AMERICAN UNIVERSITY OF ARMENIA

INTERGOVERNMENTAL FISCAL RELATIONS IN ARMENIA:

CURRENT STATUS AND PERSPECTIVES FOR REFORM

A MASTER'S ESSAY SUBMITTED TO

THE FACULTY OF THE GRADUATE SCHOOL OF

POLITICAL SCIENCE AND INTERNATIONAL AFFAIRS

FOR PARTIAL FULFILLMENT OF THE DEGREE OF

MASTER OF ARTS

BY

TATEV AYRUMYAN

YEREVAN, ARMENIA

FEBRUARY 2009

SIGNATURE PAGE

Faculty Advisor   **Date**

Dean   **Date**

American University of Armenia

February 2009

Acknowledgements

I would like to express my deepest gratitude to my Faculty Advisor Dr. Arthur Drampian for the substantial and helpful support that he has offered me during the whole process of writing this Master's Essay. I am very thankful to Dr. Drampian for his valuable advice and contribution as well as for his readiness to provide me with all the necessary information referring to the subject.

I would also like to express my gratefulness to Dr. Lucig Danielian, Provost and Dean of Political Science and International Affairs, for all the knowledge as well as professional skills acquired during my two-year study at American University of Armenia.

Finally, my special thanks to all members of the Faculty for providing me with appropriate knowledge and theoretical background which has appeared to be of immense use both for my work and for my life.

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Abstract

In new independent Armenia local self-government is already 12 years old. For more than a decade the system of local self-government was continuously reformed; as a result its legal basis evolved and numerous changes have been introduced to the system. These changes were directed at improvement of the quality of public services, expansion of the autonomy of communities, and strengthening the role of public in government decision-making.

Despite the fact that the system of local self-government in Armenia became established and developed, there are still a number of problems on the political agenda that require immediate solutions. Particularly, it is critical to raise the level of financial autonomy of municipalities and their ability to maintain financial sustainability; on the other hand the role of central government as a provider of grants and intergovernmental assistance will remain important. Today the existing system of intergovernmental fiscal relations in the country needs close review and further improvement.

The purpose of this work is to analyze the current state of intergovernmental fiscal relations, to study the financial autonomy of local self-government in Armenia, and explore what measures should be taken to strengthen financial capacity of communities and promote fiscal decentralization.

As a first step of studying the current state of intergovernmental fiscal relations in Armenia this paper discusses the international experience of different countries, preferably those European nations, which have similarities with Armenia (transitional economies, comparable size, large number of small communities, etc. (Czech Republic, Hungary, Bulgaria and Poland).

The paper next reviews the governance structure in the Republic of Armenia, and analyzes the relationship and the division of powers between central and local government.

It is then followed by a discussion of the budgetary system, where the main focus is local government budgeting and structure of intergovernmental transfers. The paper makes an in-depth analysis of equalization grants (subsidies) and targeted (earmarked) grants (subvention), reveals their strengths and weaknesses. The final part of the paper focuses on the key challenges to existing system of IGF and provides a set of recommendations on how to overcome the main shortcomings of the IGF relations and what could be the main direction for the future reforms.

Introduction

Today governments around the world are increasingly elected on a platform of free democratic elections. Along with strengthening democratic traditions and institutions certain extent of decentralization is introduced in almost every modern political system. As a result political systems predominantly centralized in the past become more and more devolved with wider scope of mandates being delegated to lower tiers of governments (regional, local).

In addition to this, due to the economic development some of the arguments in favor of fiscal centralization have been eroded and the service delivery capabilities of local governments have improved dramatically. Today important points on the agenda of transition to market economy are privatization and consequentially decentralization of the government itself as much of the world has come to see that granting some form of local autonomy is more efficient and effective than separatism as a policy direction (Bahl 1999).

Kornai noted that the process of decentralization is a very complicated and long process. "A change of government is not a change of a system, merely one of the preconditions for it. The change of a system is a historical process that seems likely to require a long period of time." (Bird et al. 1995, 1)

For the purpose of this analysis decentralization is defined as the transfer of authority and responsibility for public functions from the central government to intermediate and local governments. A decentralized system is the system which requires and provides multiple parties with a capacity to make their own independent decisions (Terteryan 2004).

In accordance with the European Charter of Local Self-Government one of the important and necessary conditions for the establishment and development of local self-government system is the financial sustainability which is assured through the allocation of financial means and their targeted use. Municipal budget should provide the financing of those duties and responsibilities the fulfillment of which contribute to the community development and is

regarded as the financial basis that ensures operation of local government (European Charter of Local Self-Government). Usually only municipal own revenues cannot suffice to execute all the decentralized functions, there comes intergovernmental finance in various forms, but whatever form it takes it is transfer of funds from upper tier of government to the lower.

This is the desired mechanism defined by the law; however, the reality differs from the perfect scenario. In many cases the proper financing is not assured, in others the system for the allocation of transfers is not fully and finally developed, in the third case the allocated financial resources are not managed effectively and efficiently.

This fundamental issue is encountered by particularly all the countries that have adopted the path of transition from a centralized system to a decentralized one.

This problem exists also in Armenia. The experience of local self-governance shows that many communities are extremely weak and still highly dependent. The insufficient financing as well as the inability to set any rate over their own revenue sources, the limited institutional capacity and the lack of transparency create many caveats within the system, which, in their turn, put a number of serious limitations on the further development of local self-governance (Tumanyan 2001).

As a result, the established system is unable to mobilize and manage the allocated resources effectively, more, in a present environment the cooperation between central and local government can hardly be considered a successful one. This causes the centralization of the system, makes local government highly dependent on the central government and the projects implemented by the local self government produce ineffective outcome in the majority of cases.

In addition to this, the limited role of local governments within the public sector influence negatively on the macroeconomic stability as well as on the country's overall fiscal balance (Tumanyan 2001).

Today there is an urgent need to make some important changes in the system as further development of local self-governance system is really impossible unless the financial sustainability is assured and the financial equalization mechanism is developed. The development of financial equalization mechanism is necessitated by the fact the latter is accepted as one of the important components which significantly influences on the relationship between different levels of the government as well as greatly shapes the strengthening and further development of communities' financial capacities (Tumanyan 2004).

The purpose of this paper is to analyze the current state of intergovernmental fiscal relations by studying the governmental structure and the budgetary system of the Republic of Armenia, and by considering the intergovernmental transfer system with its strong sides and existing challenges. It discuses international experience of four CIS countries and aims to explore those measures that should contribute to the further development of financial sustainability of communities, should strengthen local self-governance budgeting system and should ensure fiscal decentralization.

The paper addresses the following research questions:

1. What are the necessary steps that should be taken to assure effective and efficient functioning of the financial equalization mechanism?

2. What are the main shortcomings that hinder the further development of intergovernmental fiscal relations and fiscal decentralization?

3. How international experience can be used to promote the further development of the financial equalization system in Armenia?

4. What are the major outcomes of the expected/suggested reforms?

Literature Review

Intergovernmental Finance and Fiscal Equalization: Theory and Major Definitions

One of the factors that lay grounds for the consolidation and further development of democratic government and civic society is the establishment and development of a decentralized system where greater powers are gradually devolved to local authorities which become an integral element in a decision making process and an efficient tool for the implementation of local polices (Tumanyan and Movsisyan 2006).

Among the theoretical arguments for decentralization the most common one is that it improves the efficiency of resource allocation. Due to decentralization of duties and responsibilities the lowest levels of government perform functions more efficiently and effectively as decisions taken closest to a local constituency are expected to better reflect the preferences of citizens. As a result, local governments are more likely to implement a desired policy through community participation and social inclusion.

Moreover, as subnational governments are closer to people, citizens are considered to be more aware of subnational governments' actions; so it is argued that decentralization promotes accountability and reduces corruption in the government.

In addition to this, making services more responsive to the demands of local population, the decentralization is argued to have the added benefit: households are argued to be more willing to pay for and maintain services that match their demand and needs. This is regarded as the flip side of the allocative efficiency coin (Briscoe et al 1995).

The fact is that a decentralized system will not be able to function properly and effectively unless proper financing is assured. To put it differently, finance will follow function. Therefore decentralization of functions is always related with decentralization of finance. This brings the necessity of intergovernmental transfers to equalize fiscal disparities

and meet some national priorities, which otherwise could be ignored or understood (Bahl 1999).

Basically the re-allocation of fiscal resources from one level of government to another takes place in two ways: through the sharing of tax revenues or through a form of grants. In the case of revenue sharing, tax bases can be either shared on a tax-by-tax or taxes can be pooled and shared systematically thereafter (Chang Woon Nam 2001).

The allocation of grants is realized through an intergovernmental transfer system. Intergovernmental transfers are designed to correct inefficiencies, which are sometimes raised when the benefits or costs of an activity spread beyond the jurisdiction undertaking the activity (ACIR 1985). Analysis of IGF often meets two dimensions of the issue: the first one is the total size of the divisible pool and the second one is the distribution of this pool among eligible local government units. Some have referred to the divisible pool dimension as having to do with the vertical fiscal balance and the others the allocation dimension as having to do with horizontal fiscal balance (Bahl 1993).

If we refer to international experience, we can see that there is a considerable variation in the design of intergovernmental transfers. Particularly, grants could be distributed based on a formula (population, land area, etc.); based on derivation (where the money is collected); based on cost reimbursement (how much was spent for roads, etc.); or even on a political basis (Barbara 1997).

Grants from higher to lower levels can be conditional which are closely tied with specifications regarding the use of the funds and/or the performance achieved in the supported program and unconditional respecting the autonomy and discretion of local governments in spending such financial means (Chang Woon Nam 2001).

The most common form of intergovernmental grants is the categorical grant which is designed to achieve the goals of donating government. Categorical transfers are designed for

different objectives such as addressing vertical imbalances, redistributing fiscal resources, addressing externalities, promoting sub national expenditure in areas of national importance or supporting national programs implemented locally. Their exclusive use means that the central authorities have identified all priorities at the local level, more, higher management and monitoring is a necessity.

Another form of government grants are block grants. The US Advisory Commission of Intergovernmental Relations (ACIR) defines block grants as those that go "chiefly to general purpose of governmental units in accordance with the statutory formula for use in a variety of activities within a broad functional area largely at the recipients' discretion." (ACIR 1978, 3)

The financing of local self-government's budget can be also realized by the allocation of different subsidies and by the provision of low- or zero-interest loans.

In reality, besides block and categorical grants, there exist many different kinds of intergovernmental transfers and each of them influences local government finances differently. Some transfers are designed to stimulate local spending, some are substituted for local revenue effort, some lead to more local and fiscal autonomy, the others are equalizing.

What is the most important is the management to design an intergovernmental transfer system in accordance with the country's economic, social and political spheres as only in this case it would be possible to overcome horizontal and vertical imbalances. Rémy Prud'homme (2001) notes that the menu from which one can pick one or several transfers to form a transfer system is large and diversified, the problem and the main task is to define the one which will be the best fit for the country.

In the next section of this chapter we will discuss the international experience of different countries, preferably those European nations, which have some similarities with Armenia (transitional economies, comparable size or population, large number of small communities,

etc.). Like Armenia the countries under consideration in 1991 started to implement a set of reforms which were designed to increase the overall efficiency of public sector.

The consideration of international experience will help to identify successful solutions to current problems and recommend their application in Armenia. Particularly, review of international experience will help to find effective ways to develop the following dimensions: a) the possible creation of intermediate tier of governance on regional level; b) devolution of responsibilities currently held by central government to regional and municipal governments; and c) the enhancement of fiscal capacities of local and regional governments to take over more functions.

Each country is reviewed separately to present the peculiarities, achievements and weaknesses of IGF system. Particularly such aspects as an administrative structure, expenditure and revenue assignments, fiscal imbalances and transfers as well as budgeting practices are reviewed.

International Experience in Intergovernmental Finance and Fiscal Equalization (Czech Republic, Hungary, Bulgaria and Poland)

Bulgaria

The first chapter of the Bulgarian Constitution proclaims that "The Republic of Bulgaria is a unitary state on the basis of local self-government." The constitution provides for two main levels of local government: the municipality and the region. More, according to the Administrative Division Act of the Republic of Bulgaria city districts and mayoralties are regarded as municipal subdivisions where city districts are set up within municipalities of more than three hundred thousand inhabitants and in cities of over one hundred thousand inhabitants.

There are 345 municipalities in Bulgaria and the City of Sofia has the status of a region and is a specific administrative and territorial unit comprised of twenty-four city district administrative structures (Savov 2006).

The Law on Municipal Budgets governs the drafting, adoption, execution, balancing and reporting of municipal budgets, as well as regulates transfers between the municipalities and the state budget. Transfers from the national budget (block grants) are determined on the basis of objective criteria by means of an official methodology, which is approved annually by the National Budget of the Republic of Bulgaria Act. The Minister of Finance consults with the National Association of Municipalities on the draft National Budget of the Republic of Bulgaria Act for the relevant year.

According to the Constitution of Bulgaria municipalities have separate budgets that are independent financial accounts of revenues and expenditures for one fiscal year. The revenue side of the municipal budget consists of revenues from municipal sources and transfers from the state (Savov 2006).

Ad hoc grants allocated in specific instances for the acquisition of tangible long-term assets and for the implementation of regional programs and projects of national significance, subventions are allocated in specific instances and for specific purposes from the national budget under specified conditions.

The municipality receives financial compensation from the state when additional municipal financial obligations are incurred due to the implementation of statutory instruments after the adoption of the national budget; an adjustment is made to municipally financed remuneration of employees in public entities and similar cases prescribed by law (Savov 2006).

Two new equalizing mechanisms are now regulating the system of transfers, the first one is the supplementary subsidy that funds the services which are delegated to local

governments by the state via a mix of shared taxes and the second one is a general grant. The amount of the transfers is based on unified costing standards that are annually updated and become part of the State Budget Act for the respective year.

In 2005 the share of total revenues of the units of local and regional government in total consolidated government revenues was 13.6% while the share of total expenditures was 14,9% and the share of grants of total revenues is 64,9% (Savov 2006).

Poland

After the implementation of the last stage of local government reform in Poland two new tiers of local government - *poviats* and *voivodships* were established and today there are three tiers of local self government. The number of municipalities in Poland is 2549; the capital city Warsaw has a special dual status of municipality and urban district being divided into 11 municipalities.

Before the reform in stable financial environment the significant part of local revenues consists of tax and non tax revenues (in 1999 it was 49, 8%). After the implementation of several changes the statutory tax authority of subnational government has been limited and the upper tax rates are determined and updated on an annual basis by the Finance Minister within the framework of the general tax policy of the state (Regulski 2003).

Today the revenue source is formed from three basic sources: taxes, non-tax revenues and grants (general subsidy and special purpose grants). The Polish intergovernmental transfer system is quite simple and aims at achieving the traditional goals of relieving the local fiscal constraints, it is also designed to guarantee and enhance the quality of local goods and services provided by local governments (Levitas 1999).

Each gmina receives a general subsidy from the state budget, which consists of three components: basic, educational and fiscal equalizing. As for the general subsidies for poviats and voivodship, they consist of the following components: educational, road and compensating amount (OECD 2001).

The amount designated for the basic component of a general subsidy for all gminas is calculated as the sum of the amount equal to at least 1% of the state budget revenues as planned in the Budget Act, and the amount of payments made by gminas with high (above average) tax potential (i.e. gminas where the ratio of basic taxable revenue per one resident exceeds 150% of the corresponding ratio determined for all gminas). A gmina where the ratio of basic taxable revenue per resident is below 85% of the corresponding ratio calculated for all gminas, receives a compensating amount. The fiscal equalizing component of the general subsidy is compensation for the loss of tax revenues that would otherwise have been received if tax regulations abolishing or reducing certain tax obligations would not be adopted. The amount of compensation for all gminas is set as at least 10.5% of receipts from excise tax on engine fuels as projected in the Budget Act by the Minister of Finance following consultations with the representation of the units of local self-government (OECD 2001).

The educational subsidy is allocated to individual self-governments pursuant to an algorithm (specified in the regulation). The main element of this algorithm is the conversion number of students, i.e. the actual number of students living within the area of a gmina, poviat or voivodship, multiplied (weighted) by the agreed number of students of a given type of school.

Individual units of local self-government are responsible for public roads under their jurisdiction. The amount intended as the road component of the general subsidy for all poviats and voivodships, for the purpose of construction, improvement, maintenance, management and protection of the roads, is set as 60% of the amount determined under the

Act on Public Road Financing and 10% of that amount is withheld as a reserve for investment (OECD 2001).

The only criteria included in the Act of Local Government Revenues provide that allocation should not be more than 50% of total cost of capital investment (80% in education and 75% in local government with high unemployment rate) and that unused allocation should be returned (Tumanyan2006).

Apart from the above mentioned specifications there are no provisions for eligibility such as maximum size of transfers, selection criteria, application procedures, etc.

The average share of intergovernmental transfers and grants in recent municipal budgetary revenues is 36%, while revenues from taxes and fees are approximately 34% on average. At the same time, it is worth to note that state budget transfers have strict compliance with legal requirements, more, serious restriction exist especially in the case of using transfers for capital investments (Tumanyan 2006).

Czech Republic

The Constitution of the Czech Republic anchors the division of the Czech Republic into basic (municipalities) and higher (regions) territorial self-government units. Today, the territorial self-government in the Czech Republic has two tiers; an intermediate level of government at the level of regions has been introduced where the basic unit of local self-government is municipality. Regional self-government is formed by 14 regions, including the City of Prague which is at the same time a municipality and a region. There are 6,249 municipalities, of which 20 are chartered towns, 496 are towns and 5,733 are municipalities (World Bank 2002).

Municipalities administer their jurisdictions within the framework of independent competence; moreover, within their self-competence all municipalities and towns exercise equal rights and obligations. Besides, they execute competences delegated by the state, and the execution of different duties depends on the size of the municipality and the administrated territory (World Bank 2004, World Bank 2002).

The intergovernmental funding of local budget is mainly executed in two ways: the first source of revenues are shares of VAT, personal tax (30%) and corporate income tax (20.52%), the second one is channeled through sectoral line ministries. Under the second scheme, after appropriations by the parliament have already been done, the ministry distributes allocated funds to local governments on a competitive basis for specific purposes (Tumanyan 2006).

The intergovernmental transfer and grant system is quite heterogeneous in the Czech Republic, There is no equalization grant involved in the system and all the transfers from the central government are either specific or purpose-oriented. The main objective of the grant system is to provide central government assistance for certain local government activities where education, social care, environmental protection delegated state administration function and cultural activities are the main areas of this support.

Important operating grants are provided on the formula-based system and the basic down-flow transfer sum is defined based on certain statistics (for example, per pupil in the pre-school and primary school facilities, per bed in the elderly people homes, etc.) (OECD 2001).

The major part of grants to local governments is represented by operating grants (60%); they are calculated each year when preparing the central government budget. As for the capital grants, they are provided to local governments in accordance with the approved central government budget (or its chapters).

Within capital grants, only grants for building homes for social care, if they compensate the primary owners in the restitution process, could be considered as not conditional. In this case municipal co-financing is not required as all costs are funded from the state budget. Other capital grants are conditional on the terms of cost sharing, which means that a municipality, when receiving this grant, must finance a certain share of total costs. The municipal share is not fixed at the same level for all capital grants. Only a minority of these grants is calculated at standard costs. These include grants for building flats for rent owned by municipalities, and building houses with community care services. The remaining grants are calculated as a share, at actual cost. More, if the allocated grants are not spent in the given year or for the given purpose, they must be returned (OECD 2001).

Grants to local government are not only distributed from the state budget but also from extra-budgetary funds, especially from the State Environmental Fund. Those grants are provided for environmental improvement activities such as management of wastewater facilities, introduction of energy-saving schemes, and construction of gas pipelines and revitalization of the countryside. The financing design consists of a combination of grant, loan, and the receiver's own financial participation (OECD 2001).

In 2005, according to the Human Dynamics Consortium and IMF data the share of total revenues of the units of local and regional self-government in total general government revenues in Czech Republic was 10.9% while the share of total expenditures was 8.8%. If we compare these numbers with Denmark (32, 6% revenue, 33.3% expenditure) or Sweden (25% revenue, 23.9% expenditure) then it become quiet clear that the system is still highly centralized. As for the share of tax revenues in 2005 it was approximately 50, 3%, the share of non tax revenues was 36.3% and the share of grants was 37.4%.

Today in the sphere of expenditure responsibilities the government is clarifying expenditure responsibilities making local authorities fully accountable for policy results.

As for the revenue assignment it is worth to note that the government of the Czech Republic has already boosted local revenue autonomy, which will improve budget predictability and local authorities' accountability (World Bank 2002).

Hungary

Hungary is one of the first among the Central European countries that started developing and implementing municipal decentralization and development program.

Local government in Hungary exists at two levels: the municipality and the county where the municipalities are the basic units of the system organized by localities, which include villages, cities and cities with county rights. A two tier system of local governments in this country is represented by 3,100 municipalities and 19 counties. As for the capital city Budapest it has a special legal status (Tunamyan 2006).

The budgets of local governments are provided transfers through three sub-systems of general government primarily in the form of subsidies. The fist one is Health Insurance Fund, which allocates grants for the performance of health-related tasks, the second one is Labor Market Fund which is responsible for the performance of tasks relating to providing services and benefits for the unemployed and finally the third one is directly the central budget. The latter source in its turn slits into three distinct groups:

a) Grants for the performance of mandatory responsibilities central budgetary contributions paid based on standard unit costs; spending of these grants is fully discretionary. (OECD 2001)

b) Central budgetary contributions paid based on standard unit costs; these grants are earmarked for specific programs: This category includes so-called targeted grants with legally determined specific ceiling of the share of certain priority investment expenditures

provided by the central budget with a condition that the remaining amounts have to be provided by the local government. The central subsidy, therefore, is not commensurate with the actual expenditures.

c) The allocation is based on ad-hoc decisions and provided only for specific purposes: This category is also comprised, for the most part, of development subsidies. The amounts of such subsidies are stated in discrete legal acts taking into consideration the total costs of relevant projects and are determined based on the proposals of the ministries concerned. This type of source funding also includes the aid provided to help cover expenditure relating to so-called force majeure occurrences (natural disasters) on which the Minister of the Interior and the Minister of Finance make joint decisions on a case-by-case basis.

Hungary currently has a quite complicated intergovernmental system and the most important sources for municipal finance in this country have been grants. In the last six years average share of intergovernmental transfers and grants in recent municipal budgetary revenues is 60% (OECD 2001).

It is worth to note that today National and Regional Development Councils are the focal points for regional development and control funds for which the municipalities and the micro-regional associations as well as private businesses and NGOs have to compete. Ministries, however, still have more power and can decide on the allocation of funds and oversee their use. The Council makes grants, supervises implementation and monitors the uses. The positive side here is that local government tasks as well as financial relations between local and central government have been defined quite clearly. More, majority of central government transfers is not earmarked which gives local self-governments some degree of discretion in expenditure management. Though both the National and Regional Councils have authority to rank countries and micro regions in order of priority the Minister

of Agriculture and Regional Development has a veto power over their decisions (Tumanyan 2006).

The analysis of bureaucratic decentralization in post-communist Hungary proves that this country did indeed launch an impressive program of administrative change that brought to a qualitative change in governance.

Taking into consideration the analysis it can be concluded that the above reviewed countries have adopted the path of transition from a command to a market economy which in its turn have laid grounds for the development of democratization and consequently decentralization.

Robert Charlick explains that "The relationship between governance and decentralization as a way of the state providing multiple centers of participation in decision-making in its turn assures better management, responsiveness, and accountability which are basic features of good governance." (Charlick 1992, 16)

As it is seen there is no standard model of decentralization and it varies considerably from country to country. Responsibilities, functions, resources and relationships between different levels of government are regulated by a coherent set of rules, which include political (constitutional, legal and regulatory frameworks), fiscal (spending, revenue management, inter-governmental transfers, sub-national borrowing), and administrative factors (civil-service reform, bureaucratic capacity, managerial ability).

What is important to note is that the allocation of grants in the majority of cases is regulated by laws and secondary legislation, there are certain criteria to receive different grants and certain basis for the rejection or for the approval of this or that request for funding.

In spite of the fact that the intergovernmental transfer systems are designed differently in the investigated transition countries, the dominance of a purpose and project oriented grant system is apparent. It is beyond doubt, that the amount of intergovernmental transfers from

the central government to the local ones has made a substantial contribution to development of municipal fiscal capacity, at the same time the central government still plays an important role and has a final say in the provision of local public goods and services, which, of course, makes the process of carrying-out legally assigned public activities by municipalities less "self-governing".

It is worth to note that the implementation of regional development policy and the execution of regional programs in these countries meet some similar challenges as Armenia does. The most common example is the large number of municipalities: in Armenia they are 930, in Czech Republic -- 6528, in Hungary -- 3100. In addition to this, there exists a limited scope of local government competencies, another issue is the human capacity of designing, developing and implementing fiscal decentralization and regional development programs (Tumanyan 2006).

At the same time, today these counties enjoy higher levels of decentralization as compared to Armenia. Various reforms implemented in these countries contributed to the development of fiscal decentralization, as today decision-making power almost belongs to territorial self governing units, municipal authority over current local taxes have been improved, the range of local taxes was enlarged, new taxes were added and municipal investment levels as well as the provision of services were increased. As a result the relationships between different levels of the government is much deeper and mutual, intergovernmental transfer system is considered to be more developed, fair and transparent, as the latter is regulated by laws and secondary legal acts. Moreover, the allocation of financial and administrative resources is accepted to be more effective and efficient.

Methodology

The methodology applied for this research is based on the content analysis, by reviewing relevant literature and legal documents, the international experience should be also taken into account. Necessary information will be also obtained through interviews with representatives of the Ministry of Finance, Local Governments, different governmental and nongovernmental organizations and other experts in the mentioned area. For the selection of interviewers the purposive sampling method will be used.

Findings and Analysis

Governance Structure in the Republic of Armenia

In 1991, after the breakdown of the Soviet Union, post-Soviet countries adopted the path of transition from a centralized system to a more decentralized one and started to rejoin the mainstream of European democratic institutions. During this period different local government systems have been developed, which in Leeman's terminology are defined as fused, dual and split-hierarchy systems.

Like many other CIS countries Armenia selected a strong central supervision system which is a combination of a French fused system combined with elements of German legislation (Drampian 2004).

Today Armenia has a unitary status and is an indivisible state; the government has a two-tier structure: central government and local government units.

According to the Constitution and Law on the Administrative-Territorial Division of the Republic of Armenia (4 December 1995), Armenia is divided into ten regions (*marzer*); marzer are further divided into rural and urban communities (*hamainkner*); according to 2005 Constitutional amendments capital Yerevan became a community. There are 1000 localities

(settlements) in the Republic of Armenia which are governed by 930 local governments and local self-government is executed in communities (*hamaynqs*), where *hamaynq* is defined as one or several settlements (Article 104.1, the Constitution of Armenia).(See Appendix 2, Table 1)

Marzer lack elected officials and their administrations are considered to be subdivisions of the central government, in which it has deconcentrated branches. Marzers are governed by Marzpets who are appointed regional governors. Within the scope of their authority, under the legislation the Marzpets implement the government's regional policy, coordinate the activities of local branches of the executive authority, elaborate regional development policies, and supervise the work of local self government. As such the marzpets' offices are the representatives of the central government and should not be accepted as a subnational tier of government. In Armenia local governments have the Mayor-Council structure and both are elected every four year through direct and free elections (Tumanyan 2001). [1]

For the purpose of our analysis it would be highly dvisable to analyze the relationship and the division of powers between central and local government both from functional and legislative framework.

The key documents forming the bases for the concept of the local self government system, the division of powers, as well as the framework of rights, duties and responsibilities between local and central governments are the Constitution of the Republic of Armenia, government decrees, the European Charter of Local Self Government, the Laws of RA and other relevant acts.

If we refer to Article 2 of the Constitution, which corroborates the political and economic independence of local and central governments, as well as their direct accountability to the citizens then it can be stated that the citizens exercise their authority through the State and

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[1] The term was expended from 3 to 4 years in accordance to 2005 amendments made in the Constitution. The first time this provision came into force in 2008 elections.

local self government bodies. One of the most important guarantees of the above stated aspect is that the formation of local self government bodies is realized by citizens through direct and free elections (Article 104 of the Constitution).

Article 10 of the Constitution states that it is the Law that specifies the powers of the local self government bodies, so the President of RA, National Assembly, the Government, governors and others can not make local authorities perform any activity that is not provided by the Law.

The right of the municipality to pursue independent policy is established by the Law being based on the following provision: the community is entitled to have a budget and the community council determines the local duties and fees, which means that the Community is to determine by the procedure (established by Law) the types and rates of the local duties and fees (Article 106 of the Constitution).

In regard to local self-government issues the legislation gives broader powers to the Central government as compared to local one. Article 109 of the Constitution contains a provision, according to which the central government is entitled to dismiss a mayor elected by the citizens, based on the Constitutional court conclusion. It is beyond doubt that this provision hinders the autonomy of local governments and deprives the communities of political independence.

In addition to this, the place and the role of local self-government system is very small, more the interrelation between the national and local authorities is extremely weak. When the central government introduces certain legislative changes, in the majority of cases, there isn't a sufficient level of transparency and involvement of local authorities in discussions and decision making process (Tumanyan 2005).

This means that the local self-government system is still weak and highly dependent on the will of central authorities.

According to the Law on the Local Self-Government responsibilities of the communities are classified under two categories: own and delegated, where own responsibilities are further divided into mandatory and voluntary. In regard with the established laws mandatory and delegated responsibilities are a priority and must be fulfilled in the first place. 19 delegated powers are assigned to the chief community on a sectoral basis. (Appendix 2, Table 2)

To exercise assigned powers as well as to run an autonomous policy the local governments (LG) need to have adequate finance. The community budget is formed from own revenues of the community (local taxes and duties, other non-tax revenues, revenues from the redistribution of the national budget) and from state transfers.

Two major types of transfers subsidies and subventions are allocated to lower tiers of government. Several laws give distinct definitions of equalization grants (intergovernmental transfers that are designed to mitigate disparities among communities), stipulate under what conditions and when local government can apply for government grants. The same can not be stated for the allocation of subventions (targeted transfers allocated to municipal budgets to fund specific programs); what is missing is a concrete mechanism of decision-making, formal procedures for transfer of funds that would both facilitate the process and would create conditions under which high efficiency of utilizing the funds can be achieved (Tumanyan 2006, the Constitution of Armenia, Law on Local Self-Government).

The Budgetary System in Armenia

Decentralization of functions is closely related with finance. Even if government functions are devolved to the lower levels of the government their execution would be impossible without proper financing.

The budgetary system of Armenia is based on general principles of a unified budgetary system, distinction between the revenues and expenditures of the budgets of various levels, autonomy of the budgets, complete reflection of all revenues and expenditures in the budget and their balance, efficiency of utilization of budget resources, transparency and targeted use of the budgetary means, as well as realism (The Law on Budgetary System of RA).

The state budget, community budgets and the budget of mandatory social insurance constitute the consolidated budget of the Republic of Armenia. The budgetary system of the Republic of Armenia is composed of two levels: State budget and Community budgets which are built upon a unified fiscal, monetary and tax policy of the State. These two levels are interrelated with each other and the efficient management of the duly authorized institutions within the legitimate powers can be assured only through clear regulation of the existing interrelations and activities (Constitution of RA, the Law on Budgetary System of the RA).

Comparability of the budgets of two levels is based on the budget classification which groups revenues and expenditures by relevant types and directions according to the objective to compile and execute budgets. The Law on the Budgetary System of Armenia defines types and directions of the budget classification structures underlying the fact that their application is a compulsory for the state and local self governments while planning and executing their budgets.

According to the existing laws revenues of state and community budget, which constitute financial bases of the budgets, include revenues as well as credits and other borrowed funds envisaged by the legislation. Revenue sources of the state budget fall into the following categories: a) revenues from taxes and duties, b) non-tax revenues, c) revenues from capital transactions and d) official transfers.

As for the budget expenditures they are also classified under different categories, which enable to carry out economic analysis of budget expenditures according to their direction, as well as ensure proper supervision over spending of the budget resources.

The main expenditure groups that represent national importance programs financed from the state budget are as follows a) general government services, defense, maintenance of public order and security, education and science, health care, social safety and social insurance, communal services, culture, sports and religion, energy and fuel complex, agriculture, forestry, water reserves and fisheries, mining industry and extraction of minerals (except fuel), processing industry, construction and environmental protection, transport, roads and communication as well as other expenditures (Law on the Budgetary System of RA).

The state budget of Armenia for 2008 totals about $2.5bln. Under the draft budget, the receipts are 744.7bln Drams and expenditures are 820.8bln Drams with budget deficit being 76bln Drams. The consolidated budget for 2008 is 766.9bln Drams, expenditures – 842.9bln Drams, deficit – 76bln Drams. The above mentioned indicators exceed the planned indicators of consolidated budget for 2007 in revenues by 164bln Drams or 27.2%, expenditures – by 193.7bln Drams or 29.8% and in deficit – by 29.7bln Drams (Ministry of Finance and Economy).

Fiscal functions of the state and community budgets are fulfilled through the Treasury System of Armenia, which operates within the Ministry of Finance. It realizes the acceptance of reports, statements and their summarization as well as serves as a tool due to which an implementation of the financial policies in the republic can be implemented.

The role and influence of the budgetary system in the unified financial system of the country is really important. The clear distinction between the revenues and expenditures, their effective and efficient allocation, the provision of autonomy as well as completeness and

balance of the revenues and expenditures, the division of duties, powers and responsibilities among different levels of the budget is a vital necessity at the same time a very complicated and difficult process. Dan Bennett noted that "The trouble with a budget is that it's hard to fill up one hole without digging another" (Bahl 1999).

In any case, if a country is on its way of decentralization a centralized system one of the prior tasks of the State is the allocation of financial means to local government units. It's already high time make a step forward and analyze the structure of local budgeting system of the Republic of Armenia, the framework of its revenues, expenditures and consequently its duties, rights and responsibilities.

Local Budgeting

Among many other powers that are provided to local government in accordance with the existing laws, with an aim to assure transparent, effective management of municipality's revenues and expenditures, alignment of cash flows, and other needs the LGs have been given the possibility to form and execute municipality budgets in accordance with the procedures defined by the Law on The Budget System of the Republic of Armenia. In addition to this, the Law on Financial Equalization, the Law on Local Duties and Fees, Law in Property Tax, Law on Land Tax as well as ratification of the European Charter of Self-Government form the legal foundation of municipal finance and further enhanced local initiative, economic and political autonomy (Tumanyan and Movsisyan 2006).

According to the acting legislation municipal budgets consists of two parts: operating and capital. Each of the above mentioned part is allowed to have a reserve fund which is up to 5-20% for the operational budget and up to 30% of the capital budget for contingences. Both the operational and capital budget has strictly defined and separate sources of revenues.

It should also be mentioned that that the overwhelming majority of do not have capital budget at all (Movsisyan 2004).

Revenues of the Community Budget

Local budget revenues may be classified into the following groups: tax revenues own revenues, official transfers and borrowings. Particularly, the range of community budget revenues contains tax revenues (property tax and land tax) non-tax revenues some 12% of the total revenues), duties (around 37% of total revenues) and official transfers (around 48% of the total revenues) as well as revenues from capital transactions (about 3%). It is supposed by Law that some deductions from income and profit taxes, as well as environmental taxes should be provided to the local budget. The truth is that this type of revenue from deductions is not a practice yet (Movsisyan 2004). (Appendix 2, Table 3)

The great part of the community budget is formed from tax revenues and duties. As compared with 2002 in 2003 tax revenues and duties increased by 27.9% and totaled approximately 30% of budget revenues. In respect with only property tax the increase was 29.3%.

In accordance with the Law on the Local Duties and Fees communities of Armenia have the right to define 10 types of duties and 3 types of fees (Tumanyan 2004).

Official Transfers

An important part of intergovernmental finance between state and local governments is subsidies, which based on the purposes of allocation are classified into financial equalization subsidies, other subsidies and subventions (Appendix 2, Table 4).

Transfers from the central to local budgets are regulated by the Financial Equalization Law (23 December 1998), which establishes the general concept of financial equalization, the form of subsidies and the main factors for their calculation. Subsidies are distributed from a fund, the precise size of which is determined each year by the Annual State Budget (Tumanyan 2004).

According to existing Laws community budgets may also receive credits and loans from the state budget. Unfortunately this type of funding is not exercised in our country. From 1996 to 2004 there were only one or two cases when communities received loans, while no bonds have been issued in any community whatsoever.

Expenditures of the Community Budget

According to the Law on the Local Self-Government 19 delegated powers are assigned to the chief community on a sectoral basis. The powers of the community are separated into two groups, namely own powers (mandatory and voluntary) and those delegated by the state. As it has been stated above the mandatory powers are funded from the community budget on a priority basis and the voluntary powers by the decision of the community council from the community budget, if extra funds are available. As for the powers delegated by the central government they are carried out in accordance with the law and through mandatory funding from the state budget (Tumanyan 2005).

Predominant portion of the community budget expenditures belong to operating budget, another great portion belongs to the expenses of capital renovations which are 57.1% for 2006. (Appendix 2, Table 5)

The share of expenditures for delivery of services was 42% in 2003, 45% in 2005 and 49% in 2006. Instead staff maintenance costs increased. Particularly drastic increase was

observed in 2003. The reason was that the right to decide the number of staff was given to the heads of the communities and the Community Council. The share of expenditures for the staff maintenance in the above mentioned years is approximately 30-32% (Ministry of Finance and Economy).

It is worth to note that the delivery of services implemented by municipalities has many weak points and shortcomings. The main cause of impossibility to ensure the delivery of services at satisfactory level and high quality is the scarcity of financial resources on the one hand and the small size of communities on the other hand.

It is worth to remember that there is direct link between decentralization and financial autonomy of the local government. Particularly, entirety of two indicators - a) distribution of power to render public services among central regional and local governments and b) share of expenditures incurred by local government in total public expenditures and/or in GDP, gives a picture about the degree to which powers of local government are financed.

Powers of the governments in Armenia are nearly the same as in Slovenia, however in our country the share of local budgets in total public spending is 5.7%, whereas in Slovenia it is 9.2%. As for the public expenditure in GDP it has been 21-25% during the last years. This means that Armenia is well behind both in terms of decentralization and financing of the powers (Horvath 2000).

Basic Structure of Intergovernmental Transfers

It would be senseless to talk about local government finance without considering the system of intergovernmental transfers.

Despite relatively small country size and population there are 1000 settlements governed by 926 local governments which significantly differ from one another in socio-economic,

finical geographic, demographic and climatic conditions. Moreover, enormous number of communities creates unfavorable conditions and hinders the effective use of financial and administrative resources, prevents application of economies of scale. Though the range of communities varies significantly the law on the Local Self Government grants all communities with equal powers. As a result of these conditions, some of these communities are strong and can assure productive development while the others are weak or extremely weak being hardly able to promote even general development strategies (Drampian 2004, Tumanyan 2004).

The coordinated work of different institutions is designed to weaken the negative impact of the above mentioned conditions and contribute to the harmonious community development.

The most important role among these institutions belongs to the central government. The state fulfills its "duty" in various ways with significant role assigned to the allocation of official transfers provided to local budgets from the state budget.

Due to intergovernmental transfers allocated from the state budget, mutual obligations are established between central and local government which, in its turn, lays ground for the further development of the effective and efficient cooperation (Tumanyan 2004).

In the Republic of Armenia intergovernmental transfers constitute an important part of municipal finance, and equalization mechanism is designed to strengthen further development of communities' financial capacities. As such there are three types of transfers provided to municipalities: equalization subsidies, subventions and other subsidies.

In order to see on what basis the allocation mechanism in Armenia works as well as to understand why the provision of equalization grants and subventions is still accompanied with some difficulties and why the established systems are still unable to achieve desired results and correspond requirements of financial equalization it would be highly useful to

analyze the current mechanism of subsidy and subvention allocation separately and from more detailed perspective.

Equalization Grants

Subsidies to local budgets are allocated in accordance with the Law on the Financial Equalization. Article 20 of the Law on the Budgetary System of Armenia defines equalization grants as government transfers, appropriated to mitigate financial disparities among municipalities. It also states that equalization grants should be allocated to communities pursuant to the financial equalization allocated from the state to the local budgets (Article 3).

Among intergovernmental transfers subsidies constitute a great share and are earmarked for communities based on equalization principle. The amount designed for transfers is presented by a separate line and after it receives the status of a budget line item the amount earmarked for communities are protected and subject to mandatory payment.

The minimum amount of subsides is defined in the Law on Local-Self Government, according to which total amount of subsidies allocated to communities from the state budget shall not be less than 4% of actual revenues of the consolidated budget of two years ago. The precise amount as well as distribution of the total amount of subsidies by individual communities it is approved on yearly basis by the Law on State Budget of the Republic of Armenia (Law on Local-Self Government).

The amount of subsidies is estimated in respect to individual local budgets which are differentiated on the following principles: a) communities with the population no more than 300 people and b) communities with population more than 300 people.

Subsides which are allocated to the communities with the population less than 300 people are estimated proportionally in the annual Law on the State Budget of Armenia. As for the

amount of subsidies provided to the communities with more than 300 people it is defined on the basis of the following factors:

1.   Per capita land and property taxes in the community (hereafter factor "a")

2.   Number of community population (hereafter factor "b")

 For communities with population under 300 people the amount of subsidies for the factor "a" will be no less than 25% of the aggregate revenues from land and property taxes collected in the previous fiscal year and the total amount of subsidies under factor "b" will be no less than 10% of the actual revenues from income tax for the previous budget year (Law on the Local Self-Government).

Subsides that goes under the category "a" are envisaged for all those community budgets (except for those communities that have population under 300 people) where per capita revenues from land and property taxes are lower than the national per capita of total amount of land and property taxes and subsidies envisaged for communities under the factor "a". According to this principle, the amount of subsidy is defined according to the following formula:

$$A = (M-H) \times B \times G \, ^{2}$$

Subsidies under factor "b" are envisaged for all the local budgets (except for those communities that have population under 300 people) multiplying the number of population by per capita subsidy. The latter is estimated through relating the total amount of subsidies under the factor "b" to the total number of population (Law on the Budgetary System of RA).

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[2] A is the amount allocated to a community under factor "a"

 H is the per capita level of revenues from land and property taxes of community population (which does not belong to the communities less than 300 people) which is lower than the national per capita revenues from land and property taxes and subsidies allocated to communities under the factor "a"

 M is the average national capita revenue from land tax, property tax and subsidy allocated by the national budget upon formula a

 B is the number of population of the community in question (which does belong to the communities with the population less than 300 people)

 G is the average adjustment factor

Subventions

The picture becomes more complicated when it comes to the allocation of subventions. The rules and procedures for the provision of subventions are not equally clear and transparent as in the case of equalization grants. Subventions are targeted transfers allocated to municipal budgets to fund specific programs. They may be allocated to operating or capital budget of a municipality depending on the purpose of allocation. According to the Law on the Budgetary System of Armenia, the procedures based on which the subventions are allocated should be defined by the government. However, there has been no law or any government decree, which would have regulated the procedure of allocating subventions (Tumanyan 2006).

Subventions from the state budget can be obtained in two different ways. In the first case local governments through the relevant territorial authority submit applications to the Ministry of Finance by August 1 of the year proceeding the planned fiscal year. After the approval of line ministries and after meeting all other formal requirements (the goal of the project, expected results, actions taken to reach each result, project budget, etc.) the package of documents is included in the list of projects to be reviewed by the government. The Government of Armenai discusses all projects and makes final decision. Usually the Cabinet discusses and reviews the list of all proposals in its sessions and makes final decision. After the Government gives the approval it is included in the draft budget and is submitted to the National Assembly and after being approved the money is allocated to the community. Nevertheless, there are no exact rules or procedures, which subjectively entail the decisions made by the representatives of government (Tumanyan 2006).

The second way of allocating subventions is in the case of force-major situation when there is an urgent need for additional funds. In this case funds are appropriated through

government decrees and the Government has the right to make appropriation within the limits of the state budget reserve fund.

It is worth to remember that the aggregate amount of capital funds is a sum of all capital projects approved by the Parliament. Besides the above discussed two cases, there are no undesignated capital funds that would be available for other types of distribution during the fiscal year (Tumanyan 2006).

On the one hand, the system for the allocation of subventions is not finally and fully developed, more, because of budget constraints much importance and priority has been attached to equalization grants. On the other hand, public expenditures are extremely centralized with a miniscule portion channeled through the local governments. In 2005 and 2006 0.11% of the state budget is planned for municipal infrastructure. However, it does not still mean that that the central government is not interested in investing into public infrastructure. During the same years about 22%-26% of the national budget was planned for spending on public investments (Gevorgyan 2008).

Now let's make a step forward and estimate the existing system of intergovernmental transfers in terms of its effectiveness, efficiency and equity.

In the Republic of Armenia the regulatory framework of the allocation of capital transfers can hardly be considered an effective one. J. Mikesell noted that unclearly defined policy guidelines as well as priorities that also miss the criteria based on which municipal capital projects are selected diminish the value of transfers, make them meet the requirements for the momentary needs and long term policy goals are neglected (Tumanyan 2006).

Lacks of clearly defined procedures as well as the absence of legal provisions bring to distorted equity and arbitrariness in decision-making. Apparently the status quo with the necessary limit of transparency and certainty as well as public awareness about the procedures of decision making, concrete and clear reasons for approving one project and

rejecting the other are those important factors that are completely absent from the present mechanism.

It is but natural that if the effectiveness and the equity of the mechanism need real changes and urgent improvement the efficiency of the system can hardly be considered the desired one. Since the aggregate amount of capital transfers is negligible this might not seem a priority issue today. However, with the growing amount of transfers inefficiencies may result in increasing losses and investments in projects that have relatively low value and priority (Tumanyan 2006).

It is beyond doubt that the existence of formula secures certainty and transparency in the allocation of subsides as this creates a sense of fairness and everybody knows the exact criteria by which distributions are made. Simultaneously, the established formula has a number of shortcomings and needs some improvement.

If we refer to legislation where the law defines 4% value of the total amount of subsidies allocated to communities from the state budget where the consolidated budget included the compensations paid to the communities, we come across with a contradiction with Article 71 of the same Law. In general, this weakens community revenues because all the communities that get compensation receive it from funds earmarked for other or at their own expense (Gevorgyan 2008).

In addition to this, current procedure does not take into consideration real needs of the communities and contradicts the equalization principle. One of the weaknesses of the existing system is that it takes into account the revenue capacity of municipalities while their expenditure needs are not considered. Moreover, the indicators of revenue capacity needs included in the formula (per capita land and property taxes in the community and number of community population) are not enough to consider the peculiarities of 926 communities and meet the requirements of the financial equalization. The components addressing the real

needs and expenditure specification are not included anywhere in the formula so it becomes a quantitative criterion for the allocation of subsidies among municipalities. E.g. the subsidies of 1.5 million and 2 million drams for communities with population with less than 300 people were allocated in 2005 and 2006 to 70 and 66 communities respectively. In turn, such communities are very much different from one another: population in 36 communities is less than 100 people, 60 communities have population of 100-200 people and the rest 97 have population of 200-300. In addition to this there is no link between the quality of provided services and equalization subsidies. More, the system lacks financial equalization evaluation and control and does not provide incentives to LGUs to increase the collection level of own income (Gevorgyan 2008, Movsisyan 2004).

Financial equalization subsidies can be estimated in three ways: the communities that have population under 300 people and those estimated under the factor "b" are very close to each other. In the first case communities with less than 300 people population receive equal amounts of subsidies, in the second case the amount of subsidy depends on factors mentioned above. In the former case there is no baseline indicator based so it is difficult to estimate to what extent financial equalization objectives are met while in the latter one the principle of financial equalization is violated (Tumanyan 2004)

In accordance with the existing system all the communities are entitled to get subsidies irrespective of the fact whether they are rich or poor (only Yerevan receives 4.95 billion subsidies which is approximately 31% of all subsidies).Under such conditions the distribution of the transfers is not really effective, more, the principle of financial equalization is roughly violated (Movsisyan 2007).

As for the third case it is closer to concur with the principle of equalization; however, it considers only fiscal capacities of communities and neglects their financial needs.

As is it seen the existing system as well as formula based distribution of equalization grants lacks some important components and does not fully reflect the objective of equalization and hence needs improvement.

If we view the process and logic of allocating subventions from a more detailed perspective then it would be possible to classify the major drawbacks under the following groups:

Regulatory: The law provides only general guidelines for the provision of subventions and there is no procedure or formula that regulates the distribution of subventions.

Institutional: There is no clearly defined body or structure that has the right to take the whole responsibility of the whole process and coordinate collective decision-making on providing subventions. Since 2005 Ministry of Territorial Administration has the right to "coordinate development, discussion and approval of regional social-economic development programs." (Government Decree, N 633, May 19, 2005)

Fiscal: Transfers that are allocated from the state budget to the community budgets are insignificant (small) and are not commensurate with municipalities' capital needs.

Democratic Practices: mechanism of decision making is not clearly defined, decisions made by the government are not transparent, more, this process is highly top-down as recipients of capital transfers do not participate in any stage of decision making process. The decisions made are discretionary and there is no competitive procedure for the selection.

Weakness of Public Investment Planning Process in Municipalities: During 2001-2005 only a very limited number of cities have applied medium term capital planning and participatory capital budget process that has been introduced by international donor organizations. It is worth to note that the local self-government system in Armenia is a new structure in the public administration system and the long term budgeting is not a common practice yet. As a rule, community budgets are formed for a year.

Political: It is critical to remember that successful fiscal decentralization combines not only fiscal reforms but governance reforms as well. In this case systematic and complex approaches to reform local-self government are missing. (Tumanyan 2006)

Based on the findings and analysis above it can be stated that the current system is cumbersome and not transparent, it creates uncertainty and disorder being based on negotiations, on a number of subjective factors and case-by-case basis. There is an urgent need to develop a better regulatory framework where the concrete formulas, laws and criteria are applied for the provision of subventions.

Conclusions and Recommendations

Local self government system in the Republic of Armenia is already 14 years old and in its political and substantive aspect there is a significant progress in the process of decentralization. Today the system still bears the influence of the Soviet practices. At the same time a number of factors and problems had a particular impact on the system of local self governance; the Karabagh war, blockade, disruption of established economic links, energy crisis and challenges of a transition period.

Though today a lot of important changes have been introduced within the system, there are still many serious shortcomings and some urgent problems that require immediate solutions.

The insufficient financing of municipalities is one of the most serious problems on the agenda. Analysis of municipal budgets proves that the powers and financial means of local self government bodies are not commensurate. The share of community budget in public expenditures and GDP, which actually is one of the most important indicators that show the degree of decentralization, have hardly changed through 2004-2006 accounting for 6.8% and

6.9% and 1.3- 1.5% respectively. These indicators are very law and the community budget in absolute terms is nearly incomparable with similar indicators recorded in many European countries, so the place and the role of local self government in the general government system is actually very small (Appendix 2, Table 6) (Tumanyan 2008).

In our country the system that is "responsible" for the realization of equalization and assures further decentralization consists of financial equalization subsidies, other subsidies and subventions. The provision of subsidies is regulated by the Law and is distributed in line with the formula.

Though the formula-based distribution of subsidies eliminate arbitrariness, creates a sense of fairness, assures transparency and certainty it lacks some important components as in many cases the latter does not meet the objective of financial equalization. The two factors included in the formula are not enough to reflect financial capacities of all communities; there is no link between the level of provided services and equalization subsidies. The starting gap of the capacities of municipalities is not recorded and evaluated in the context of service provision. More, the current allocation method lacks financial equalization evaluation and control and does not promote Local government units (LGU's) to increase the collection level of own income (Movsisyan 2004, Tumanyan 2005).

As for the provision of subventions, it is far from being satisfactory. According to the Law on the Budgetary System of Armenia, the procedures based on which the subventions are allocated is defined by the government. However, till today there has been no law or any government decree, which would have regulated the procedure of allocating subventions. The mechanism that is responsible for the provision of subventions is cumbersome and not transparent; there is no concrete institution that is responsible for the whole process. As a result the provision of subventions is done on a case-by-case basis, rather than application of concrete formulas, rules and criteria.

The truth is the process heading towards decentralization may not be efficient and comprehensive if the financial component is neglected since this component is responsible and largely insures the implementation of political and administrative decentralization.

So there is an urgent need to introduce several changes within the system of financial equalization otherwise it will be impossible to assure further development of local self government institutions. Reforms in this area need to be continued using systematic and complex approaches. Further steps taken on the road to a more decentralized system should be designed to assure financial stability of municipalities.

Though there is no ideal model of decentralization it will be useful to consider international experience of different countries. The experience of CIS countries considered in this paper may be useful for Armenia as these countries have passed through the same way as Armenia does, however, today they have more consistent local self governance and more developed and fair systems for the implementation of financial equalization (moreover, all of them are designed to meet the requirements of European Charter on Local Self Government).

Taking into consideration the specificities of local self government in Armenia, the international experience, as well as new conceptual approach and the result of interviews that were conducted with different representatives from this field *the following recommendations are made for the development of subsidy allocation mechanism*:

➢ In addition to the two factors included in the formula, consider the revenue capacity of municipalities and necessary expenditure needs as a base for the calculation of subsidies to be allocated to municipalities by the equalization principle, whereas;

 ✓ To consider municipality per capita land and property tax calculation level, (actual) municipality per capita collected revenues and actual level of state fees as a base for the calculation of revenue abilities.

✓ To consider the following factors: the geographical location (remote location, altitude) and accessibility; municipal service quality; number of settlements (localities) incorporated in a municipality; population age structure, since all these factors significantly affect the expenditures directed to the provision of mandatory responsibilities and should be considered as a base for the calculation of expenditure needs.

➢ To foresee supplemental direct financial resource in the equalization subsidies for those communities that have small population (less than 300) as even in the case of high level per capita budget adequacy they will not have enough financial resources for the implementation of mandatory responsibilities.

➢ To allocate financial equalization subsidies only to those municipalities with revenue capacity lower than the average national level or lower than some discretionary level established for the entire country. (Today all communities, irrespective of their financial resources, receive equalization grants.)

As for the allocation of subventions the following recommendations are made.

➢ To introduce a mechanism regulated by clearly defined laws and secondary legislation that allocates subventions in accordance with predefined criteria (e.g. high level of unemployment in the community, municipalities considered economically and socially disadvantaged etc.) or formula (formula can be based on the number of pupils in school, number of beneficiaries in extracurricular school, etc.).

➢ Continues to earmark certain portion of state budget revenues for the allocation of subventions. However, this process can be improved by either specifying the total amount of subventions to be provided in the given fiscal year as a fixed percentage of actual consolidated budget revenues (as in the case of equalization subsidies) or as a fixed

percentage of separate types of tax revenues (10% of VAT, 20% of road maintenance fee, etc.).

➢ To establish a collegial body responsible for making open and transparent decisions. (We can follow the example of Hungary and establish National and Regional Development Councils which can be the focal points for regional development).

➢ To diversify government approach in providing financial support to municipalities with different revenue capacities. Those municipalities which are capable to generate less revenue should be further considered for receipt of subventions. Those with better revenue generation capacities should be shifted to government programs providing subsidized credits with low interest, loan guarantees.

➢ To allocate part of government funds to municipalities on a competitive basis for a specific purpose (for example development of industrial zone, or techno park).

➢ To establish National Development Funds, Community or Municipal Development Funds and through them channel investments to municipalities ensuring transparent decision making and distribution of funds in these institutions based on certain criteria along the lines of national priorities.

It is critical to remember that successful fiscal decentralization combines not only fiscal reforms but governance reforms as well. If implemented successfully, many communities will be able not only to meet minimal requirements but implement certain steps that will lead to development of decentralization system in the country. Moreover, many problems will be solved in the atmosphere of mutual understanding due to an effective and efficient co-operation between different levels of the government; the municipalities will be shaped as a unified force to present and protect their rights and can fully perform their crucial role in public administration system.

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Appendix 1

Questionnaire

1) ՀՀ օրենքի համաձայն բոլոր համայնքները, անկախ բնակչությունից և ֆինանսական կարողություններից, ունեն նույն լիազորությունները: Արդյունքում ստեղծվել են բազմաթիվ մեծ թվով փոքր, թույլ և բնակչությանը ծառայություններ մատուցելու կարողություններ չունեցող համայնքներ: Այդ համայնքները հիմնականում գոյատևում են դոտացիաների հաշվին: Խոշոր քաղաքային համայնքների կախվածության աստիճանը դոտացիաից ավելի քիչ է: Ինչպե՞ս կարելի էր ավելի ճկուն դարձնել դոտացիաների տրամադրման համակարգը:

2) Համահերթացման մասին օրենքի բանաձևը հիմնականում հաշվի է առնում բնակչության թվաքանակը և մեկ շնչին ընկնող գույքահարկի և հողի հարկի հաշվարկային մակարդակը:

ա/ արդյոք այս երկու գործծնը բավարար են Հայաստանի բոլոր համայնքների համար առանձնառանձնահատկությունները հաշվի առնելու:

բ/ ինչ այլ գործծների կառաջարկեիք հաշվի առնել:

3) Համահարթեցման դոտացիաները համայնքներին տրվում են "Ֆինանսական համահարթեցման մասին" ՀՀ օրենքի համաձայն, նույնը չենք կարող ասել այլ պետական տրանսֆերտների՝ սուբվենցիաների մասին, այսինքն դրանց տրամադրման ընթացակարգը հստակ սահմանված չէ օրենքով:

   i) Ինչպե՞ս և ի՞նչ հիմունքներով է կատարվում դրանց տրամադրումը համայնքներին:
   ii) Ո՞ր պետական մարմին(ներ)ն է իրավասու համապատասխան որոշումներ կայացնելու:
   iii) Վերջին 5 տարիների ընթացքում արդյո՞ք ձեր համայնքը ստացել է սուբվենցիա: Եթե այդ, ապա ինչ նպատակով:
   iv) Ի՞նչ քայլեր կառաջարկեիք սուբվենցիաների տրամադրման (բաշխման) համակարգն ավելի արդարացի և թափանցիկ դարձնելու ուղղությամբ:
   v) Ինչպե՞ս կարելի է տրամադրվող սուբվենցիաների օգտագործումը դարձնել առավել արդյունավետ:
   vi) Ո՞ր խնդիրների լուծման համար առաջնահերթ պետք է պետությունից սուբվենցիա խնդրել:

4) Համայնքների եկամուտները բավարար չեն իրականացնելու նույնիսկ օրենքով սահմանված պարտադիր լիազորությունները: Ինչպե՞ս կարելի է հաղթահարել այս խնդիրը՝ ընդլայնելով համայնքների ֆինանսական ինքնուրույնությունը, թե՞ ավելացնելով պետության կողմից տրամարդվող տրանսֆերտները (դոտացիա և սուբվենցիա):

Appendix 2

Tables

Table 1: Area, population and number of communities and community associations (including the number of communities in these associations) in Armenia

Marz	Area, sq. km	Population, 1000 people	Number of communities	Number of community associations	Communities in the associations
Yerevan	227	1104,9	12	-	-
Aragatsotn	2753	140,0	114	2	14
Ararat	2086	275,1	97	4	67
Armavir	1242	280,2	97	-	-
Gegharkunik	5348	239,6	92	2	30
Lori	3789	282,7	113	5	103
Kotayk	2089	276,2	67	-	-
Shirak	2681	281,3	119	-	-
Syunik	4506	152,9	109	4	108
Vayots Dzor	2308	55,8	44	1	27
Tavush	2704	134,2	62	4	60
Total	29733	3222,9	926	22	409

Source: Local Self-government Reforms in Armenia (2004-2006), Book 2.

Table 2: Services Rendered to Communities and Bodies Delivering these Services

Sectors	Agencies delivering services				The power to render a service			
	Central government authorities	Regional administration	Local governments	Private sector	Exclusive	Joint	Mandatory	Voluntary
I. Education								
1. Pre-school			X	X			X	
2. Primary		X	X	X			X	
3. Secondary		X	X	X			X	
4. Professional and technical		X	X	X	X			
5. Higher	X			X	X			
6. Trainings	X	X		X	X			
II. General governance								
1. Regulatory services (licences, permits, et cetera)	X		X		X			
2. Public safety, police	X	X			X			
3. Fire service	X	X						X
4. Defense of civil population	X		X		X	X		
5. Justice	X				X			
6. Service for registering civil status			X				X	
7. Notary services			X				X	
8. Statistical service	X	X	X		X			
9. Electorate registry		X	X				X	
III. Social security and insurance								
1. Kindergartens			X	X			X	
2. Social protection to families	X	X	X					X
3. Social security	X		X			X		
IV. Public health								
1. Disease prevention and primary health care	X	X	X					
2. Hospital medical care	X	X			X			
V. Culture, sports and recreation services								
1. Theaters	X	X	X			X	X	
2. Museums and libraries	X	X	X			X	X	
3. Recreation sites and parks	X	X	X			X	X	
4. Sports and organization of recreation	X	X	X			X	X	
5. Other cultural services	X	X	X			X	X	
VI. Environment protection and public sanitary services								
1. Quality of water and removal of waste water		X	X					
2. Solid waste removal			X				X	
3. Maintenance of cemeteries		X	X				X	
4. Protection of environment	X	X	X			X		
5. Protection of consumers' rights	X		X			X		
VII. Road infrastructure and transport								
1. Road infrastructure	X	X	X			X	X	
2. Transport	X				X			
3. Urban transport			X				X	
VIII. Development of urban infrastructures								
1. Residential stock	X		X			X		X
2. Urban planning			X				X	
IX. Utilities, communal and household services								
1. Gas supply				X				
2. Heating network				X				
3. Potable water supply				X				
4. Provision of irrigation water				X				
5. Agriculture	X		X	X		X		
6. Forests	X		X	X				
7. Fishery	X		X	X				
8. Electricity system				X				
9. Elaboration of development programs	X	X	X	X		X	X	
10. Industry, commerce and tourism	X	X	X	X		X		

Source: Local Self-government Reforms in Armenia: Policy Options and Recommendations

Table 3: Revenues of Communities and Official Transfers

(mln drams)

Line	Description	2004 Amount	2004 Share in total revenues (%)	2005 Amount	2005 Share in total revenues (%)	2006 Amount	2006 Share in total revenues (%)
1	2	3	4	5	6	7	8
001	Revenues and official transfers	27101.6	100.0	32565.4	100.0	40639.9	100.0
002	Including: A. Revenues	15491.4	57.2	16850.6	51.7	23469.5	57.8
003	Including: A.1. Current revenues	11875.3	43.8	13037.6	40.0	16293.3	40.1
005	Land tax	2341.6	8.6	2316.5	7.1	2727.6	6.7
010	Property tax	5016.5	18.5	5742.4	17.6	6617.3	16.3
040	Stamp duties	319.1	1.2	327.6	1.0	739	1.8
050	Local taxes	576.2	2.1	667.2	2.0	895.8	2.2
090	Non-tax revenues	3621.9	13.4	3984.0	12.2	5313.6	13.1
170	Including: Financing delegated powers	330.2	1.2	385.8	1.2	480.1	1.2
200	A.2 Revenues from capital transactions	3616.1	13.3	3812.9	11.7	7176.2	17.7
220	B. Official transfers	11587.5	42.8	15700	48.2	17162.1	42.2
242	Including: Financial equalisation subsidies	10696	39.5	13752	42.2	14583.6	35.9
250	Other subsidies	44.8	0.2	63.6	0.2	555.6	1.4
255	Subventions to administrative budgets	76.5	0.3	185.3	0.6	159.3	0.4
271	Capital subventions	646.6	2.4	1481.6	4.5	1204.7	3.0

Source: Local Self-government Reforms in Armenia (2004-2006), Book 2.

Table 4: Share of official Transfers in Revenues of Municipal Budgets in Armenia

(mln drams)

Year	Revenues, total	Administrative budget — Subsidy — Financial equalisation Amount	% of total revenues	Administrative budget — Subsidy — Other Amount	% of total revenues	Administrative budget — Subvention Amount	% of total revenues	Fund (capital) budget — Subvention from state budget Amount	% of total revenues	Fund (capital) budget — Subventions from other sources Amount	% of total revenues	Official transfers, total Amount	% of total revenues
1	2	3	4	5	6	7	8	9	10				
2004	27101.6	10696	39.5	44.8	0.2	76.5	0.3	646.6	2.4			11463.9	42.3
2005	32565.4	13752	42.2	63.6	0.2	185.3	0.6	1481.6	4.5			15482.5	47.5
2006	40639.9	14583.6	35.9	555.6	1.4	159.3	0.4	1204.7	3.0			16503.2	40.6
2007	48514	17686.5	36.5	352	0.7	94.3	0.2	2314.4	4.8			20447.2	42.1
12 neighbourhood communities of Yerevan													
2004	9120.1	3730.5	40.9	9.5	0.1		0.0		0.0	10	0.1	3750.0	41.1
2005	10732.3	4684.8	43.7		0.0		0.0	91.6	0.9		0.0	4776.4	44.5
2006	11800.9	4925.7	41.7	211.5	1.8		0.0	29	0.2	122	1.0	5288.2	44.8

Source: Local Self-government Reforms in Armenia (2004-2006), Book 2.

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Table 5: Total Capital Expenditures of the Municipal Budgets in Armenia

(mln drams)

Line	Expenditures	2004 Amount	2004 Share, %	2005 Amount	2005 Share, %	2006 Amount	2006 Share, %
640	Capital expenditures	4575.2	100.0	6805.1	100.0	9222.2	100.0
650	Including: 1. Capital expenditures costs	2050.2	44.8	2900.5	42.6	3952	42.9
660	Including: • Capital construction costs	641.4	14.0	1494.8	22.0	1495.4	16.2
700	• Acquisition of capital assets	718.5	15.7	868.5	12.8	1801.2	19.5
701	Including - Acquisition of fixed assets	28.3	0.6	45.3	0.7	32.5	0.4
702	- Acquisition of equipment and tools	123.1	2.7	289	4.2	429.9	4.7
703	- Acquisition of transport	288.2	6.3	351.6	5.2	926.9	10.1
704	- Acquisition of land	0.0	0.0	0.0	0.0	1.2	0.0
706	- Acquisition of other assets	698.2	15.3	181.9	2.7	410.2	4.4
740	2. Capital renovation costs	2525	55.2	3904.6	57.4	5270	57.1

Source: Local Self-government Reforms in Armenia (2004-2006), Book 2.

Table 6: Decentralization Indicators for CEE Countries (in %)

Country	Share of revenue of units of local and regional self-government in total general government revenues		Share of expenditures of units of local and regional self-government in total general government expenditures		Share of tax revenues in total revenues of units of local and regional self-government		Share of nontax revenues in total revenues of units of local and regional self-government		Share of grants in total revenues of units of local and regional self-government	
	2000	2005	2000	2005	2000	2005	2000	2005	2000	2005
Bulgaria	16.9	13.6	20.6	14.9	46.3	19.4	13.8	11.1	42.7	69.6
Czech Republic	20.8 (1999)	27.3	26.1	21.5	47.7 (1999)	50.3	36.3 (1999)	12.3	25.3	37.4
Hungary	26.7 (1999)	29.3	24.1	26.3	33.0 (1999)	35.1	17.0 (1999)	15.3	49.3 (1999)	49.4
Poland	28.8 (1999)	31.2	45.1	28.5	24.5 (1999)	32.7	24.21 (1999)	6.9	39.3	50.4

Sources: IMF (2001, 2006a); Human Dynamics Consortium (2007)