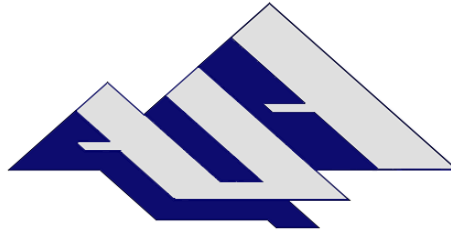


AMERICAN UNIVERSITY OF ARMENIA



**FISCAL DECENTRALIZATION
IN ARMENIA
CONCEPTS, STRUCTURES AND PROBLEMS**

**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**

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TABLE OF CONTENTS

	Page
List of Tables.....	5
List of Abbreviations.....	6
Abstract.....	7
Listing of Research Questions.....	8
Methodology.....	9
Literature Review	10
Introduction.....	13
1. Part One: Implementation Rules of Fiscal Decentralization.....	15
2. Part Two: Ongoing Process of Decentralization in Armenia.....	24
3. Part Three: Barriers of Local Governments and Communities.....	34
4. Recommendation and Conclusion.....	51
5. Reference.....	53

LIST OF TABLES

	Page
Figure1:	17
Figure 2: Own income in Communities Budget.....	36
Table1:	40
Table 2: Unemployment by Marzes.....	38
Table 3: State Budget Deficit.....	48
Table 4: State Budget Operations.....	48
Table 5:Transfers to Marzes from the Armenian State Budget.....	50

LIST OF ABBREVIATIONS

CEE.....	Central and Eastern Europe
CIS.....	Commonwealth of Independent States
GDP.....	Gross Domestic Product
TACIS.....	Technical Assistance for the Commonwealth of Independent States
USSR.....	Union of Soviet Socialist Republic

ABSTRACT

My Master's Essay is going to discuss and deal with the decentralization issue, thus, investigating the process of decentralization in Armenia. The concentration of this paper is to be the concepts of fiscal decentralization, its problems and strategies in Armenia.

The paper examines the structure of fiscal decentralization in Armenia, its ongoing process of decentralization, the efficiency of the division between the local and central governments, the existing barriers for localities

The problem that is going to be discussed in the paper is the inabilities of local governments to fulfil their legal responsibilities in view of critical lack of funds available both at the local level and through transfers from the central government.

Given the present legal and financial framework, critical barriers exist which will prevent local government from fulfilling its mission and legal responsibility.

The above mentioned analysis will take the period of 1995 – 2000 years.

THE HYPOTHESIS AND RESEARCH QUESTIONS IN THE STUDY OF
THE FISCAL DECENTRALIZATION IN ARMENIA
ARE AS FOLLOWS:

For my Master's Essay I am going to present and discuss the following hypothesis.

Since the problems in local budget exists and become worsened, the local governments may not build their capacity to acceptable standards and maintain them at adequate levels in the coming future.

The study looks into the following research questions:

1. *What is fiscal decentralization?*
2. *How has the process of decentralization gone in Armenia?*
3. *How efficient is the division between the central and local governments?*
4. *What are the barriers for local governments?*
5. *How can we reconcile the responsibilities of local governments, in view of limited financial resources?*

EMPLOYED METHODOLOGY

This is a descriptive study as her we illustrate various values, statistical analysis. The content analysis should be used here. The units of analysis of the study are interrelated social artifacts – local governments and the major indications of the fiscal policy such as local revenues and expenditures.

The study is going to be done by the quantitative and qualitative control. For carrying out the analysis, the cross-sectional study must be used (from1995-2000) including explorational and descriptive factors.

Literature review

According to J.M Buchanan (1987,174) "decentralization of governance is an important component part of the processes of social transformation in the countries of central and east Europe and CIS". Further he asserts that "decentralization is promoted as an institutional prerequisite to democratic and efficient government and it is justified only to the extent that it serves this purpose." However, R.G.Einsweiler (1991,186) stresses, "decentralization of the government is not a value in itself. In the democratizing reforms decentralization is rather a matter of degree, i.e, of choosing an optimum level and optimum variant of decentralization, relative to circumstances. "

W.H Buitter (1990, 64) in regard to the level of decentralization notes " decentralization brings government nearer to the citizens creating conditions for democratization of governance and for its increased efficiency. " Indeed, J.M.Buchnan (1987, 214) argues "while saying decentralization, it doesn't only refer the degree of democratization, but rather the two important components." He adds "factors are characterized by the complete division of central governments and local ones".

R.G.Barro (1990, 119) mentions "decentralization of decision-making and resource management enhances political and economic participation and efficiency of the local government development."

D.S. King (1991, 126) point out "the strongest form of decentralization is the devolution when local authorities have decision-making powers and are fully responsible for them without reference back to the central government". However, as E.K.Kellar (1992, 86) describes" decentralization of government in some countries has different forms". Further in her book she notes that "although the devolution is the perfect form of decentralization, the

delegation, sometimes, goes parallel to devolution." The concept of delegation is shortly explained in Human Development Report, Armenia (1996, 18) by the following words, "some authority and decision-making powers are passed to local authorities that central government retains the right to overturn local decisions and can take these powers back to at any time."

Thus, .Kellar asserts it may be that a strong local government can not be captured either for institutional or economic reasons."(E.K.Kellar, 1992) According to J.L.Mikesell (1991, 352) "the amount and modality of local level financing, particularly the degree to which the local authorities dispose of local revenues of their own and to which they depends on central government grants or transfers, is pivotal for determining the scope of local autonomy, or conversely, the degree of dependency within which the local authorities, in reality, operate". D.S.King in his book "Challenges to Local Government " explains that given the present stage of local government development, the local governments face the problem of maintaining a careful balance between the local revenues and expenditures." (D.S.King,1991) Furthermore, he adds that "to achieve a balance expenditure policy, the local governments must set mechanism to identify priorities of local government expenditures and to enhance cost efficiency. " (p.182)

Actually, J.M. Bryson (1991, 117) assumes "almost irrespective of local revenue sources transfers between central and local governments are an important feature of the public finances of many countries." Further he notes that "as a rule,, transfers constitute the principle way in which countries achieve what is sometimes called 'vertical fiscal balance' that is ensure that the revenues and expenditures of each level of government are approximately equal."

However as R.J.Barro (1990, 313) mentions that "If deficits are allowed to arise, they must be financed and the manner in which they are financed may itself exert important

influences on the government's ability to make a reasoned comparison of public benefits and public costs."

So, as E.K.Kellar (1992, 274) marks " there are instances when decentralization is clearly dysfunctional. Such as when government is decentralized to territorial units so small that it can not operate efficiently or when decentralization serves the central government to pass the financial burden to lower tiers which, however, cannot cope with it".

Introduction

One of the most discussed aspects of the dramatic reform taking place in the former Soviet Union and Central Europe has been the decentralization as it moves from command system to one of the liberalized ones. The debate whether decentralization is “good” or “bad” is unproductive in a global context in which decentralization is a political reality and where its form varies greatly within and among countries.

Most developing and transition countries are characterized by very great inter – regional disparities. It may be said that for many developing countries, the efficiency gains from having a strong local government cannot be captured, either for institutional or economic reasons.

The territorial governmental reforms were set up in Armenia rather late beginning with 1995. Before that, there were attempts to “make ” the previous Soviet system workable. If we consider that the Communist Party was kicked away both from political and economic field of action and without any “governing and leading ” power the acting regional governmental system seemed not so inefficient. It was supposed that such condition might be well founded and would not bring any problems.

In newly independent years Armenia was subdivided into 37 territorial administrative units, i.e into regions where each governing official was elected through the appointed committee of that region. Unfortunately, the time showed that only declaring Democracy would not solve the process at once or arbitrarily. First of all, people ought to be psychologically ready for that and, afterwards, democratic mechanisms and institutions need full establishment and confirmation.

Hence, 1995 adopted new Constitution of the Republic of Armenia appeared to be as a jurisdictional base for the regional governmental reforms. The Constitution listed the following 2 principles regarding the decentralization of power to local levels of government: state governance and local self – government where the former has applied to the nation’s provinces and the latter to the smaller administrative units. So, several established laws and legislative acts gave an opportunity to create new regional governmental and local self-governing systems. The Marzes and municipal governments were created. In 1995, the whole Republic of Armenia has divided into 11 marzes, where the state governing is conducted in marzes, whereas in municipal regions the local self-governing is present.

The logic of the conducting policy was the following. The solution of local issues bring close to the residents but the resolvment of global regional issues remains on the initiative of the state government.

It was supposed that the settlement of issues and disputes of local importance could be transferred into the local self – government bodies.

Thus, coming to the issue of Armenia, we acknowledge that some serious barriers have occurred during the decentralization process in Armenia. This paper is going to concentrate on the fiscal decentralization concepts and its problems that exist in Armenia.

For the discussion and investigation of the concepts and problems of fiscal decentralization in Armenia, the paper will cover the following research questions as the guidelines of the study.

1. *What is fiscal decentralization?*
2. *How has the process of decentralization gone in Armenia?*
3. *How efficient is the division between the central and local governments?*
4. *What are the barriers for local governments?*

5. *How can we reconcile the responsibilities of local governments, in view of limited financial resources?*

The paper will cover the formation of decentralization process discussing the adopted laws and regulations. Further, we shall consider to what extent these laws coincide with the implementation in reality. Actually, according to the decentralization theory the local governments should operate on their own capacities. But, in fact, central government has considerable economic and political leverage over local government structure. For this reason, the paper will investigate and carry out the existing barriers for the local government on this issue. It also aims to propose some recommendations, which would be essential for further development of the local system. The paper consists of three parts where all mentioned above research questions are touched.

Part one Implementation Rules Of Fiscal Decentralization?

It is clear that there are costs and benefits to fiscal decentralization. Whether it is good policy for a country depends on how these considerations are weighted.

D.S.King

Throughout the world central governments are decentralized some political, fiscal and administrative responsibilities to lower level governments and to the private sector.

"In all countries concept of decentralization has promoted allocative efficiency for the nation as a whole. Moreover, in countries with limited tradition of self- government, developing effective fiscal and political institutions may be critical to nation building."¹

¹ <http://www.osi.hu/lgi/publications/dp/html/disc02.html>, "Local Government in Post-Socialist Cities"

Thus, decentralization is a term widely used but often means different things to different nations. Many factors affect both the ideal and actual form of decentralization adopted in any country for any service at any time. Desmond S. King (1991, 75) motivates this in such way. “Perhaps economic conditions have not been right for the countries to adopt comprehensive decentralization schemes, or perhaps political freedoms were too new in some cases, and the idea just takes some getting used to decentralization”.

Whatever the reason, there are signs the countries do not follow the same path of fiscal decentralization. What they have in common is that they begin by assigning certain functions to sub-national governments. Sometimes this assignment is clear, and sometimes it is murky, sometimes it involves major expenditure responsibilities and sometimes it does not. (Nicholos Henry,1984)

Hence, for this reason there are many analyses of fiscal decentralization as a policy strategy. Most focus is on evaluating the decentralization experience around the world, and looking for the match between theory and practice. However, far less attention has been given to the implementation strategies.

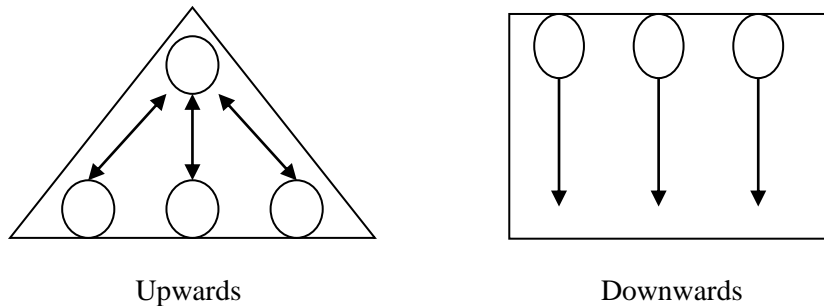
Thus, we shall begin a discussion of a rationale for the fiscal decentralization, i.e, with the statement of the objectives that should lead the design of decentralization. Some of the stated implementations are conditions necessary to the success of fiscal decentralization. Now let’s see the basic rules of fiscal decentralization to have a complete picture of its structure.

- **Electing and appointing issue**

Political autonomy is perhaps the most crucial element of a decentralized system. According to the rule the Councils must be locally elected, while in many countries, local

officials are not elected by popular vote, but are appointed by the center. In this case, voters may not express their preferences through elections, and may not replace those who do not represent their views.

Figure 1:



Thus, according to the illustrated figure, if the local leader is appointed by higher level of government, their accountability will be upwards and not down to the local population. For this reason, the efficiency gains that are at the heart of fiscal decentralization strategies will not be captured. Since “efficiency is a factor enhancing the government's legitimacy and vice versa -legitimacy may be an important factor in bolstering governmental efficiency.” (R.C. Einsweiler,1991,153)

Also, it is almost as important that the elected local council appoints the local chief officers (e.g. treasurer, chief education officer etc.). This is a necessary condition so that the programs of the council are implemented. In many countries, however local chief officers are appointed by higher level governments. Sometimes these officials are seconded by the center, and actually report directly to the center. In this case, it is next to impossible for the local government to implement its proposed programs. This is, indeed, what we can say about Armenia's decentralization structure where it can be said, in most cases, local public officials are appointed by the central government.

- **Finance Follows Function**

The second rule is to get the correct order of reform. First should come the assignment of expenditure responsibility to local governments, and then the assignment of revenue responsibility should be determined. This is an important rule for two reasons. “The first is that the central government must establish expenditure needs for each level of government before tacking the question of revenue assignment. The second is that the economically efficient assignment of revenue requires knowledge of expenditure assignment.”² Thus local government should have some freedom to choose how they will allocate their revenue resources among competing expenditure demands. For example, services that may be priced (public utilities, buses) should be largely financed by user charges; general services with a local area benefit zone (roads, parks) should be financed with local taxes; and goods characterized by significant externalities should be financed from region wide taxes and intergovernmental transfers.³

In fact, the expenditure needs of local governments are so great that feasible intergovernmental reform program does not make a big dent into the service level and infrastructure backlog. (D.S.King, 1996) Unfortunately, for good policy, most countries begin the business of intergovernmental reform on the revenue side. Some would see this as not so serious policy mistake.

So, giving local governments significant control over the expenditure budget, reduces the control that can be exerted by the ministries and shift the balance of power away from the center. Moreover, once decentralized to local governments, expenditures are not so easily controlled or “called back”. According to R.G.Barro (1990,152) "Revenue assignment, as

² <http://www.man.ac.uk/idpm/ispswpf7.htm> "Centralized vs. Decentralized Management of Public Information"

³ <http://www.cato.org/pubs/pas/pa-166.html> "Bigger is not Better: The Virtues of Decentralized Local Government"

practiced in most developing countries, is less permanent proposition: local tax rates can be limited or subject to approval, intergovernmental transfers to local governments might be subject to central government approval." However, if we come to Armenia, we'll notice that the order of the expenditure and revenue assignment is not in a fitting balance. Surely, there are problems in this point too.

Significant local government taxing powers.

Fiscal decentralization requires significant local government taxing powers. J.M.Buchanan (1987,189) argues that" local government must have adequate tax administration capacity to collect those revenue sources that are assigned to it. Actually, this is often a problem because local taxes tend to be administratively different and local governments tend to have the least experienced tax administration staff." For example, the property tax can be a major revenue producer, but it rarely produces significant revenue. It is said that property tax is administratively difficult and expensive, and it is politically unpopular.(W.H.Buiter.1990) The same is true of excise taxes, which can be an appropriate revenue source for subnational governments, but not for goods where there is some sort of natural monopoly. "In this case, the tax burden would be exported and there would be an incentive for local governments to overspend. Retail sales taxes are not possible in many developing and transition countries because of administrative difficulty of tax collection from small vendors."⁴

So, the tax administration is often a central government function, i.e, central collection on behalf of the local governments with only 'indirect' local government inputs.

⁴ <http://www.osi.hu/lgi/resources/misc/links.html> "Local Government and Public Service Initiative"

However, for reducing the problems with tax administration, Elizabeth. K. Kellar suggests “local government must have some taxing powers. Local government who set up some tax rates may adjust both the level of the budget and the burdens of financing these services” (E.K.Kellar,1992). Then she states ”if all revenues are received in the form of transfers from the center, then it is actually the central / regional government that determines the size of the budget”. (Elizabeth. K. Kellar, 1992,219) Actually, in many developing and transition countries, as well as in Armenia, local governments do not have the power to set the tax rates on any but very minor local taxes. This condition is present in Armenia too, where the communities do not have the authority to introduce and/ or collect local taxes by themselves. Almost all taxation is controlled by the central government. The only tax revenues are considered to be the property and land taxes, which in their turn, tend to produce not significant revenues due to some circumstances. These circumstances should be discussed in the third part of the paper.

Impose a Hard Budget Constraint

According to W.H.Buiter (1990,252) "a hard budget constraint implies that those local governments who are given autonomy will be asked to balance their budgets without recourse to any end-of-year assistance from the central government". This is another of those rules that central governments must keep, and local government must believe that they are ‘on their own’. "‘Enemies’ of the hard budget constraint include fiscal measure such as the following:

- Deficit grants that is year – end grants to cover revenue shortfalls
- Bailouts on the delinquent debt.

- Direct central government coverage of year – end shortfalls on certain items of expenditure. Many central governments prefer to hold to a paternalistic approach to intergovernmental fiscal relations."⁵

So we see that the above mentioned enemies of the hard budget constraint hamper the real process of fiscal decentralization.

In most cases, the fiscal year begins with a vertical imbalance between local government expenditure needs and revenue authority, and perhaps even an uncertain level of grant distribution from the center. "A year–end budget deficit is planned, and deficit grants are the guarantee that local governments come to depend on. Thus, true fiscal decentralization requires that central government begins implementation by defining a proper match between the expenditure responsibility and revenue capacity."⁶

Urban and Rural Sector

In fact, one intergovernmental system does not fit the urban and the rural sector let's see why it is so.

Many countries believe that there must be a uniform intergovernmental fiscal system under which all subnational governments must operate. This may not be a necessary condition for effective decentralization. In fact, a better route may be "to begin fiscal decentralization with the larger local governments units and let the smaller ones 'grow into it'. Subnational governments have very different capabilities to deliver and finance services, and certainly different capabilities to borrow."⁷ It may be necessary to set up a system where

⁵ http://www.eerc.ru/activ/ws8/right_projects_e.htm/, "Implementation Rules of Fiscal Decentralization"

⁶ <http://www.osi.hu/lgi/publications/dp/html/disc02.html> "Local Governments of Post -Socialist Countries"

⁷ <http://www.osi.hu/lgi/resources/ceecis94/1foreword.html> "Critical Elements of Local Governments"

these differences are explicitly recognized, i.e, where different local governments are given different financing powers and expenditure responsibilities. D.S King in his book "Challenges for local government suggests that places that are in the lower tier could rely more heavily on grants, while more developed places could rely more heavily on local taxation and could borrow to finance capital outlays. In countries that choose this route, it is necessary to have a clear set of rules about when a local government graduates from one status to another. (D.S.King, 1992)

It is not at all uncommon to see such graduations, e.g, the Kenyan cities, large cities in American states, and many national capital districts are given special fiscal powers. Or, for example, in Russia comparing with Moscow and Saint Peterburg.

Thus, mentioning all the urgent implementations that are efficient for the success of fiscal decentralization we should stress and bring forward a concluding note that

Central government must keep the fiscal decentralization rules that it makes.

While fiscal decentralization surely means "a step away from a paternalistic approach to intergovernmental fiscal relation, it will be the central government that makes the rules by which the new system will operate."(J.M.Buchanan,1987,263) However, as J.M.Bryson (1991, 349) in his book "Shared Power" stresses, "very often the central government does not always keep the rule it makes. There are many examples of this.

- Imposition of unfunded expenditure mandates on local governments
- Under-funding of transfer programs
- Reassignment of expenditure without commensurate reassignment of revenues
- Abolition of local taxes"(J.M.Bryson,1991)

Local governments recognize this and in many countries believe that this gap between the central and local ones will proceed in further too. But if the decentralization is to have a chance, the central government must keep the rules it makes. And this rule for successful

fiscal decentralization should be carefully heeded when the central government is designing its program. If the center intends to give local governments finances a low priority on its policy agenda, on the first cut when times are hard, then it should not develop a law that guarantees a particular revenue flow. Further Bryson (1991, 257) in his book point out that "if local government expenditure autonomy depends on a central judgment as to whether the 'right' choice is made, then it is better not to promise the autonomy in the first place. Transparency in the rules is not enough. There must be adherence to the rules. "

Unfortunately, if we draw some comparing lines between the implementation rules and the Armenian decentralization structure, then we shall notice some obstacles occurring in the way of its process. Hence, all these issues are going to be discussed in the second and third parts of the paper.

Part two

Ongoing process of decentralization in Armenia

Decentralization of decision-making and resource management enhances political and economic participation and efficiency of the local governments' development.

R.G.Barro

Before analyzing the whole process of decentralization in Armenia it would be important to discuss about the previous centralized system to compare with the existing one.

The Communist regimes were institutionally characterized by the omnipresence of the totalitarian state which, in order to serve the Communist Party as instrument of centralist rule, comprised the state-run economy and also permeated the entire societal sphere. In Communist era, "state administration was made up of a political and administrative apparatus which, following from the doctrine of the '*unity of state power*' and so-called '*democratic centralism*', was organized and ruled in a strictly centralist, hierarchical and '*top down*' manner."⁸ This means that, it did not allow for any autonomy at the subnational levels and suppressed and prevented the emergence and existence of any independent economic and societal organizations. So, under these circumstances, local authorities were hardly more than 'local organs' of the central government. Actually, accountability of the local and regional administrative bodies to the local elected councils was but perfunctory, as their collective 'territorial' responsibilities for the respective territorial units were superseded by the 'sectorial' fragmentation. (L.Holmes, 1993)

⁸ <http://www.osi.hu/lgi/resources/ceecis94/1index.html> "*Local Governments in the CEE and CIS, 1994*"

There is no need to go into details on the each part of centralized system, but it would be better to illustrate shortly the characteristic of the system that Armenia for about seventy years felt on its skin.

Characteristics of that system can be seen as the following:

- It was undemocratic. The elected bodies (assemblies) were created more by nomination than by true elections. Although elections were held regularly and a democratic facade was maintained, in reality they were a more-or-less formal affair, more a manifestation of political loyalty than voters' choice.(L.Holmes,1993) Higher levels of authority could suspend decisions or even dissolve a local council. This is regarded as the principles of 'double subordination'.

- Real decision making power resided with the Communist Party bureaucracy.

"Territorial governments, their functionaries and personnel were under the permanent control of Communist Party bodies which instructed them how to act on important and politically sensitive issues and which could intervene at any moment in the decision making process." ⁹

- Territorial government lacked economic and financial foundation. Local finances were part of the state budget, the bulk of local revenues were central grants and financial resources left in the hands of territorial governments were extremely restricted. Communal property did not exist - lands, buildings and infrastructure were just part of state property administered by territorial governments.

So, the system was centralist where authentic territorial self-government was excluded. Important issues of local and regional development were decided and financed by higher-level territorial administrations or by central ministries.

⁹ <http://www.man.ac.uk/idpm/ispswpf7.htm> " A Core-Periphery Solution"

Hence the characteristic of the given period reflects the notion that "public administration and self government were amalgamated into a single system based on the ideology of 'democratic centralism', where a single political and administrative body was made locally responsible for advocating both local and central interests."(L.Holmes,1993)

In fact, the state served a dual role as the owner of enterprises existing in local governments and as the own tax collector.

But after the breakdown of this 'totalitarian' system, these communist countries faced quite a new system with its new rules and acts.

Now, they were ready to feel a new system on their 'skins' which was considered to be just the opposite of the centralization concept.

The Tasks of Decentralization

General objective of the decentralization reforms in the CEE/CIS countries is to create a real decentralized territorial government at the local and the regional levels which will be "capable of exercising a *democratic* and *effective* local governance conducive to civic participation and to developing a modern market economy"¹⁰ Consequently, decentralization, deregulation of public administration are their dominant aims, where territorial self-government has to be introduced and separated from state administration.

Considering the grip in which the Communist regime held the subnational levels, using the local level as its 'local organs', it is particularly the devolution of powers to elected local regional authorities exercising 'local or regional self-government' that decisively overcomes the former centralist structures.(Human Development Report, Armenia,1998)

¹⁰ " Journal of Public Policy", Volume20, Part 1 January-April 2000. Clearance Ceenter, 222 Rosewood Drive, Danvers, MA01923,USA

Decentralization in the constitutional democratic state through devolution is characterized by the unambiguous assignment of powers and responsibilities to the respective level.

According to Human Development Report, 1998 (34) "This is particularly true for the devolution of tasks to the elected local and regional authorities. It is only up to them to discharge the powers and responsibilities assigned and devolved to them, and the state agencies cannot intervene except for reviewing the legality of such local activities."

However, decentralization has reached different stages and achieved different levels of success in the individual countries of the region. Although everywhere in the region, decentralization was declared by the national governments as one of their legitimate programmatic goals after 1989/1990, the actual process of decentralization did not run smoothly but, rather, turned out to be more complicated and lengthier than originally expected. In the same report it is stated that "there are considerable differences between countries of the region as far as the understanding and scope of decentralization and the pace of the reform are concerned. This is the result of significant differences in their political and economic development, their initial conditions, histories and cultures."(Human Development Report, 1998)

Thus, the decentralization schemes must be sensitive to circumstances in developing countries and must refrain from recommending uniform models and strategies.

As it is cited in the Human Development Report, (1998, 32) "there is no universal approach to decentralization according to which all countries should proceed and all decentralization reforms could be evaluated. Certainly, in different countries different decentralization processes has occurred with their rules of implementation. Particularly, everywhere some important components of the reform have remained unsolved and are in need of further measures."

After the break up of the USSR, Armenia, like other former communist countries, was "handed a legacy of grossly inadequate public administration structures and a bankrupt economic system which had to be revamped as soon as possible. The establishment of a liberal democracy and the emergence of an economy based on market principles required a drastic reconceptualization of the entire public administration system." (Human Development Report,1997) It became necessary to pursue a set of strategic reforms, which revised the state's role, objectives and functions, in order to meet the new challenges in securing economic growth, strengthening independent statehood, improving the living standards of the people, and ensuring the security of the country. "These reforms included streamlining existing public administration structures and adding new structures where appropriate, modernizing the civil service, and reorienting the government's methods and objectives to the new realities." (Human Development Report,1997, 33)

More specifically, the reform of the public administration system, occurring in tandem with other major political and socioeconomic reforms in the country, "marked a shift from a system of direct centralized control over all facets of the nation's political, economic, and cultural life to a system where the state acts as a partner and regulates, stimulates, assists, and sets "the rules of the game" for society."¹¹ To this end, the following principles and approaches have been pursued:

- decentralization of vertical structures of administration and the strengthening of horizontal connections
- delegation of authority, functions, obligations, and responsibilities to lower levels of government
- improvement of communication and information flow in all directions,
- emergency and crisis management,

- program-oriented management, prioritized to cope with these problems (e.g.,
- reconstruction of the earthquake zone, strengthening of border areas, protection of Lake Sevan, creation of market infrastructures, and development of small businesses),
- streamlining and combination of public administration bodies to achieve maximum effectiveness.¹²

Thus, all these concepts and structures were not present during the first period of Armenia's democratization (1991-1995). Establishment of public administration was settled later, with the formation of the first democratic Armenian Constitution (adopted in 1995).

The Constitution determined the framework of the new decentralization system for the local governments as well as the new administrative – regional divisions of the republic.¹³

The Armenian Constitution lists the following two principles regarding the decentralization of power to local levels of government: state governance and local self-governemnt. The former applies to the nation's provinces and the later to smaller administrative units. The local self –government takes place in communities, whereas the state government takes place in the regions. In regions, the government appoints regional governance (marzpet) that implements the government's regional policy and coordinates the activity of regional service with the republic executive bodies.

The clarification of Marzpetarans' functions is of immediate importance. "In accordance with current Law, Marzpetarans implement the government's territorial policy in Marzes and coordinates the activity of territorial branches of central executive bodies in the areas of national security, defence, communication, energy, trade and services, tax, crisis

¹¹ <http://www.undp.am/Confer/Decentr/Paper.html> "Decentralization Reforms in Central and Eastern Europe and CIS after 1989"

¹² The above mentioned points are taken from Human Development Report,1998

¹³ The Republic of Armenia was divided into 11 provinces (Marzes). The capital, Yerevan also has the status of a Marz, which is divided into 12 districts.

situations, and civil defence." (Ա.Շ.Հարությունյան, 1999)¹⁴ Since Marzpetarans are the agents of the central government they should perhaps be confined to implementing the governments' territorial policy, while their other responsibilities can be devolved to local and community administrations (local self-governments).

The local self-government bodies are the Councils of Elders with five to fifteen and the head of the community. Both the Councils of Elders and the head are elected by a secret ballot for a three- year period to administer community property and solve the issues of community significance.

It is stated that communities and their bodies operate within the framework defined by the laws and government decisions. They have the right to make independent decisions within that framework. "Generally, the extent of independence depends on local taxes and financial resources, which enable the communities to implement their decisions and projects."¹⁵

Now it would be the point to present and discuss some largest sectors that local governments are independent for decision making and carry responsibility for that.

- **Education**

"Public education is primarily the function of the local government. Providing public education is a local obligation, which means that the local government manages to be a body for supervising the educational institutions."¹⁶ Certainly, the financial transfers are received to the local government but for all actions the local government is responsible and

¹⁴ A.SH.Harutyunyan "*Municipal Law of the Republic of Armenia*". Translation is mine.

¹⁵ *ibid*

¹⁶ *ibid*

accountable by itself. It is responsible for the construction, exploitation and control of the schools, libraries, cultural clubs and other many educational activities.

So, local governments are obliged to perform this service where the rate of their own contribution is also relatively high. From the perspective of local government budgets, the education is the largest item of local expense.

The same can be said for the communities' activity upon this sphere. The head of the community is responsible for his/her actions and accountable to the local governments. What is characteristic for the communities is that the kinder-garden and musical schools entirely belong to communities. That is, all the financial expenses and management are provided by the community's local budget. Hence, the communities are independent for the implementation of their decisions and actions.

- **Health Care**

The second largest item among the local government responsibilities is the health care. The general problem of financing health care mainly concern the local government of cities and communities, because formally within the whole of public finance, only half of health care expenses are incurred by local governments. They are the owners of the institutions, so they are responsible for building maintenance, sector development, provision of medicine and medical treatments. Formally, the central budget has to contribute the costs of developments and renovations. About 83% of municipal health care expenses are covered by the National Health Care Fund.

Nevertheless, this is a sector where local governments have little influence, but relatively high responsibility.

- **Housing and Communal Management**

The third sector that local governments have been given nearly considerable freedom in deciding the problems and issues is the housing and communal management. According to this sector the local governments are responsible for the protection and supervision of residential and non residential places, exploitation of new administrative building, central heating, sewage and so on.

- **Transportation**

In this sector, the local governments take the responsibility over the construction and preservation of roads, bridges and other engineering and mechanical buildings. They also regulate the activity of public transportation.

Thus, local governments are like the masters of this and other sectors where they are independent in their decision of the given sphere.

This, in itself, could be considered quite positive with regard to decentralization of public administration.

The objectives of reforming local government was to make a distinction between the rights and responsibilities of the state, represented by marzpets, appointed by the government on the one hand, and on the other hand, local communities represented by their elective bodies and leaders. It is asserted that under the current conditions the decision – marking bodies should settle problems of only local significance by themselves.

Nevertheless, while the administration of these programs by local governments may be appropriate because they are closer to the people, the many local governments that have

been created as a result of a strong political push for decentralization cannot likely provide these services at an adequate level from their own resources. "Unless service standards and funding for such services are addressed via the intergovernmental system, they may be underprovided, or provided very disparately, depending on any resources that could be available."(Human Development Report, 1998)

Hence, mentioning and enumerating the sectors where the local governments have considerable autonomy and responsible for their actions, we, parallel to this, are evident and acknowledge that not all the functions of local government coincide with the adopted laws and the reality.

If we consider the educational sector then we'll notice that this sector faces some serious problems and the responsibilities of local government for fulfilling its mission in this sector is strongly low. The local governments are unable to sustain the strong education system in a proper manner. The resources for financing the educational institutions are scarce. The allocation of teachers' salaries, equipment and furniture maintenance and communal bills is woefully small. Moreover, the division of rights and obligations between the central government, Marzpetarans and communities are under discussion.

Indeed, as in education, financing remains the most pressing problem in Health Care too. Finances are insufficient to cover current expenditures for construction, equipment maintenance, salaries of physicians and medical personnel, and the cost of medicines. It can be said that the same disparity is present in other sectors too.

So, a question rises: Why it is so and what are the reasons that insufficiency exist in these sectors.¹⁷

¹⁷Emphasis is mine

Unfortunately, some barriers exist that prevent local government from implementing its mission and legal responsibility and, at the same time, hinder the process of the real decentralization.

Hence, the third part of the paper is going to discuss the overall picture of the problems and describe the incapacity of local governments to fulfill their legal responsibilities at the local level and through transfers coming from central government.

Part Three

Barriers of Local Governments and Communities

Evaluation of the process of fragmentation is ambivalent. Splitting of municipalities and creation of smaller units fulfilled local ambitions, brought decision-making nearer to the citizens, and enhanced local initiatives and local feelings. It redressed the damages caused by earlier forced amalgamations and was an understandable, perhaps also unavoidable component of the democratization process.(J.M.Bryson,1991)

However, in spite of the obvious advantages of smaller local governments, there are also reservations to be mentioned. "Criteria of economic and organizational rationality did seldom play any role in separation of local governments. One can doubt whether the small municipalities are really capable of performing all the functions, which they were assigned by the generous reform."¹⁸ J.M Bryson (1991, 168) notes, these units are, as a rule, too small to operate efficiently, to mobilize financial, personal, organizational and political resources, to be able to launch developmental projects and to have a diversified local political life." Economy of scale cannot be achieved within the framework of very small communities, too narrow municipal boundaries constrain or impede provision of municipal services which are

¹⁸ <http://www-wbweb5.worldbank.org/wbiiep/decentralization/topic01.3.htm>, " The Benefits of Fiscal Policy

thus frequently duplicated and difficult to co-ordinate. Further he adds that with a fragmented structure, inter-municipal differences in the provision of services increase and it is difficult to attain equity. What in the small rural communities seems to be a well functioning neighborhood, might in reality become an oligarchic rule of few families or of a small bunch of local influentials. (J.M.Bryson, 1991) Small communities are usually far too weak partners in negotiations with regional and state offices and their weakness facilitates centralist tendencies.

According to J.L.Mikesell (1991,346) "The amount and modality of local level financing, particularly the degree to which the local authorities dispose of local revenues of their own and to which they depend on central government grants, is pivotal for determining the scope of local autonomy or, conversely, the degree of dependency within which the local authorities, in reality, operate."

All the insufficiency that occur and exist in local governments and communities is due to the lack of local revenues.

Lack of Local Revenues

Typically, the decision making, management and financing practices implemented in the local government are mainly connected with the local budget.

As we have mentioned in the second part of the paper, giving the local governments a considerable autonomy in their functions, the core of this functioning is to be the local budget. Of all the mandatory powers delimited in the law of local government, the adoption of a local budget appears to be the most significant one.

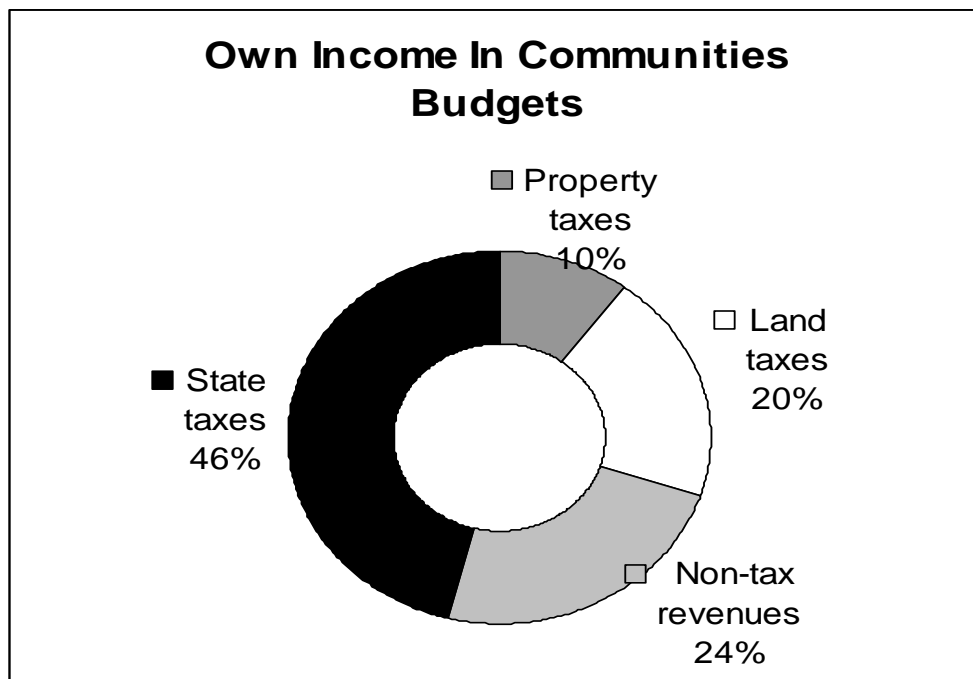
If we consider local government to be a body then the budget would be the head, which coordinates and regulates the whole body. Whereas, the hands that are the most

important and unchangeable parts for human being activity associate with the revenues and expenditures. More precisely, the revenues are in the right hand, whereas the expenditure the left one.

Maybe this is a rough comparison but the practice and reality of local governments show that these three parts – budget, revenues and expenditures are the most significant and persistent components of local governments and their communities.

At present, the revenues of local budgets are made up of their own incomes and allocations and resources allotted from the central budget. For a clear perception of the issue the following figure would be applicable for discussion.

Figure 2:



Human Development Report, Armenia 1997

Actually, the main initial sources for a community's own revenues are the land tax, property tax, state duties, and non- tax revenues. As we see from the figure the state taxes comprised the greater of the city communities' own income which is 46% whereas the property and land taxes together form only 30%.

So, what is characteristic for the local self-governments is that the share the greater part of the local revenues with the central government. Actually, the base of state taxes is defined by the state and the only collector of the taxes such as V.A.T, excise tax and personnel income tax is the central government. Here, from this percentage we see that the role the central government plays as a collector agent is presumably high because it has a comparative advantage in tax collection and the local government has contracted for its services in this respect.

So what is remained in the local budgets is the property and land tax revenues and also the non- tax revenues.

Non-Tax Revenues: In most countries, as well as in Armenia, much less use is made of charging at the local level. According to the figure 2 we see that the non- tax revenues have a considerable high percentage compared with the property and land revenues. The local government can get the ‘charging’ revenues from service fees, public prices specific benefit charges etc. By saying ‘service fee’ we mean license fees of marriage, business vehicle, dog and various small charges levied by local governments essentially for performing specific services.

Thus, all this is in local law that has to be implemented. However, charging people for something they are required by law to do, may not always be sensible in local government.

If we have a look at the Armenian point of view this kind of service fees usually do not create revenues for the local government budget. By adopting a local law it is supposed that the revenues from charging would form a proper amount which is to be filled into the local budget. But, in reality, we acknowledge that a very tiny amount of money goes to the budget expected from the non-tax revenues. In some cases, there is a reason for that. The registration offices may be situated in one region whereas the individuals that have to be charged for some services inhabit in other regions. This makes the payers reluctant to pass

through two or three villages or regions for the registration. Certainly, the illegal framework comes forward. So, the distance between the registration offices and the residential places may hamper the flow of revenues in this aspect. Almost in every local government this problem is present which hinders the high percentage of non-tax revenues that is to be in the local budget.

Property and Land Tax: Where it is impractical to impose fees or levy user charges, theory tells us, that local services should be financed by taxes levied on local beneficiaries. According to the theory of fiscal decentralization 'local taxes' are those over which local authorities have some control setting the tax rate, determining the tax base and certainly receiving the tax revenues. (R.M.Bird,1967)

As we have mentioned above, the property tax and land tax remain as the main sources of revenue for local governments budget. It is asserted that if levied at the local level property and land taxes may serve as a good means of financing local public services.

While, it is sometimes difficult to figure out just what are local taxes, it can be argued that the most important characteristic of a local tax is the freedom of the local government to determine the tax rate. Richard M. Bird (1967,387) points out that "local governments may have large receipts from what appear to be local taxes, but if they can neither set the tax rate nor determine the tax base, it is difficult to see how they can be accountable to their constituents as the margin, as both democracy and efficiency require."

In a country like United States, the local governments have almost complete freedom in setting tax rates and determining tax bases. However, in a transition and developing countries this may be misleading measure of decentralization because the local governments may have little freedom in determining the tax rate or defining the tax base. The similar condition is present in Armenia too.

Although the local governments in Armenia have the freedom in collecting property and land taxes, in fact, it is not upon them to decide and set the tax rate or base but this is the 'obligation' of central government to do. It sets the rate of property and land taxes, which should be applicable for all the local governments. So there is virtually no tax decentralization in Armenia.

However, it can be argued that the extent of freedom and autonomy of local governments in setting tax rates by themselves or by central government appears to be not a significant factor in revenue assignment. With or without setting tax rates or tax base the major problem of the local governments remains on the revenue side. It is quite evident that local governments in Armenia are unable to collect property and land taxes to the accepted extent (even 30% together as it is in figure2).

Some argue that "the property tax is more visible than other taxes (collected by central government), in reason, that it is not deducted at source but often has to be paid directly to the community by taxpayers in periodic lump- sum payment."¹⁹ The same can be said about the land tax, which is to be administered by local governments since it requires identification of each parcel of land, new improvement and changes in ownership. In short, both the property and land tax assignments require a familiarity with local area. Thus all this is quite comprehensible, but the dramatic factor is that the local budget revenues for localities cannot be filled to the expected extent so as to meet considerable local expenditures. The low-income population is substantial, and where affordability and conducting policy are major problems. Hence, as the findings has shown the major problems in the local budget revenue scarcity appear to be mainly the unemployment, and agricultural problems. Furthermore, the paper is going to introduce these factors that contribute to the local budget deficit due to the lack of local revenues.

¹⁹ <http://www.mah.gov.on.ca/busapp/applic-e.asp>"Municipality Capital Budgeting Handbook"

Unemployment

The development of the Armenian economy since independence has caused various changes in the structure of employment. Unfortunately, while saying the development of the Armenian economy we meant not the prosperous economic conditions but rather the opposite conditions, which has become an ongoing process for.

According to statistical data, due to the economic changes the distribution of employment, mainly in manufacturing sector has decreased. "The change to a market system along with government economic policy, mass privatization, political events, and an unstable economic legal framework has caused a massive slowdown for many enterprises resulting in unemployment or artificial employment and low productivity."²⁰

So, because shock therapy of the Armenian economy resulted in deep structural displacements, the outcome of these displacements became the labor surplus.

Thus, the hard-working population, being accustomed to Soviet guarantees of a job and income now, is in expectations of significant assistance from the government in providing jobs and regulating labor relations.

Table 1:

		1996	1997	1998
<i>Unemployed people(thousands)</i>		131.7	159.3	174.4
<i>Average unemployment rate %</i>		6.7	9.3	10.8
<i>Unemployment rate</i> %	<i>Male</i>	2.2	2.7	3.1
	<i>Female</i>	4.5	6.6	7.7

Source: *Human Development Report, Armenia 1999*

²⁰ Արամ Մկրտչյան "Առավոտ", 16 Սեպտեմբեր, 2000.թիվ 193, էջ 3 (Aram Mkrtchyan "Aravot", 16 September, 2000.num.193, p.3

As it is shown from the table1 the level of unemployed people in the state during the given years not decreased but rather increased. And as we see the average rate in 1996 is 6.7 while in 1998 it grew by 4.1 percent. For two years this percentage is too much according to international standards. However, these are the official numbers that the state could collect. Indeed, many unemployeds are not registered yet. So, regarding this factor, we may suggest that the rate of unemployment is much higher than the official data states.

The official unemployment rate while not necessarily accurate, can still show important trends in local governments too.

Table 2: Unemployment by Marzes (% of labour force)

	1999 H1	2000 H1	Unemployment change (percentage points, year-on-year)
Total, including	10.4	12.1	1.7
Aragatsotn	2.5	2.6	0.1
Ararat	5.5	5.8	0.3
Armavir	7.9	9.4	1.5
Gegharkunik	9.3	12.6	3.3
Lori	16.5	20.3	3.8
Kotayk	10.4	11.8	1.4
Shirak	22.2	28.4	6.2
Sunik	19.1	22.7	2.6
Vayots Dzor	5.9	7.3	1.4
Tavush	7.5	8.0	0.5
Yerevan	9.1	13.0	3.9

Source: *National Statistical Service, AET calculations.*

The data for 1997 shows large disparities of unemployment by regions. The highest unemployment rate was in the earthquake zone-28.4% in Shirak Marz and 20.3% in Lori Marz, while the south of the country also registered high figures. In Siunik Marz 22.7% whereas in Vayots Dzor 7.3%, Gegarkunik 12.6%. According to the unemployment change percentage we notice that the greatest is in Shirak Marz.

Before the independence, in 1980s, the manufacturing sector in these regions was highly developed. The state had its branches of various industrial factories in each region, where the half of the population was involved in manufacturing activity. So, the unemployment rate, at the times where almost all the plants and factories were working didn't show any high percentage of unemployment as it is now.

For instance, Shirak marz had seven huge plants where the textile industry was developed. The same can be said about Lori, which was known for its chemical and authogen plants, Gegarkunik for its copper industry. We can numerate the profiles of several industrial plants that are in these regions. Nevertheless, the pitiful situation is that almost no one of these huge enterprises, well known for their production not only domestically, but also outside of the region, especially in the countries of former Soviet Union, is working now. Since, about 60% of the employed population is now unemployed, inadequate employment opportunities have led to seasonal or total emigration from these regions, particularly of able bodied men, in search of work and income.

So, again a question rises: "how can local budgets be filled if the great portion of the remained population is unemployed and unable to pay the taxes levied by the local government?"²¹

Thus, the only hope remains on the agricultural side, where the state, privatizing the lands and giving them to the farmers, assumed that this reform would create better conditions for local governments and their residents. But, anyhow this side has its insufficiency too.

²¹ Emphasis mine

Agriculture

Armenia was the first among the CIS countries to carry out agricultural reforms in 1991. Eight hundred and sixty collective farms were transformed into 305,000 individual farms. Farmers received as individual property 66 % of the land, 80 % of the livestock and almost all other associated resources.²²

The farmers have received small farms with scattered parcels of land averaging between 1.2 – 1.4 hectares of arable land. There has been formed a cadastral value of land, where the land is divided into 5 groups. According to this land grouping, the farmers need to pay a substantial tax in cash based on the cadastral value. It was assumed that the interaction with the local governments and the farmers would remain on this issue, whereas in other side, local governments completely give the farmers freedom in their every-day activity.

The farmers were free to determine which crops to sow and where to sell them.

However, their options are limited by numerous *physical, financial and marketing* constraints.

The fact is that the outlook for agricultural production, in general, during these five years remains uncertain. The main problem in production side is that these arable lands are limited. From the overall number of arable land that form 410,000 of the entire country, only 210,000 is irrigated, though in irregular terms. What we should note here is that it is irrigated irrationally which cause the rest land to remain uncultivated and saline.

The indications show that 55%-60% of crops in the mountainous areas in Gegarkunik, Aragatsotn, Tavoush, Shirak marzes rely on natural precipitation, where the irrigation is the major problem and because of it the crops are damaging to some extent.

Hence, topography and climate conditions, soil fertility and the access to irrigation water vary greatly and affect yields in every region. Thus, for this reason, with only 20% of

²² all the data is taken from the Ministry of Agriculture

the land suitable for cropping, small holdings and about 60% of the cropped land sown to cereals whereas crop rotation schedules are not being respected even in the fertile valleys.

Nevertheless, not only the climate and the water supply may become an obstacle for the crop production but also unqualified and scarce inputs and old machinery may hamper the fertile production. Indeed, access to qualified inputs and innovated machinery is very important, though it is quite difficult phenomena regarding Armenian current economic situation. About the 60% of the existing technology that are mainly inherited from the Soviet Union has already been worn out and need renewing. So, with inadequate use of fertilizer over a decade, lack of adequate drainage in the valleys, soil erosion, degradation of pastures, yield potential is undermined.

Another shortcoming that exacerbates the agricultural aspect is marketing. Marketing constraints are possibly the chief obstacle to increasing farm income and the most difficult for the farmers to overcome. Appropriate marketing and transport infrastructure for small farmers is lacking. Roads are poor and transportation is expensive. The domestic market is small and contracting and access to external markets remains very difficult. Since, road, rail and market infrastructure is inadequate, it reduces the competitiveness of exports. As a result, there are seasonal surpluses perishable produce, while shortages persist elsewhere. For example, this year we witnessed that there was a grape and apricot surpluses and because of poor inadequate market infrastructure. The farmers could not afford to sell these crops in an appropriate manner so as to get profit from.

Thus, people in rural areas frequently mention their lack of transportation and marketing services, which leave them in poor conditions. According to the discussion of agricultural problems, we assume that there is a failing feedback of inputs and outputs. On the one hand, farmers are unable to get the cash they need to pay for farming inputs (seeds,

fertilizers) at the beginning of the crop season or for harvesting costs (pays of farm equipment -fuel) whereas on the other hand, the access to market for selling is limited.

Therefore, the core and the final point of the agricultural problems appear to be the lack of cash. In fact, both urban unemployment and rural inability to sell agricultural products leads to lack of access to cash. Respondents in both rural areas and urban areas express an understanding of the need to pay for public services and taxes and a willingness to pay. However, they also express a frustration with their inability to get the money required to pay.

So, this is a condition, which is now actual in every local government. Moreover, these hampering conditions are omnipresent and would lead to worsened situation due to the lack of local revenues. These present conditions are unable to contribute to the collection and raise of the local budget revenues.

However, since it is unusual for the revenue-raising capacity and the expenditure needs of local governments to be perfectly matched, fiscal transfers are usually required to close the resulting gap.

Actually, this problem-solving item is acceptable in every country, being it developed or developing one. In some countries, to some extent, the intergovernmental transfers give sufficient results for the recovery of the local governments. But, in other countries we witness that central government is sometimes unable to provide transfers or subsidies in an equalizing basis to the local governments. This is another barrier that local governments expecting better conditions from the central government again face to it.

Lack of Transfers and Subsidies

As we have mentioned above in many developing and transition countries, local (subnational) governments are given relatively little taxing power. The major source of local

government revenue in these countries is intergovernmental transfers from the central level. In this case, local governments cannot set the tax rate or define the tax base for most of the major levies, therefore, they have little control over the total level of revenues available.

However, intergovernmental transfer systems can be decentralized to varying degrees.

Let us illustrate the major ones:

- By guaranteeing local government revenues an adequate flow of revenues
- By providing local governments with some degree of certainty in the flow of revenue so that more efficient fiscal planning is allowed
- By providing local governments with transfers that do not have ‘strings attached’, i.e., by giving unconditional rather than conditional grants."²³

To evaluate the degree of centralization of the grant pool, "the size of the total grant pool must be determined in one of three ways: a) as a share of a national tax, b) on an ad hoc basis, and c) on a basis of cost reimbursement."²⁴ The former has the potential to be the most decentralized in that it can guarantee the local government some significant flow of revenue, surely, assuming that the center does not change the rules for distribution. The other two forms of determining the distributable pool are more centralizing. The ad hoc method lets the central government determine how much will be allocated to local governments in any given year.

In most transition economies, as well as in Armenia, the aggregate volume of transfers is determined entirely ad hoc by the central government, often changing with each annual budget. The rule - based allocation formulas are not yet common in the transition economies. Apart from Hungary and Poland, where an explicit formula for the normative

²³<http://wbln0018.worldbank.org/network/prem/premdoclib.nsf/080e778ec5bef48f8525677d007864c7/7fd9b1c8e485b0ea85256746004d5d4d?OpenDocument>, "Fiscal Decentralization and Intergovernmental Transfers in Less Developed Countries"

²⁴ *ibid*

grant includes an equalization component and a complex formulation of expenditure needs most intergovernmental fiscal flows continue to be essentially discretionary and negotiated.

Indeed, in Armenia, central transfers to local governments' funds form a large share of local spending. This concept can be approached from two sides. Either this reflects the center's reluctance to give up a tool for controlling local governments or the failure of some local authorities to modernize and strengthen the limited revenues they do control. We can assume that two approaches are applicable for Armenia from both sides.

However, according to my paper discussion we see that the latter approach is more applicable and urgent one. Surely, the bulk of Armenian local funds are provided by the central government in the form of transfers and subsidies. As a result, they allow local governments to provide services and the central government to set standard.

Unfortunately, a striking feature of transfers and subsidies is that they are largely unconditional. Since, in Armenia the formula of the transfers is not a rule-based but rather entirely ad hoc where they can be changed with each annual budget, the responsibility of the central government towards the transfers is very weak. Indeed, the weakness and unconditionality of transfer allocation have their reasons. The major one appears to be the budget deficit that the state faces each year. While, saying the budget deficit, we mean the amount that expenditures exceed revenues.

For instance, the following table will illustrate the deficit situation of Armenia over years.

Table3: State Budget Deficit

	1996	1997	1998	1999	2000
Deficit (mln AMD)	-61648.2	-37599.3	-35191.4	-58008.9	-66253.8
Deficit (% of GDP)	4.3	2.5	3.7	6.2%	5.6%
Domestic Financing	30.08%	-7.62%	57.5%	13.90%	19.85%
Foreign Financing	69.9%	107.6%	42.4%	51.40%	46.85%

Source: *Tacis Report, Armenia, Economic Trends (1Q, 2000)*

This table shows us that each year the country faces to budget deficit, accordingly, without any hope that it can provide considerable transfers to local governments as it is used to be planned at the beginning of the fiscal year. As the figures show the foreign financing is three times more than the domestic financing.

Thus, the main reason of the deficit is due to the lack of tax revenues. During these five years the revenues from main tax categories are characterized by a declining tendency.

For a complete comprehension and discussion of the budget deficit it would be appropriate to illustrate another table with the description of the state budget operations where revenues and expenditures are the major components and to see to what extent they are correlated to each other.

Table4: State Budget Operations (in percent of GDP)

	1995	1996	1997	1998	1999	2000/ H1
<i>Total revenue and grants</i>	20.1	15.1	16.4	15.5	20.3	19.2
<i>Of which tax revenue</i>	11.5	10.6	13.4	14.3	16.8	15.4
<i>Total expenditure Breakdown</i>	26.5	24.4	21.1	22.2	25.5	23.3
<i>State budget balance (accrual deficit) " - "</i>	- 16.8	-9.6	-8.6	-6.3	-6.8	-5.3

<i>State budget balance (cash deficit "-")</i>	-10.5	-11.7	-9.3	-6.3	-7.2	-6.4(6)
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Source: *Tacis Report, Armenia, Economic Trends (1Q, 2000)*

The illustrated figures show that the total expenditure numbers exceed with the total revenue and grant numbers. Thus, for this reason, it can be said that the balance of the state budget would be formed with minus. The fact that revenues were lower in the first half of 2000 than a year ago implies that decline of the deficit was mainly attributed to expenditure compression. The latter was generated through two main channels: compression of capital expenditures and accumulation of new arrears. This means that the decrease of the deficit does not depict the real picture, as the main part of postponed expenditure should eventually be met.

So, what is characteristic of the Armenian state budget is that at the beginning of fiscal year the experts predict that the year would end with less budget deficit and the proportion of the total revenues and expenditures would be on equal basis. However, even in the middle of the year they acknowledge that the projected revenues wouldn't be received and then they face to contrary fact that it has predicted before. The well known is this year's example (budget deficit 2000).

However, as we refer to the issue of local governments then we'll see that the dramatic situation of the state budget has its own 'contribution ' to the local governments.

The local government sector is part of the national economy, so its financial situation and financial management cannot be viewed independently of general economic and financial potential of the country as a whole. Thus, possibilities for local governments' local budget are primarily influenced by the GDP, the amount of centrally and locally collected income, and

the proportional distribution of total central. Here, the following table illustrates the transfers to marzes from the Armenian State budget from 1999 to 2000.

Table 5: Transfers to marzes from the Armenian State Budget

	<i>1999 planned thousand/drams</i>	<i>1999 actual in percentage</i>	<i>2000 planned thousand/drams</i>	<i>2000 actual in percentage</i>	<i>Difference between 1999-2000 Planned transfers/thousand drams</i>
<i>Yerevan</i>	2014564.3	64%	2116135.8	61.4%	101591.5
<i>Aragatsotn</i>	146372.0	48%	184451.9	44.3%	38079.9
<i>Ararat</i>	362572.4	57%	373378.8	52%	10806.4
<i>Armavir</i>	2854731.6	42%	356930.9	38.6%	71457.3
<i>Gegharkunik</i>	384693.9	46.4%	422043.7	47%	37349.8
<i>Lori</i>	590899.2	50.3%	753609.8	45.3%	162710.6
<i>Kotayk</i>	443253.1	48%	449643.2	49.2%	61349.0
<i>Shirak</i>	513754.7	53%	711313.1	45%	197558.4
<i>Syunik</i>	2845931.2	38%	345942.2	33.5%	61349.0
<i>Voyots Dzor</i>	86372.0	32.5%	137180.0	30.4%	50808.0
<i>Tavush</i>	214301.5	39.8%	245055.1	41%	30753.6

Source: Ministry of Finance and Economic Sheet: Indicators

From the drawn table we witness the fact that local governments really, in present, face to serious problems. According to the figures, we see that the amount that is planned for these two years is considerably small, whereas the percentage of the actual receipts is dual small that the local governments get. Although it should be mentioned that these figures are taken from the official data, that is from the Ministry of Finance and Economy of Armenia, which, for sure, would not coincide with each local government's data.

Hence, according to the aggregate volume of fiscal decentralization the transfers from the central governments should be served as an equalizing factor for each local government that meets local budget deficit. But, as reality of Armenian fiscal policy 'dictates', during these 5 years the match between the central government and local ones is murky, where none of these governments knows its place and responsibilities.

Recommendation and Conclusion

In this paper I attempted to describe and analyze the local governments' capacity and responsibilities arguing whether to what extent they are independent and how their mission is implemented in the regions.

However, while analyzing the concepts and structures of local governments I found several barriers that hamper the real process of fiscal decentralization. As I have mentioned in the introduction of the paper some research questions were put forward as the guidelines of the study. Therefore, now it is the point to answer briefly the question as a concluding note.

Hence, in view of Armenian (fiscal) decentralization we may assume that it has not provided sufficiency for the legal responsibilities assigned to local government. Moreover, the division of fiscal responsibilities between the central and local governments has not developed effectively. Surely, barriers exist which reduce the ability of local government to raise its own funds and fight against the local budget deficit. Unfortunately, at the moment, there appears to be no reconciliation between the central and local governments concerning the revenue difficulties, which drastically limit local government functioning.

However, we may assume that these conditions are present because of several factors, among which the major one is that Armenia is considered to be one of the transition countries that is attempting to be recovered from the previous system that was quite in a contrary with the decentralization theory. Indeed, some remnants of the former system exist that surely hinder the real path of decentralization.

Thus, based on these problems and barriers that exist in the central and local governments, it could be said that broad scale recommendations are in question now, as according to the mentioned barriers this include not only the recovery of local government but the central one too.

One thing is for sure, that by encouraging foreign and domestic investment into the localities might be dually beneficial for the state. Definitely there are some regions in Armenia that are rich in their resources but for poor control and financing these regions remained unproductive and useless.

The government must realize that providing sufficient finances to those local areas, which have prospects in future, would increase the entire welfare of the state regarding the increase of revenue income. However, this is a long-run activity and now the state cannot

provide considerable finances to these regions for development because of the state budget deficit. Moreover, for the foreign investment a stable and uncorrupted environment must be provided, which is too far from now.

Consequently, introducing a functioning system of decentralized governance is a demanding process that has to be carefully designed. It cannot be completed within a short time as a one-off legislative act. The reform rather requires a continuous attention and permanent fine-tuning and has sometimes to be implemented in several stages. As we see from the study decentralization is also a complex process whose dimensions and prerequisites are not just political, legal and administrative, but also economic too.

So, here can be said only the following: Armenia is new for this new system and some changes and amendments are required for the real form of decentralization.

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