the tasks is the basis for meeting financial needs of local governments (Oplotnik, Brezovnik, and Vojinovic 2012).

Slovenia has two tiers of local government: municipality and region. The state may allocate grants to municipalities in the forms of general and specific grants. In order to fulfill investment and/or current expenditures, municipalities may also receive specific grants.

General grants are obtained based on the financial adjustments from the state budget calculating own revenues of the municipality and the amount of appropriated expenditures per capita (Repar 2006).

5.1.11. Romania: Romania is a unitary state; it consists of sub-units counties (judet,e) and the capital city Bucharest. Such division is based on the Constitution (1991) and the Law on Local Public Administration. In 1997, a new system, which included separation of the country into regions, was proposed. The revenues of local budgets consist of own revenues (from taxes, contributions, charges, etc.), shared amounts from some of the state budget revenues, subsidies (from the state or other budget), and sponsorships and donations.

Equalization funds are under the discretion of central authorities and distributed based on the formula. This formula includes two factors: fiscal capacities of the county (with the relative weight of 70%) and its jurisdictional land area (relative weight 30%). From this fund, the county receives 25%, and the remaining part it should distribute also applying formula, which is calculated based on the local fiscal capacities, population, land area, and “other factors” determined by the county council. The relative weights for the fiscal capacities and land area are 30 % for each, population 25%, and “other factors” 15% (Dragoş and Neamţu 2007; Dragoman 2011).

5.1.12. Armenia: The concept of the equalization according to the acting law is the following: “Financial Equalization grants are given to weak municipalities to support the harmonized development of the municipalities and to assist them in provision of minimum expenditures. Financial Equalization is the minimization of financial capacity differences among municipalities in the process of fulfillment of mandatory responsibilities of the local self-government bodies.” (National Assembly 1998).

According to the acting law, municipalities are divided into two groups, those, which have less than 300 people, and those, which have more than 300 people. In addition,

government base calculations of the amount of subsidy on factors “a” and factor “b”. Factor “a” is based on the level of personal and income tax per capita of the municipality, and factor “b” is based on the number of population in the municipality.

The draft law of 2008 has suggested additional factors to the law, in order to mediate unequal distribution. Those factors are scale factor, provision of public transportation, the quality of services provided by the municipality, the altitude, the number of settlement inside the community, and population age. However, because of complexity of the formula and other political factors the new draft law was removed from the National Assembly’s agenda. Later, in 2014 the new phase of preparations was undertaken, as it was mentioned in previous sections.

In addition, provision five of the article nine of the European Charter of Local Self-government (which Armenia signed in 2002) states that governments need to protect financially weak communities. Besides, potential financial resources should be designed in the way that will correct effects of the unequal distribution (Council of Europe 1985). What's more, the report by Monitoring Committee from the 26th Session of the Chamber of Local Authorities on Local Democracy in Armenia held in Strasbourg in March of 2014, clearly states shortcomings of the law. According to point 6.j of the report, Armenia does not comply with the appropriate financial equalization mechanisms (Article 9.5 of the Charter); additionally there is a lack of any regulatory law on grant allocations of other than equalization subsidy types of state transfers (Mermagen 2014).

5.2 Statistical data analysis

In the “Law on the State Budget” for 2015 year, the total amount for allocation of Grants is 134,483,565.4 thousand AMD, from which grants allocated to other tiers of government constitute 131,289,347.0 thousand AMD. This includes such grants as

subventions to the lower tiers of governments (9,032,463.4 thousand AMD), “current grants” to the state and community non-profit organizations (19,407,671.8 thousand AMD), “other current grants” to communities (4,300,685.0 thousand AMD), etc. A substantial part of grants is allocated to “other current grants” 45,954,184.0 thousand AMD. The allocation of finances for financial equalization based on the “Law on Local Self-Government” constitutes 44,018,692.6 thousand AMD, which is 32.73 percent of the total amount allocated for grant, and 33.52 percent from the grants allocated to other tiers of governments. The amount allocated to each community is based on the formula presented in the “Law on Financial Equalization”.

According to the “Law on State Budget of 2015”, and based on the formula, Yerevan is the main recipient of the equalization subsidy. It constitutes 12,267,763.3 thousand AMD, which is 27.86 % of the total amount. Considering that, there are 915 communities in Armenia, which constitutes considerable amount. Furthermore, if we group communities according to marzes, small marzes, such as Vayots Dzor, Aragatsotn, Ararat and Tavush together receive less than Yerevan in total (9,500,959.5 thousand AMD). The argument may be that Yerevan needs that money, as it is the most densely populated community, and its expenses are more than in any other community. However, the counterargument is that Yerevan has diverse sources of revenues, whereas others are limited in that sense. Based on the recent amendments in the law, the communities which because of the small number of population have received less than two million subsidy, now should receive three and a half million AMD, as it is the lowest amount which should be allocated to the community with population less than 300 people.

The statistical data have shown that there is a difference between equalization subsidies to the villages and towns. Forty-nine towns receive 25,316,025.1 thousand AMD, which is 57.5% of the whole amount, whereas 866 villages receive 42.5% of the total amount

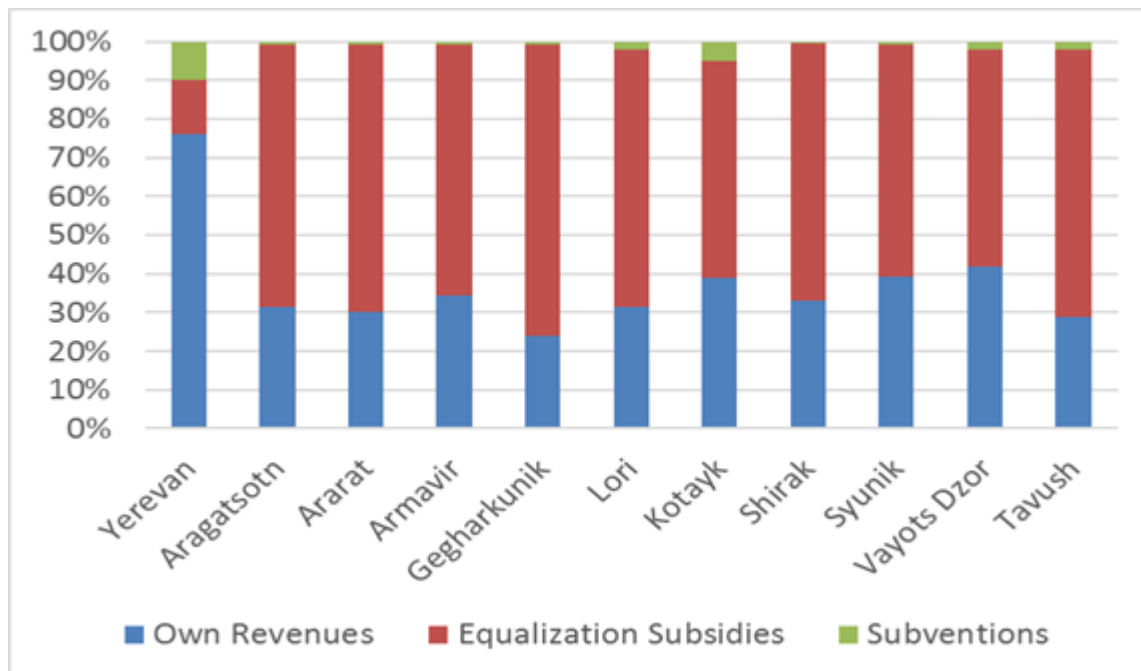
that is less than the half of the allocated resources. Main towns of Armenia: Yerevan, Gyumri, and Vanadzor receive 15,399,865.7 thousand AMD, which constitutes 73% of the amount distributed to the towns. Thus, only remaining 27% goes to other 46 towns. The average for towns constitute 516,653.6 thousand AMD with Yerevan and 271,838.8 thousand AMD without Yerevan. Moreover, for 866 villages, the amount of equalization subsidy is small.

The aforementioned data have shown that financial equalization subsidy based on the statistical figures does not provide sufficient support to the financially poor communities of Armenia. Furthermore, communities receive such equalization subsidy without any effort, which may diminish the autonomy of the community and does not provide incentives for development and increase of self-determination. In addition, the statistical data, on which the formula is based, represents the amount, which the central government should allocate to the community. It does not assess the real need of the community, which includes mandated responsibilities of the latter.

Another issue that should be considered is that the aim of the financial equalization is providing support to the communities for executing their mandated responsibilities. However, figures of collected taxes (factor “a” in the formula) for calculation of equalization subsidies are based on the previous budget year numbers provided by the authority of the community. Moreover, during recent years the number of population of the community (factor “b” in the formula) was based in some cases on the number provided by the statistical service, in other cases on the number provided by the state register. Thus, such figures may be inaccurate, yet the size of the equalization subsidy is highly dependent on them.

In order to understand the size of the subsidy in the municipal budget following figures were constructed.

Figure 1: Shares of Equalization Subsidies in Total Budget by Marz, 2014



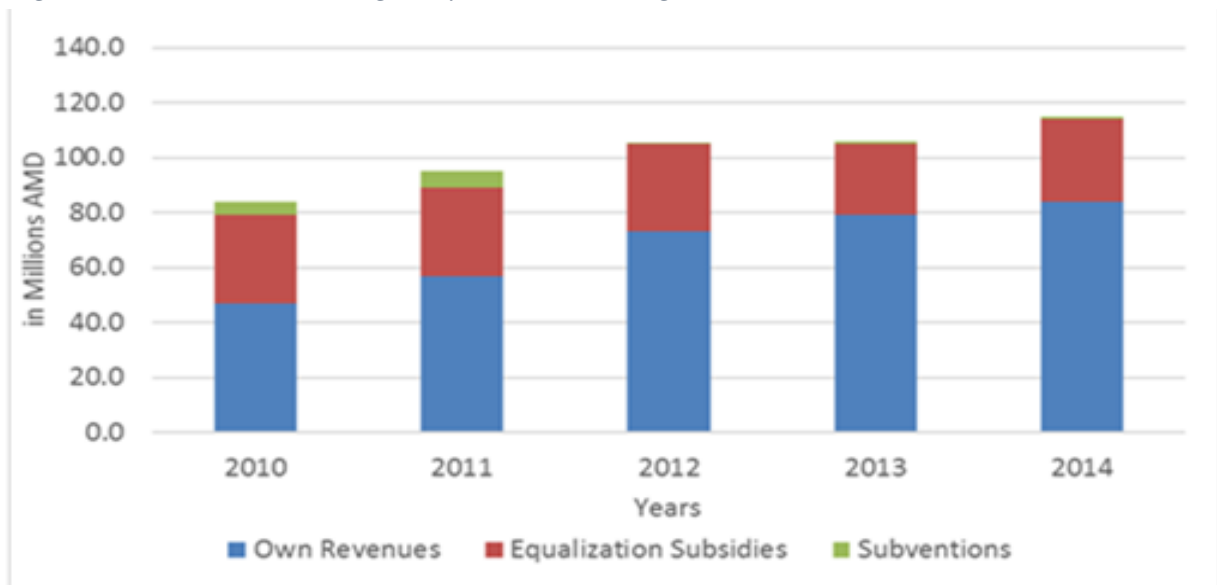
Source: Ministry of Territorial Administration and Emergency Situations

As Figure 1 depicts, a considerable share of the budget of marzes depends on the equalization subsidy. About 20 % to 40 % represents own revenues of municipalities and only Yerevan has about 80% of own revenue.

Additionally, the size of subventions is very small; some of the marzes receive such small amount that it can be hardly seen in the figure (Aragatsotn, Ararat, Armavir, Gegharkunik, Shirak, Syunik). Yerevan is the main recipient of the subvention, which is almost equal to the size of the equalization subsidy. Consequently, according to the statistical data of 2014, Yerevan is less dependent on the equalization subsidy, than other marzes of the Republic of Armenia.

Shares of equalization subsidies in municipal budgets by marzes since 2010 are shown in the Figure 2 and Figure 3. The Figure 2 shows budgets including the budget of Yerevan, whereas, in the Figure 3, the budget of Yerevan is omitted. The picture considerably differs in the Figure 3, mainly, the size of own revenues in the budget share is relatively small compared to Figure 2. In both figures the trend of total budget is increasing, yet, the Figure 2

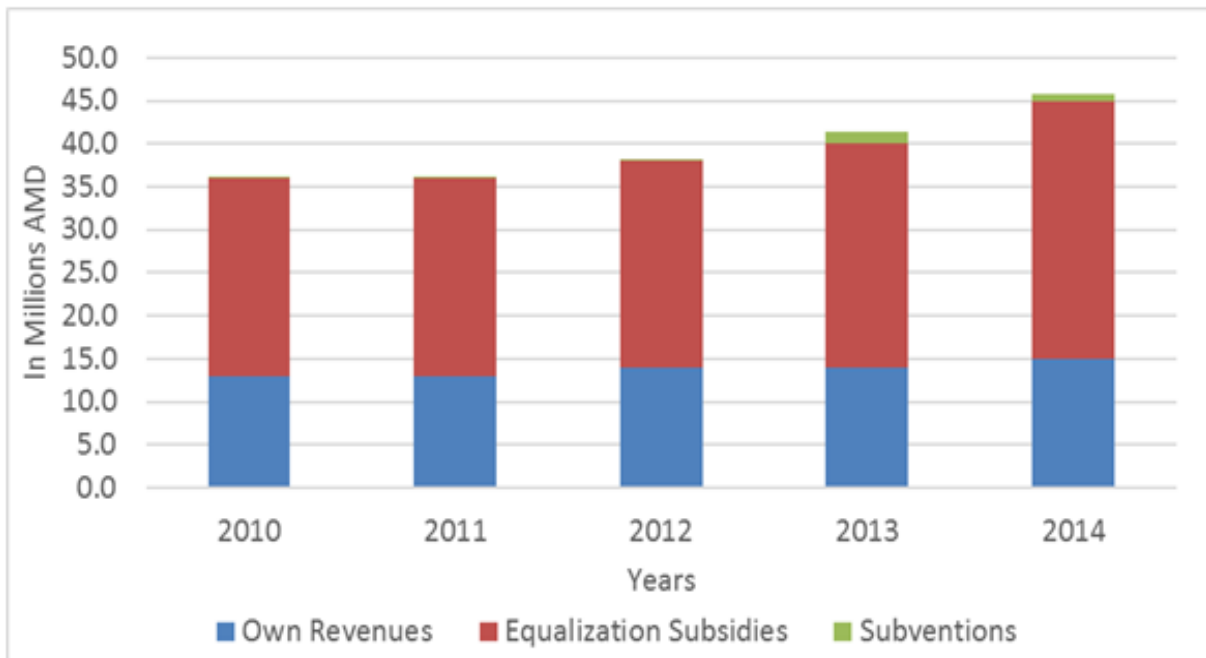
Figure 2: Share in Total Budgets by Years including Yerevan



Source: Ministry of Territorial Administration and Emergency Situations

shows that the increase is due to the size of the own revenues, in Figure 3 it is clear that the size of the municipal budget in marzes depends on the size of the equalization subsidy. Also

Figure 3: Share in Total Budgets by Years without Yerevan



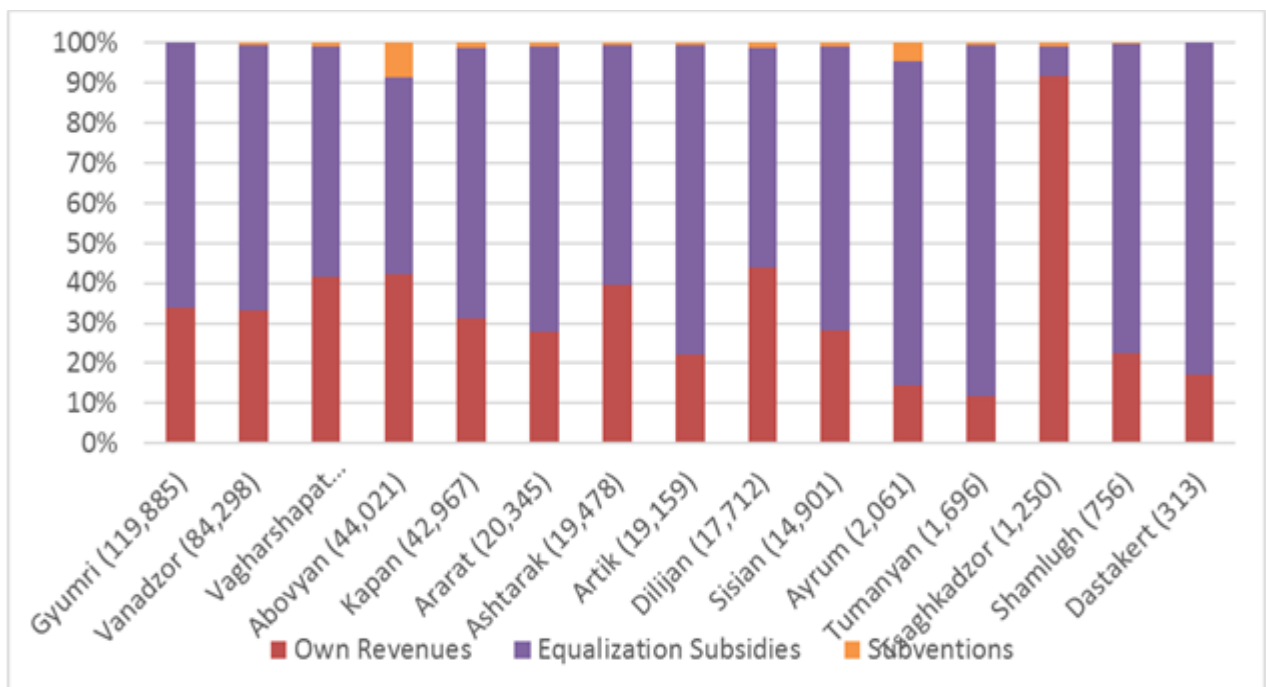
Source: Ministry of Territorial Administration and Emergency Situations

it worth mentioning, that the total size for the revenues in 2014 including Yerevan was 114.4 million AMD, whereas without Yerevan the total amount constituted 45.7 million AMD. This

information suggests that indeed the most affluent community in Armenia is Yerevan and that other communities are highly dependent on equalization subsidies during past five years. In order to study further the share of equalization subsidy in the shares of local budgets, the study has considered the size of equalization subsidy in smaller units: in the cities of the Armenia. For that purpose, 15 cities were grouped based on the following criteria: five cities with the largest amount of population, five with the medium, and five with the least amount of the population.

As the Figure 4 shows, here also the considerable share of the budget consists of the equalization subsidy. The amount varies, yet, almost all communities have own-source revenues amounting less than 40 % of their budgets. It is interesting to note, that despite that Tumanyan and Tsaghkadzor have little difference in the size of the population: 1696 and 1250 residents respectively, the Tumanyan has about 10 % of own revenues and Tsaghkadzor has 90 % of own revenues. Such results may be because of the economic conditions and the extent of the economic activity of the community. For example, Abovyan, Vagharshapat and

Figure 4: Share of ES by Big-Medium-Small Towns of Armenia



Source: Ministry of Territorial Administration and Emergency Situations

Dilijan have relatively higher own revenues based on the ability to gain own revenues, while Artik, Ayrum and Tumanyan have own revenues about and less than 20% of their total budgets. This picture supports the assumption that some communities need more, and some communities need less equalization subsidy depending on whether they have ability to collect their own revenues or not. Which in addition emphasizes the importance to take into consideration local economy as one of the factors in the equalization subsidy formula.

5.3 In-depth interviews

As it was mentioned in the Methodology section of the study, eleven interviews were conducted with those who are familiar with the concept of equalization subsidy in Armenia. The following part will elaborate positions of the respondents towards such issues as the reason for postponing the new law presented in 2008. In addition, the correspondence between the acting law and the European Charter on Local Self-Government, to which Armenia is signatory since 2002. Further the interviewees were asked about the composition of the formula of the law, particularly whether two factors are enough or there is a need for increasing the number of factors. Finally, it will provide views of respondents towards the potential factors accelerating the process of modifying the acting law and who will be in favor of such amendments.

As it was discussed earlier, during 2008 after the first hearing in the National Assembly, a draft version of the Law on Financial Equalization was postponed. During the interviews, various reasons for this were discussed. The main reasons according to nine respondents were political. Three of the interviewees underlined political situation in the country during that period, mainly, that it was not ready for the mentioned change. The amendments were connected with administrative changes, which also would have entailed structural modifications. Six of the respondents also emphasized that such amendments

would have resulted in the cutting the amount of subsidies to several largest cities, mainly Yerevan (which at that time constituted from 12 districts), Gyumri and Vanadzor, and there were no resources to compensate these losses. Thus, the mentioned communities actively lobbied and prevented enactment of the bill in question. One of interviewees stated that in 2008 the legislative process was interrupted, because other more important issues were prioritized by the Government (such as coping with the economic crisis in the country), before considering new version of the “Law on Financial Equalization”. Another interviewee stated that the reason for not developing amendments to the law, and enacting new law in 2008 was the fact that neither the state nor communities were ready for such changes.

To the issue whether the acting law is in compliance with the European Charter of Local Self-government, eight stated that it does not contradict to it. Three from which stated that the compliance is partial, one considering that it complies fully. However, one from these eight respondents also mentioned that although the acting law does not contradict to the provisions presented in the charter, it has issues, which have been the reason for proposing amendments again in 2014. According to one of the respondents, equalization subsidy in Armenia does not address the issue of fostering development of the recipient communities; it only supports communities so that they would be able to survive. Even if the size of the overall equalization subsidy grant doubles, it will not be enough for providing sufficient monetary resources for the development of the communities. In such situation, it is difficult and is not relevant to consider the provisions of the European Charter.

One from the eleven respondents stated that the acting law is in contradiction with the charter, because it undermines the authority of local governments in the communities. Whether the law has undergone changes since the signing the European Charter of Local Self-Government, five of the interviewees stated that there were no key changes, and six were undecided.

According to the majority of the interviewees, the acting law provides resources only for somehow covering mandatory responsibilities of the community. Yet, there are many issues that need to be taken into consideration, which the acting law does not. For example, nine of respondents agreed that the number of factors in the formula should be increased. Two out of nine were in solidarity with the factors suggested by the draft law of 2008. The main attributes that should be incorporated in the formula of equalization subsidies according to respondents are the population size of the community, the types and quality of services provided, its distance from the administrative center of the region as well as from the capital. In the opinion of one of the respondents, few statistical figures may not fully portray the real conditions of the community.

Another respondent underlined the importance of including motivating factors in the formula of financial equalization. For example, the number of kindergartens in the community will affect the size of the equalization subsidy. If the community has one kindergarten, one portion of the equalization subsidy will be based on it, and in case the number increases, the equalization subsidy will increase respectively. Correspondingly, if the community does not have a kindergarten, the portion connected with that specific factor will be removed; hence, the size of equalization subsidy will be smaller.

Only one respondent stated that additional factors would cause complications. In the opinion of the respondent, the foremost advantage of the acting law, transparency and simplicity, will be lost. Moreover, the problem may occur with misunderstanding of the counting mechanisms, as well as the weight of each factor will reduce significantly, because of increased number of units. Thus, the suggested amendments to the formula may bring additional flaws, which would overweight advantages. The reason is that the scope of the law is not providing monetary support to the communities in need, rather it directed to help all communities to cover their mandated responsibilities. In order to help communities in need,

there are other programs and ways to provide support and funding to those communities, and/or provide special privileges.

Again nine of the respondents agreed that the formula should be modified. One of the interviewees also stated that although current formula provided by the law considers the main factors for calculating financial capabilities of the community, as in his opinion the amount of per capita tax capacity and number of inhabitants may depict financial capacities of the community, increasing number of factors in the formula might have its positive results. In general, the interviewee supported the argument that the discretionary intervention in the implementing the law should be reduced as much as possible. The respondent believed that increasing number of factors might lessen the role of human intervention in the implementation process. Furthermore, the position of Yerevan municipality, according the one of the respondents representing it, is that it is not interested in amending the acting law; rather it is engaged in the development of a new mechanism of shared tax system. Likewise, three of respondents agreed that Yerevan should not receive equalization subsidy; it may supplement its own revenues by other taxes from the state budget. Incentives for communities of having such system of shared taxes will be that the community will be aware how much the financial allocation will be.

According to another respondent, besides increasing the number of components in the formula, it should be adjusted to the specificities of the community. The interviewee discussed the option of dividing recipient communities in categories. The main idea is that big cities have opportunities to diversify their own financial resources, while some remote villages or demographically disadvantageous communities do not have such diverse sources of own revenues. Thus, such communities are financially weak, and they depend mainly on the equalization subsidy.

One of the respondents also stated that because Yerevan is one of the most affluent communities of Armenia, and it has ability to collect its own revenues more than other communities, it should not receive equalization subsidy at all. In addition, this respondent stated that it might be better if the type of the subsidy would be targeted, in order to avoid ineffective use of the allocated resources. Besides, if the community will be deprived from the monthly unconditional financial support it may consider new ways of having money. It will positively affect the development of the community. According to the interviewee, based on the current allocation of funds, communities do not have incentives to raise revenues themselves because they have their monthly “check” from the central government.

Whereas the impact of modifying the law, and increasing the number of factors in the formula will have positive or negative impact, interviewees stated that it will depend on the financial capacities of the specific community. Four of them stated that the more factors will formula have, the better it will be, because it will ensure equitable allocation of resources. According to five of the respondents, the amendments will be positive for financially poor communities, and negative for communities that are more affluent. Yet, one of the respondents underlined sensitivity of the issue, and that factors in the new formula should be thoroughly deliberated, in order not to repeat the events of 2008 connected with the first draft law.

Furthermore, according to one of the respondents the issue here is that the weak communities should receive monetary support and wealthier communities should not. For example, in some countries, the wealthier communities not only do not receive equalization subsidy, but also they need to make compulsory payments, which are called negative equalization subsidies. Such equalization mechanisms are not in practice in Armenian. The reason is that currently there is no single community in Armenia, which would be able to

sufficiently finance its mandatory responsibilities with its own resources. Thus, the idea of negative equalization subsidy cannot be discussed yet.

However, one of the interviewees stated that modification of the formula would entail negative results both for affluent and for poor communities. The acting law on Financial Equalization in Armenia, according to the respondent, serves its equalization purpose, and is not designed for solving other issues. It should equalize financial capacities of the communities, and should not be seen as a way of solving the issue of fair allocation of resources. In addition, in December 2014, small amendments to the law provided opportunity to those communities, which have received less monetary support in the particular year, as they would receive the remaining amount during subsequent year based on recalculations, which was not the case in the past.

To this end, five of the interviewees underlined the importance of awareness-raising among communities. Particularly, local governments should understand the real impact of making amendments in the acting law. It will further support the attempt of making modifications in the law, thus will provide an opportunity for mediation of inequalities between more and less affluent communities. Three of respondents connected the acceleration in the process of making amendments in the law with the ongoing process of making changes in the territorial-administrative structure, mainly consolidation process. One of the respondents stated that the discussions of amending the law will take place during the April 2015.

To the question whether community consolidation process¹ would have an impact on amending the “Law on Financial Equalization”, eight of respondents answered that it may affect, two respondents were undecided, and one hoped it will not have an impact. The

¹ The consolidation of municipalities is achieved by amalgamation of small municipalities and reduction of their number. Since 2011, the Government of Armenia has started the process of community enlargement and formation of intercommunity reforms in territorial administration. Then, starting from 2013, community enlargement processes were initiated by the Ministry of Territorial Administration and Emergency Situations.

reason, according to the interviewee, is that although due to consolidation process small municipalities will be amalgamated with larger municipalities, their share in the equalization subsidy will remain same. However, the respondent did not take into consideration the possible connections between the size of the community and the proportion of the equalization subsidy in the new law.

In addition, according to two interviewees the territorial administration reform mechanisms will pose questions that still will need thorough deliberation by the government. One of the issues, which should be considered, is that how the equalization subsidy will be allocated among communities: will the formula remain the same? Or it will need adding new factors, with more specific issues included. Another important issue, which should be considered is: who will be responsible for the allocation of the equalization subsidy among the administrative units of consolidated communities? Will the central government allocate it originally, or it will become the responsibility of local authorities?

According to eight of the interviewees, those who will fully understand the actual impact of making amendments in the law will be in favor of it. Mainly, that those funds, which would be cut from some (more affluent) municipalities will be re-directed to those municipalities, which indeed need them. Furthermore, new concepts are developed for compensating those communities, which will face reduced subsidies, hence, the change would not be drastic. Moreover, eight of the respondents also stated that the process of amending the acting law should not be politicized. Those, who are interested in the development of the state, should be professional in the issue of equalization subsidy allocation. In addition, in the case of impeding the process, opponents should validate their position via providing substantive argumentation. One of the respondents considered that everyone will be in favor of making amendments, while two of respondents mentioned that the parliamentary opposition will support modifying the acting law.

To sum up, all three types of analyses have revealed that the acting law has room for further improvements. Legal and secondary document analysis has suggested that many countries, other than Armenia face similar problems connected with the allocation of equalization subsidies. The advantage of the system in Armenia identified by the study is that it has formula, unlike Latvia, Lithuania, and Macedonia. However, there are a number of steps that need to be done. Furthermore, statistical data analysis has shown that indeed considerable amount of the subsidy goes to Yerevan, and that vast amount of communities remain with insufficient amount of financial possessions. Finally, interview results have provided more details about equalization mechanisms in Armenia, and have revealed possible ways to achieve reforms in the system. The following section provides analysis and discussion of findings and tries to link them with international experience and findings of different scholars discussed earlier in the paper.

6. Analysis and Discussion of Findings

Based on the results of findings *the hypothesis*, which is the amendments in current “Law on Financial Equalization” will help to reduce polarization between communities with various financial capacities in Armenia, *is proved*.

As the studied literature has suggested in many countries development of equalization mechanisms was connected with the process of decentralization. Armenia as well initiated territorial administration reforms since 1990th, after the collapse of the Soviet Union. As it was the case in such countries as Albania, Bulgaria, Croatia, Lithuania, Serbia, and Romania presented in previous sections, Armenia likewise gradually moved towards such changes. Some countries were more successful in the development and implementation of the equalization mechanisms, whereas others need thorough considerations by the governments and further improvement of the level of coordination between central and lower tiers of governments.

Armenia by becoming the signatory to the European Charter of Local Self-Government deepened its commitment to making the allocation of equalization grants more in compliance with European standards, similar to Lithuania and Slovenia. Moreover, in 2008, governments of Armenia undertook a new phase of making amendments in the law in order to improve conditions of financially weak municipalities. However, similar to the findings of such authors in the Literature Review section as Levitas (2010), Hankla (2009), and Grazzini and Petretto (2006) Armenia also witnessed political pressure while attempting to change the law during that period.

Afterward, one of the reasons for preparing amendments in the acting “Law on Financial Equalization” in 2014 has been the need to comply with the provisions of the aforementioned European Charter of Local Self-Government. According to the interview results and the findings of the Report of Monitoring Committee on Local Democracy in

Armenia prepared by the Chamber of Local Authorities², the acting law has shortcomings that governments should regulate. Moreover, the lack of financial resources in weak communities is growing, and there is a strong need to address those issues as well.

Furthermore, nowadays the central government in Armenia lacks financial resources for increasing the total amount of equalization subsidies; hence, alternative methods should be developed and implemented according to the majority of interviewees. In addition, much of the literature suggests that it is under the responsibility of the central government to assist financially weaker communities, as well as regulate allocation of equalization funds (Péteri 2006; Boothe and Kryvoruchko 2004; Hankla 2009).

Additionally, as the majority of respondents have stated, according to the acting law the subsidies finance only part of mandated responsibilities of communities. There is an apparent shortage of resources, and the issue of providing means for boosting development in the municipalities, even may not be discussed. Equalization subsidies help financially weak communities simply to survive. As it was shown in Figure 4, for example, Tumanyan has only 10% of own revenues, and vast amount of the budget (almost 90%) constitutes equalization subsidy. Thus, without subsidy, the community would have been in sharp need. Yet, according to the law, and standards of the European Charter, equalization subsidy aims not only mediate differences in financial capacities among municipalities, but also provide resources for supporting the development of those municipalities in need.

What is more, based on the acting law, all municipalities receive equalization subsidies, regardless of their financial capabilities. Besides, as the amount of the subsidy depends on the size of the population as well, communities with a larger number of residents benefit more. As statistical data analysis, and also interview analysis have shown, Yerevan, Gyumri, and Vanadzor are primary recipients of the subsidy. However, those communities

² One of the chambers of the Congress of Local and Regional Authorities of the Council of Europe

are less dependent on the subsidies, than, for example, villages in remote areas, or communities that are on high altitude.

A considerable amount of literature is also devoted to the issues of effectiveness and efficiency of equalization grant allocation in studied countries. Many authors have discussed the adjustment of horizontal and vertical imbalances connected with financial capabilities of communities (Bucovetsky and Smart 2006; Freinkman, Kholodilin, and Thießen 2011; Wongpredee and Sudhipongpracha 2014). Some researchers discuss the importance of targeted grant allocations, also discussed by one of the interviewees. Besides, others consider also revenue sharing mechanism and assess its effectiveness (Romanik 1999). Likewise, two of interviewees were also in favor of developing alternative methods for revenue gaining in communities, one being the development of shared tax system.

The presence of formula and its composition is also underlined by the literature and by interviewees. Those countries, which lack formula for equalization subsidy (Latvia, Lithuania, Macedonia) exercise poor equalization mechanisms. There are high disparities among wealthier and poorer communities. Moreover, there is clear disproportion of finances between the capital and outside of it (Levitas 2010; Yusufi 2006). Although equalization system in Armenia has formula, similar problem is relevant to Armenia as well, as it was shown by figures and was discussed by interviewees.

According to the interviewees, after the law will be modified the main expected outcomes are that the system will create incentives for communities to increase their own revenue collections. One of the reasons is that equalization subsidy, in that case, will be less dependent on the size of the population, and more depend on other factors (for instance size of the collected tax, or the quality of provided service).

In addition, ongoing discussions on territorial administration reform in Armenia will also influence the process of amending the “Law on Financial Equalization”. Although there

is no direct link between those two policy reforms, many communities after the consolidation may be interested more in the new, modified system of equalization subsidy allocation, as some components in the formula (such as the number of settlements/administrative units in consolidated communities) will be significant in the calculation process.

Besides, interviewees, which directly participated in the process of preparing amendments to the current law (3 respondents), agreed that new concept will answer not only to the question how much equalization subsidy will be allocated to the community, but also why is that specific amount assigned. Clear calculations will also be provided for the minimum amount of the subsidy. As it was mentioned above, currently the minimum amount for communities with less than 300 people, the equalization subsidy is 3.5 million AMD, yet, there are no clear explanations how that number was calculated. The main reason for that number is that it is based on the Government's decision, and it is in compliance with the minimum amount of equalization subsidy abroad, mainly in Europe.

To summarize this section, the hypothesis of the paper is proved. Furthermore, the reasons for preparing amendments to acting law has been mainly due to the lack of resources in small and financially weak communities, and the obligation of Armenia to comply with the provisions of the European Charter. Additionally, weak communities are highly dependent on the equalization subsidies provided by the central government. Current allocations to some communities provide even less than a minimum required amount for financing their mandatory responsibilities, and assigned resources help those communities simply to survive. Yet, equalization entails also assuring harmonized development of weak communities by the central government. What is more, all communities receive equalization subsidies, including those, which are more affluent. Finally, amendments to the acting law, discussed by interviewees, and to some extent similar to the draft version of the law of 2008, will encourage weak municipalities to improve their own revenue collection, as well as

consolidate in order to be eligible for larger transfers. The law will clearly identify not only how much the community will receive, but also why it will receive that particular amount of equalization subsidy.

7. Conclusions and Recommendations

7.1 Conclusions

The system of IG transfers in Armenia has undergone significant changes since 1990th. The reformation of territorial administrative division and promulgation of new laws have marked a new phase in the decentralization process of the country. With initial territorial administrative division almost all localities in Armenia were granted with self-governance, which resulted in large number of financially non-viable communities. The issue of insufficient financing of weak municipalities remains one of the most serious problems that need to be addressed. One way of addressing the issue is certainly reverting the extreme fragmentation and consolidating small municipalities. This issue is, however, beyond the goals of this study. As the study has shown, the system of IG transfers in Armenia is another way of addressing viability of small and financially weak communities and it needs further development and improvement, in order to address their needs.

Furthermore, according to the “Law on Financial Equalization”, one of the main functions of the equalization subsidy, is the softening of polarization among more and less affluent communities. The central government allocates financial resources to the communities for covering their mandated responsibilities defined by the law. Based on the acting law all communities in Armenia receive equalization subsidies, yet those subsidies are vital for smaller and less wealthy municipalities.

In addition, there is an underlined need for a revision of the acting law, as there are several weaknesses, which the current paper has identified. Those weaknesses include the

lack of consideration of expenditures of the community. All municipalities receive equalization subsidy, regardless their financial needs. Likewise, all municipalities receive the subsidy, regardless the number and the quality of services provided. Additionally, the equalization subsidy increases financial dependence of the community from the central government. It does not encourage local governments to develop mechanisms for raising their own income's collection level. Finally, there is a lack of proper monitoring and control of equalization mechanisms, in order to address the gaps in the system. Thus, such mechanisms are important and should not be neglected.

7.2 Recommendations

The issue of mediating financial inequalities between communities in Armenia needs to be addressed. In addition, communities lack the opportunity of harmonized development, which also is of vital importance for the overall development of the country. Thus, equitable allocation of resources needs to be addressed and solved by the Government of Armenia. The current study, based on the findings and discussions of the legal and secondary documents, statistical data analysis, and interview results came up with recommendations presented below:

- The Governments should identify the threshold line of revenue size of the community or per capita tax capacity above which they do not receive equalization subsidy
- Governments of the RA need to increase the number of factors in the formula, thus making allocation of financial resources more flexible and adaptable.
- In addition, take into consideration not only the size of the revenues of the community, but also the size of expenditures.
- The Governments and the Ministry of Finance should increase the electronic procedures in the implementation processes of the law

- The Governments should develop alternative methods for mediating financial inequalities between municipalities in addition to providing financial support, such as introduction of shared tax system
- The Governments should create incentives for weaker municipalities to collect their own revenues
- The Governments, the Ministry of Territorial Administration and Emergency Situations should develop monitoring mechanisms for addressing gaps in the financial equalization system

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Appendix A

Financial Equalization Mechanisms in Armenia

Interview Questionnaire:

1. In 2008, the Governments of the RA had suggested making radical changes in the “Law on Financial Equalization”. The draft law entered the agenda of the National Assembly and passed the first hearing, however, after that it was not discussed further and was removed soon. In your opinion, what was the reason that the draft law did not pass in 2008?
2. In your opinion, to what extent does the “Law on Financial Equalization” correspond to the standards of the European Charter on Local Self-Government?
3. According to you, after Armenia became a signatory to the European Charter (in 2002), what kind of changes were applied to the law in order to comply with the standards of the Charter?
4. In your opinion, the current legislation in the scope of equalization subsidy allocation, to what extent provides local governments with financial resources, to cover their mandated responsibilities.
5. Based on the acting “Law on Financial Equalization” allocation of equalization subsidies calculations are based on two factors: factor “a”, the calculation level of the land and property taxes per capita, and factor “b”, the size of the population.
 - Are those two factors enough or not?
 - What other factors would you have suggested?
 - How the mechanism of equalization subsidy allocation may be made more flexible in accordance with the specificities of the community?
6. If the number of factors will increase, in your opinion, how it will affect communities?
Why?

- In your opinion, in the bordering and the conflicting situations areas, and in the high mountainous regions what will be the impact of the changes, positive or negative?
Why?
- 7. In which conditions the process of making amendments to the acting law may be accelerated?
- 8. What kind of impact may have the current political developments in the country, particularly consolidation of communities in the process of making amendments in the acting law? Why?
- 9. In your opinion, which political forces will be in favor of making radical changes in the acting law?
- 10. In your party, have you had some discussions on the financial equalization mechanisms?
If yes, is there any particular attitude developed towards the issue?