

CENTRAL-LOCAL FISCAL RELATIONS IN ARMENIA

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Central-Local Fiscal Relations in Armenia

Abstract

This study analyzes fiscal relationships between local and central government in Armenia, within the context of the recently approved Constitution and proposed implementing legislation.

This study was undertaken during September 1995. Several documents were reviewed. A model of State decentralization was developed. Interviews were held with relevant Armenian officials from central and local government, and the model was in some instances used to guide these interviews. In addition, a series of basic tenets of good government in a democratic system was developed and applied to relevant issues in Armenia. Then a tentative set of recommendations was prepared. A seminar toward the end of the study period was held with many of the interviewees, as well as some others. Feedback and corrections were elicited at this seminar and helped to finalize the report.

The final recommendations made in this report have to do with fiscal relations, budgets, local participation, audit, division of authorities among levels of government, and public discussion of the role and future shape of the Armenian State.

Acronyms used in this report

COMECOM	Trading Bloc of the former Eastern Bloc Nations
GDP	Gross Domestic Product
GNP	Gross National Product
GOA	Government of Armenia
ICMA	International City/County Management Association
INBI	Spanish language acronym for Index of Unsatisfied Basic Necessities
NIS	Newly Independent States of the Former Soviet Union
NMP	Net Material Product
PL 480	US Public Law Number 480: Food aid programs
PPP	Purchasing Power Parity
SOW	Scope of Work
UNDP	United Nations Development Program
US	United States of America
USAID	United States Agency for International Development
VAT	Value-Added Tax
WWII	World War II (two)

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Executive Summary

This study assesses the status of fiscal relations among different levels of government in Armenia, and makes recommendations for how to improve these fiscal relations. The recommended improvements are meant to be consistent with the relationships broadly defined in the new Constitution. The recommendations are based on: the Constitution; the current direction in which the country seems to be moving, especially with regard to the desired degree of decentralization; basic tenets of public finance; and, a view for further reform in the not too distant future.

Recommendations are made specifically to assist the Government of Armenia (GOA) in the drafting of relevant legislation. Of particular importance is the upcoming legislation on "Territorial Administration and Local Self-Government". Annex III includes specific comments on this draft law.

Related laws will also need to be drafted and enacted and these should also take into consideration the recommendations made here. In particular, the following laws should consider the recommendations in this report: Budget System Law (sometime in mid-1996), and the Treasury System Law (sometime in late 1996).

The recommendations are presented in brief below:

- The GOA should host conferences to discuss the benefits and costs of decentralization and deconcentration. In a broader vein, the GOA needs to consider systematically the roles it would like to have the State and the private sector play in the country's economic and social development. This needs to be done with a good deal of discussion and consultation with civil society.
- The land tax should eventually be converted to a land-based municipal fee administered by local government. The rates applied should also be locally established, although it might be reasonable for central government to establish a maximum rate.
- It is unlikely that local governments could at this time successfully take over the administration of the land tax. Hence, for the next several years this tax should continue to be supervised by the Tax Inspectorate, but the revenues should be transferred to local government.
- The locally collected land-based municipal fee should fund locally provided services, such as street paving, trash collection, and perhaps, eventually, police.
- The GOA needs to clearly lay out in a local government code the types of fees and duties that local governments will be permitted to carry out.

- Regional administrations should not have taxing authority, nor should they have the authority to raise revenues from fees, duties, or by any other means. They should be entirely funded through the central government budget. (Specific licenses, such as for driving, or fees for passport issuance, could be collected by regional administrations.)
- The GOA needs to prepare a Budget System Law, which among other things, would establish with greater certainty how local governments will receive transfers from the central government.
- Regional budgets should be funded as part of the central government budget. Regional administration should not be treated as autonomous.
- Regional administrations should not receive transfers from central government.
- Local government budgets should be autonomous from central government control and authority.
- There is a need to encourage creative ways for local government to generate revenues.
- Regional operations should be regularly audited by a supreme audit or controller general of the Republic, as would any other central government entity.
- Local government operations should be regularly audited by the same supreme audit or controller general of the Republic, as any State entity.
- Local governments should hold public hearing during the budget process.
- Local governments should publish and make publicly available all budget plans, receipts, forecasts, and other fiscal documentation.
- Local governments should be required to make all audit reports publicly available.
- Governors should discuss their budget submissions with local government leadership.
- Governors should hold public discussion on regional administration during the year.
- Local governments should be responsible for local land use zoning. This zoning would be subordinate to national environmental legislation.
- Regional administrations need not play a role in local zoning nor in national legislation.

- Condominium associations should contract for housing maintenance and repairs instead of local government. These services could be provided through contracting out the services that are now provided (poorly) by the zsheks.
- The zsheks should be privatized and forced to compete for the provision of housing repair and maintenance services.
- The GOA should consider the Chilean model of per student funding and the injection of competition into the provision of schooling.
- Hospitals, which will probably be under the Ministry of Health's management control, should have their management privatized through innovative contracts that explicitly tie pay to performance, and these contracts should be subject to periodic re-bidding.
- Clinics, which are likely to be under the Governors' purview, should also have their operations contracted out. It is possible that local non-government organizations could participate in the competition for providing these services. Clinic services might be contracted not on a fee for service basis but rather on a per person complete, basic coverage basis. Health services should include some degree of cost-recovery.
- The GOA needs to privatize and "demonopolize" the ownership, or at least the management, of several public enterprises. The following enterprises should be subject to privatization: 1) Haybnakkomtnt, 2) Hayjrmughkoyughi, and 3) Haykomjermoenergo, which provide housing (trash, some water, communal services), water (both residential and industrial), and heating, respectively.

I. INTRODUCTION

Fiscal relationships between central and local government in Armenia have been shaped by two major historical events. The first of these was the incorporation of the country into the Union of Soviet Socialist Republics, and the second was the latest redesign of the very nature of the Republic of Armenia under a post-Soviet, recently approved National Constitution. While the newly approved Constitution defines the political powers of the different branches of the State, administrative and fiscal relations are not yet as clearly defined. The GOA is presently drafting laws on territorial administration and local government, the administration of Yerevan, and the Budgeting System. These laws together should help to clarify fiscal relations among the different levels of government and help define the size and form of the State.¹

The objectives of this consultancy are to assist the Government of Armenia (GOA) analyze the existing structure of local-central government fiscal relations and clarify policy options for restructuring these relationships. In this study I assess the status of fiscal relations between local and central government. While the roles of the regions, including Yerevan, in terms of provision of public services and fiscal powers are very important in Armenia, they are mainly functions of the central government. This is because Governors and the Mayor of Yerevan are appointed by the President or the Prime Minister of the Republic. At the same time, the GOA has also requested assistance in designing the structure of relations between central and regional government, and between regional and local government. Hence, this study also reviews the GOA's intentions in this regard, and provides comments and recommendations.

After the assessment of the status of fiscal relations is carried out, a series of recommendations is made as to how these relations might be improved. These recommendations are made within the context of the current Constitution. The objective of this report is not to suggest departures from the political framework established in the Constitution, but rather to suggest ways to operate within that framework in such a way as to create greater fiscal autonomy for local government. This should help reduce Central Government management burdens, increase transparency in fiscal relations, improve government accountability, and provide an improved set of incentives for more efficient resource use.²

The issue of local vs. central government property ownership is not covered in this report. This issue is important but could not be adequately attended to during this consultancy.

¹In this paper the term State (with a capital S) refers to all levels of the public sector: central, regional and local government, the military, and autonomous institutions, such as public enterprises and the national universities.

² "Accountability" refers to the degree to which governments can be successfully monitored and held "accountable" for their actions by their constituencies.

The next section discusses the methodology used in undertaking this study. This is followed by some comments on aspects of the Armenian economy. How the economy works and its performance represent important constraints on the possibilities for fiscal policies.

II. METHODOLOGY

The methodology followed in this study was informal. Before coming to Armenia I read a few documents, including the Constitution, to get familiarized with general aspects of Armenia. (See attached list of reviewed documents and laws.) Then three matrices were prepared, one on local revenues, one on revenue sharing, and one on the responsibilities and authorities for the provision of public services. In addition, an analytical model of central-local relations was developed. (See graphic presentation.) Together, these matrices, information gleaned from the documents that were reviewed and the model were all used in interviewing Armenian counterparts and others. (See attached list of persons interviewed.) In addition, a set of basic tenets from public finance and public choice theory and practice was presented and applied to the Armenian case. These basic tenets provide added framework for discussing the role, scope and shape of the Armenian State in the future. Toward the end of the consultancy, a seminar was held and comment and criticism were elicited and used to help refine this paper and to develop a set of specific comments on the draft law "On Territorial Administration and Local Self-Governments", which is included in Annex IV of this paper.

III. THE ARMENIAN ECONOMY

This is a difficult economy to get a handle on. Economic statistics are contradictory from source to source and casual observation belies a recent survey of income and expenditure accounts. Groliers' Encyclopedia, based on World Bank data, put annual GNP per capita at \$8,000 in Armenia in 1991. While a recent, unnamed and untitled report indicates a per capita income of \$2,000 in 1994. At the same time, the UNDP has issued its Human Development Report on Armenia, which put income at PPP\$ 510 per capita per annum, making Armenia a poor country, indeed.³ A recent ICMA report (Family Income & Expense Patterns in the City of Yerevan) puts nominal per capita income at about \$400 per

³Purchasing Power Parity (PPP) is an index that establishes a "real exchange rate" between the prices in one country versus the prices for similar goods and services in the US. This allows us to correct for particularly low prices for many goods and services in Armenia compared to the US and other countries.

year.⁴ Without yet having achieved expertise on the Armenian economy, a feat that would take time and effort, I give more credibility to the \$2,000 figure. Clearly the average Armenian does not have one-third the income of the average American. This means the \$8,000 figure is too high. At the same time, \$400 would make this country poorer than Ethiopia. And, even the \$510 would make this country poorer than Liberia in the mid-1980s, again an absolute absurdity.⁵

In Armenia, there are so many distortions and continued atavisms of the Soviet central planning model that normal national accounting is little more than guesswork, so far.

A number of economic constraints bear upon the economy and upon the possibilities for fiscal actions. Consider:

- Real interest rates (such as for construction) had been extremely negative, 3% nominal in the face of 200% inflation. Today inflation has declined considerably, to about 30% for 1995. Other, informal lending may take place at interest rates of about 100%.
- Extremely underdeveloped financial sector, which makes financial transactions extremely costly.
- There is no significant private sector activity in long term lending.
- Many basic services are provided by government, which is not unusual, but also many other services that would in other countries be privately provided, such as hot water, building maintenance for private housing, and heating.
- The blockade on the country has caused most trade to be carried out via air routes, raising the country's costs of doing business.
- There is a thriving informal market, selling both legal and pilfered products, and mostly outside the government's tax net.
- High profit taxes (had been 45% for the largest firms but was recently lowered to

⁴ The ICMA study is not entirely consistent with disaggregated national accounts data since it is only a survey of cash income. In Armenia, where housing had been provided by the employers, usually a State institution, this would be a serious undercounting of what in the national accounts would be the rental value of housing as both an income and expenditure item.

⁵ See Bakshsian and Gajewski for an treatment of the problems of national accounting in Armenia.

30%) combined with steeply rising personal income taxes, create incentives to cheat, provide benefits rather than wages, and disincentives to invest, especially keeping out foreign investment.

- A very important source of income is remittances from abroad, possibly amounting to nearly 50% of the average Armenian's personal income. Some observers feel this is a rather high approximation.

- A tax of 25% on the export of hard currency, which further giving disincentive to foreign investment. This tax has recently been rescinded.

- Few attractive methods for holding assets. For instance, in most countries real estate is the preferred asset of choice for individuals and families, with financial instruments coming in a close second. Yet, the underdeveloped state of the Armenian housing and housing finance sectors, and the until recently cleared up uncertain treatment of property rights, has made real estate less than attractive. And, the extremely underdeveloped nature of the financial sector makes holding financial instruments nonviable. Rapid inflation in the past and uncertainty for the future make the holding of national currency also a losing or a risky proposition. Reportedly, many Armenians prefer to hold much of their wealth in foreign currency, which does not increase national, physical wealth.

- *According to an ICF tax administration advisor, the country's participation in the Commonwealth of Independent States (CIS) precludes the imposition of the value-added tax (VAT) on imports from CIS trading partners, although the tax is collected from exporting industries, exactly the opposite of a reasonable competitiveness strategy.*

- Industry is dominated by State owned firms.

- Finally, a weak economy, which according to some estimates, has declined in total output for the last several years. In part this is caused by the blockade of the country, but also to the difficult transition period from the Soviet System to a modern, market oriented one. In addition, the collapse of the Soviet Union and its Eastern European COMECON partners has closed opportunities for Armenian exports and has cost the country in Soviet subsidized imports.

Each of these points has implications for any discussion of the alternatives for taxation and spending policies. For instance, the current high rates of taxation, especially given the poor economic performance of the country and the obviously low collections rates, indicate that the country should not be trying to further impose taxation on the private sector.

Hence, no new significant taxes are recommended in this study. The informal aspects of the Armenian economy have made it difficult to enforce current tax laws. Further efforts to raise revenues must consider this constraint.

While so much of the economy remains in public hands it will be difficult to raise revenues on such a small tax base.⁶ As long as the private sector remains as small as it does tax options, whether at the local or national level, will be restricted. As it is now, Armenia has high tax rates but low tax yields. Take for instance, the Value-Added Tax (VAT) which at a 20% rate only yields about 5% of national income. In El Salvador the VAT of 10% this year was yielding about 5% of national income, and in Chile the 18% VAT rate yields about 9% of national income. Increasing the tax rates in Armenia is unlikely to yield greater revenues but is likely to either hamper the growth of the private sector or just push more business into the informal sector.

Obviously the Armenian public sector is too big to continue along a path of private enterprise without considerable restructuring of the public sector, namely downsizing. Meanwhile, if not done carefully, mass layoffs in the public sector will likely cause considerable social discontent, demonstrations, civil unrest and further economic stagnation. On the other hand Caprio (1995) indicates expected economic growth over the next few years to exceed 5% per annum, under the assumption that basic reforms are followed through. Further restructuring of the public at this time, if done prudently, can help supply the resources, particularly labor, that will be required for this targeted economic growth.

IV. THE CONSTITUTION

The new Constitution does not go much into depth about the nature of fiscal relations. However, it is clear that the lion's share of administrative authority rests with the Prime Minister's government and that the Prime Minister serves under authority of the President. (art. 44 ss 4) And, that regional government, which takes place in the region (in Armenian this is the "marz"), the Central Government appoints and dismisses the Governors ("marzpets") and that the marz implement the central government's regional policies and coordinate for central government executive bodies. (art. 107) Yerevan is treated much the same way as a marz, although the Mayor, rather than Governor, is directly appointed by the President upon presentation of the candidate by the Prime Minister. (art. 108) Also, the City of Yerevan is to be much more involved in the day to day operations of managing the City and less in terms of central government regional policy, *per se*. Local government in

⁶Caprio (1995) reports that in 1994 about 850,500 people were employed in the Armenian public sector out of a total work force of about 1,492,000. Hence public sector employment came to about 57% of all employment. This includes public enterprises, central, local and regional government, the military, the Pension and Employment Fund, and all other State institutions.

Armenia takes place in the community ("hamaink") and local leadership is elected by the community vote. Local government in Yerevan takes place at the district community level. (arts 105 and 108) According to article 109 the community leader can be removed from office by the central government upon recommendation by the regional Governor (marzpet).

On the basis of the above, it appears that while some local choice is permitted, that Armenia is nonetheless a highly centralized State, with most authority ultimately in the hands of the President, albeit one who is duly elected by the population. Yet, it is necessary to go beyond the Constitution and down to the level of execution. In the next sections we discuss the reality of fiscal relations in Armenia, both as established by law and as practiced. The next section discusses revenues and local fiscal autonomy, while the section after that discusses the responsibilities and authorities of local government in the provision of services.

V. REVENUES AND LOCAL AUTONOMY

The GOA has radically altered or reformed its tax system. Indeed, by the end of 1992, almost all taxes that had been in effect in 1991 were no longer in effect. The GOA's 1992 Law on Taxes and Customs establishes the basis for this newly reformed tax system. The present tax system, entirely administered by central government, relies mainly on the following:

- Profit taxes on enterprises
- Value-Added Tax (VAT)
- Excise taxes, mainly on sumptuary and luxury consumption
- Personal income tax
- Land tax
- Property tax.

These are the central government's main tax sources and amount to more than half of total central government revenues, followed by 30-35% from grants (for instance, monetized food donations, such as PL 480) and a number of non-tax sources (rents, fees, fines, etc.)⁷

Essentially, local government, for the time being, depends upon the financial resources transferred to it through the central government's budget. These transfers, which amount to about 30% of the national budget, are not made based upon law or other mechanisms specified by law, but rather they are made based upon the central government's budgeting process, and determined annually. While the GOA's 1992 Law on Taxes and Duties allows for local duties and fees, which must be approved by referendum and approved by the National Assembly, this has not happened yet.⁸ Hence, local governments enjoy almost no fiscal autonomy, but in part this is because they have not chosen to take advantage of article 6.

While Armenia practices revenue sharing, where certain percentages of centrally collected taxes are allocated to local governments, these percentages are not clearly predetermined by law. That is, each year in the budget process the Central Government and the National Assembly assign percentages of each tax and non-tax revenue source to local government.

⁷PL 480 is the US Government's foreign food aid program.

⁸Article 6 indicates that local governments may impose taxes, but neither specifically authorizes nor proscribes the types and amounts or levels of taxation.

These percentages are determined not according to a pre-set percentage as established by law or by the Constitution, but rather are based upon the geographic sources of the particular revenues as well as the GOA's perception of budget priorities and expectations of revenue collections. This is essentially the same as making budgetary transfers to local government based upon budgetary priorities and has little if anything to do with specific revenue collections, except to the extent that tying transfers to specific tax performance makes the amounts and distributions of these transfers somewhat more variable and less certain. This is so because it is technically easier to project overall revenues than it is to project revenues from individual taxes.

In the last two years, land and property taxes, as supervised and collected by the central government's Tax Inspectorate, have been allocated to the specific local governments from which these revenues originated. In essence, these taxes have been local taxes administered by central government. However, it is not established by any specific law that these tax revenues must be assigned to these local governments in this way, and indeed, we might expect that assignments in the future may entirely separate revenue source and assignment. In which case, the land and property taxes would no longer be essentially local taxes administered by central government.

In addition, the central government passes a number of subventions to local government for specific subsidies, such as those for electricity and water.

In the case of Yerevan City, the Mayor, who is appointed by the President, presides over the overall operations of the city plus the eight districts that make up the city. The districts are led by district councils as well as a district leader who are elected by their local electorates. In other cities, district councils are also elected by their local electorates, but the mayor is also elected.

In the most recent national budget, the National Assembly assigned 38% of Value-Added Tax receipts and 38% of enterprise profits tax to Yerevan City, of which 21 % points went to the eight districts that make up Yerevan and 17% points remained with Yerevan City Central Government itself. These two taxes comprise the lion's share of these budgets. In addition, 100% of the property and land taxes collected from the particular districts have been returned to these districts.

At present, the GOA does not have a Budget System Law. It is anticipated that sometime next year that such a law should be prepared for National Assembly approval. This might be an opportunity to codify some of these fiscal relations.

Notwithstanding the above, some revenues are collected by local governments. These are essentially fees charged street vendors. Some people consider these to be business licenses, based upon the locality's conceding the street vendor the privilege to sell his wares on public property, while others have mentioned that this is a tax in lieu of the government's ability to apply the Value-Added Tax to these mobile merchants.

Although in theory, i.e., not explicitly proscribed by the Constitution or other laws, local governments can incur deficits, which they would have to finance from the banking system, this has not occurred. It is also not contemplated that this would occur; however, the issue has not yet been clearly dealt with by the GOA.

VI. SERVICE PROVISION BY LOCAL GOVERNMENT

In Yerevan total expenditures for this fiscal year will come to about \$30 million. These expenditures include that spent at the Yerevan City level, with its about 325 regular employees, and the eight district administrations, with their 518 regular employees. These expenditures pay for services such as:

SERVICES PROVIDED BY YEREVAN CITY

- street lighting
- water
- street paving
- city planning

SERVICES PROVIDED BY YEREVAN DISTRICTS

- housing maintenance and repair
- street cleaning
- trash removal
- social services

The services provided by Yerevan City are managed by the Mayor and his 325 regular employees, who contract out, to public enterprises, for these services. While the Mayor and his employees are city employees and receive the civil service protection as established for central government employees, the contractors and their employees are not direct city employees. The city hires contractors, mostly public sector enterprises or organizations, to provide services based upon competitive bidding based upon requests for proposals.

There are a number of services provided by local government in Armenia that might be provided by other than local government. Four such services that were raised in conversations were:

- trash collection
- water
- heating
- housing maintenance services

Of these, housing maintenance services should probably be turned over to the country's new home-owners. In recent years much of the country's housing stock has been privatized, and now about 65% of Armenia's housing stock is in private hands. It is expected that by the end of 1995 80% of all housing in Armenia will be privately owned. Very little of this private housing is rented, instead almost all is owner-occupied. In the cases of apartment dwelling, which is the most common form, it would make sense for housing maintenance services to be provided through contracted services, where the contracting parties would be the firm that provides the service based upon a competitive bid and the apartment house's condominium association, made up of the apartment house's owners. These owners would pay monthly fees, which would be used to cover the costs of such housing maintenance.⁹

It seems that housing maintenance is one of the first basic services that government should have stopped supplying. Also, when housing was privatized it should have been done within the framework of an established condominium or homeowners association, since it is very difficult to amicably establish such organizations once ownership has been established.

Similar solutions should be found for heating and water services. The present organization of these services is rather centralized. Perhaps these services, for the time being, could be provided by publicly authorized but privately owned corporations or perhaps via utility (eg., water, electricity) cooperatives, which would meter water and heating use by housing unit and charge according to marginal cost pricing principals.

Trash collection services at the present are funded by municipal budgets but carried out by public sector contractors. While it might seem reasonable to charge fees for trash collection, perhaps, say by the pound or trash bag full, this could create perverse incentives, where clients, rather than incur this additional cost choose to dump their trash in their neighbors' yards or in the street or in a nearby river. Further movement to the application of pricing principles for trash removal service must only be undertaken after careful analysis.¹⁰

Although local governments are responsible for funding the provision of these varied services, the services are generally provided by public enterprises that are contracted by local government. This may appear modern and an innovative way to provide public services, however, these public enterprises have a monopoly control over the provision of these services and while they are "subordinate" by law to the particular local government

⁹An alternative but similar form of common grounds maintenance organization would be to form condominium associations. Such condominium associations could contract for maintenance of common property, such as lobbies, external walls, roofs, and gardens and garages.

¹⁰ At present a small fee for trash collection is being charged.

they are also "subordinate" by law to the Ministry of Municipal Development. This situation results in unclear management authority, little accountability, and poor services. The situation is worse than having these services directly provided directly by a department of local government because at least in the case of the latter there would be some direct management control and accountability.

There are a number of other services that are provided by local government that are not provided by any level of government in the West or in most developing countries. For instance, cities or the Ministry of Urban Development provide: hotels, laundries, greenhouses, and cemeteries.¹¹ It is not enough, obviously, and given in particular the economic constraints mentioned above, to consider a restructuring of government to determine which level of government should be providing these services in the future, but rather, it is necessary to consider whether any level of government at all should be providing these services.

Meanwhile, local government has little if any participation in capital investment projects. Although there have been a few examples of local government taking the initiative -- for instance, in Jermouk, local government built a plastic bottle plant for its popular spring water -- this is generally not the case. Indeed, the present system of government essentially places all control over and funding of capital projects in the hands of the one time Ministry of Construction, now part of the new Ministry of Urban Development.

It appears also that local governments have not undertaken "self-help" projects. Such projects, as are often undertaken in poor countries that have felt under-served by the central government, include, for example: school construction, local road and farm to market road construction or repair, small bridge building, and adult literacy programs.

In almost all countries of the West, and the general trend in developing countries too, zoning or land use regulation is essentially a local affair, although national laws on the environment hold priority over local regulation. In Armenia, such zoning, to the extent it has taken place has been a central government operation. The central government prepares Master Plans (GENPLANS) for communities throughout the country and these are implemented at the local level, with perhaps a local government architect involved with monitoring the application of the Master Plan. It is understood that local government may have a voice in the preparation and application of the Master Plan, nonetheless, the preparation of the plan and its application are central government authorities.

In the past centrally prepared Master Planning might have made some sense, since the construction of factories, schools, shops, and housing was all to be undertaken by central

¹¹ Cemeteries are provided by municipalities in a number of countries, particularly in Latin America, but also in some parts of the US. This is a function that could be provided by private enterprise or non-profit, non-governmental organizations.

government. However, with the steady withdrawal of the central government from these spheres of activity, it would seem reasonable to consider turning over power for local land use to local government.

VII. ISSUES IN THE ROLE OF LOCAL GOVERNMENT

Given this framework, some of the issues that face the government are:

- the nature of local government's fiscal relations with the central government
- the nature of local government's fiscal relations with the regional government
- the nature of local government's relations with central government Ministries and Departments
- how to establish budget priorities in terms of a decentralized State
- the role of budgetary transfers
- issues of fiscal autonomy for local government
- issues in taxation for local government
- the role of public participation in local government
- treasury operations
- audit of local government operations.

These are each discussed in turn.

Fiscal relations with central government:

The need to clearly specify fiscal relationships between central and local government are paramount. Local government autonomy cannot rest solely on its own revenue generating capacity. Yet, how central government transfers resources to local government must be very carefully thought out. Such transfers should be made based on rules which are transparent and made public. The rules should not be changing from year to year. And, the rules should not be subject to political manipulation. At the same time, the rules should clearly build in the intentions of central government policy. For instance, a fund might be designed to encourage local revenue effort, while a second fund might be established to compensate districts with weaker or potential revenue bases or greater social needs.

Relations with Ministries

There may not be great need for direct relations between Ministries/Departments and local government, as one of the purposes of the upcoming legislation is to clearly define and demarcate roles and authorities. In general, local government operations should not overlap greatly with central Ministries and Departments.

Local government leaders in cooperation with Governors can present infrastructure investment proposals for Ministry approval and budgetary support.

Budget Priorities in a Decentralized State

Spending at the local level should reflect the priorities of the local electorate. Central government need not supervise nor interfere in local government budgeting, although broad guidelines for local government budgeting should be established by law.

Role of Budgetary Transfers

Budgetary transfers were already discussed above. However, it needs to be made clear that transfers to local government do not represent a gift from the people in central government to their poor cousins in local districts. Nor does providing transfers based on rules equate to functional earmarking of the budget. This is because, instead of representing a type of spending, spending at the local level merely represents spending at a different level of government. Whether spending happens at the local or national level should be based upon the breakdown, discussed later, of comparative advantages rather than on sectoral allocation.

Fiscal Autonomy for Local Government

Since local government is to represent the choices and efforts of local electorates, fiscal autonomy is needed. To not have fiscal autonomy would leave local government as merely a subject of centralized control, or worse, political manipulation. Fiscal autonomy can be enhanced by encouraging creative ways of generating local revenues that would be consistent with the Constitution. In addition, fiscal autonomy can be enhanced by making central-local transfers a right of local government rather than an allocation decision made during the central government's annual budget process.

Taxation Authority

Taxation authority is specifically not granted in the Constitution. However, the Constitution does indicate the right of local governments to impose duties and fees. This represents an opportunity for local government that will require some creative approaches. It is not clear what the distinction is between duties and fees, nor what each entails. Clearly, a tax on incomes could be considered nothing other than a tax. Yet, in some countries, municipal fees are sometimes based on the size or frontage of a property, somehow relating the use of municipal services with this fee base. One could even imagine a municipal fee based upon the value of a piece of land, since the value of a piece of land -- not including the structures on the land -- could be deemed to derive in large part from its location, particularly as location is related to the quality of municipal

services and other public services. Of course, agricultural land, which derives much of its value from its fertility, would be treated somewhat differently.

Public Participation in Local Government

In developing budget system legislation for local government, the GOA should include ways of ensuring local participation. While it may be unwieldy to have referenda on budgets, although this is done in other places, the local council might be required to hold open town meeting to discuss the budget and priorities prior to its preparation, and at other times during the budget process.

Additionally, local government should be required to publish its budget plans, its expenditures, its receipts, and all relevant fiscal documentation. These should be made publicly available and fora should be established for open discussion.

Treasury Operations

Treasury operations refers to the management of cash and bank deposits, borrowing, receipts of taxes, fees, transfers and other revenues. Treasury operations should be carried out using a single, general fund for each local government. All receipts and all expenditures should be centralized in as few accounts as possible. All expenditures and account maintenance should be a function of the local government's treasurer. Banks should not authorize overdrafts, although specific short-term loans might be provided in anticipation of revenues. Such loans should charge market-based (positive real) interest rates, and should only be made as part of cash management operations under strict rules.

In terms of borrowing capacity, there is no authority expressed in the Constitution. However, as there are already sufficient macroeconomic difficulties facing the country, and given the incipient nature of local government development, it would probably be preferable, at this point in time, to not authorize deficit spending at the local level.

Audit of Local Government Operations

The GOA is presently creating a supreme audit function, most likely to be the function of a Controller General, which would be an "autonomous State institution". While it has not yet been determined exactly how this institution will operate, the local governments, as part of the State, should also be subject to the Controller General's audits, as the new law may establish. Audit reports should be made available for public scrutiny.

In the following chart we can compare the functions and authorities of local governments as described above in Armenia, with four other instances: the United States of America (US), El Salvador, Colombia, and Chile.

Comparative table on municipal authorities and elections								
Country	Taxation	Fees	Education	Health	Zoning	other services	Elected Mayor	Elected Councils
Armenia	none, although permitted		mixed function with central govt	none	limited, supervision of central Master Plan	regular municipal functions plus myriad of others	elected by district councils	elected by popular vote
El Salvador	none, although permitted	several, similar to property tax, plus fees for emission of documents	no municipal role	none	essentially a local function, but not much enforcement	regular municipal services	elected popularly	council goes to winning party
US counties and municipal	property tax is major, also sales taxes	wide ranges of fees, for services, businesses, licenses	mainly a local function, some states is local district others it is city or county run	usually have county public health service, and larger cities	local government function, must be consistent with state and central gov't regulations	varies but limited	elected popularly (some place a county supervisor is elected from board of supervisors)	elected popularly. In counties board is elected from constituent districts
Colombia	property tax is major local revenue generator	fees for services and document emission	locally implemented with regional and central funding	na	na	na	elected popularly since 1986	
Chile (1980s)	na	na	local schools, municipal and other compete for central funds	services of central funding with local supervision, much private sector participation		na	mayors were elected but president was not	na
<p>Information based on author's familiarity, but documentation was not available at the time of this table preparation. Countries were selected based upon the author's familiarity. Further work in this area should include a number of West and East European countries, as well as some Asian countries.</p>								

VIII. REGIONAL ADMINISTRATION

What role regional governments, outside of Yerevan, will have in Armenia is still to be determined. The Constitution does not endow the regional government with many specific tasks. Indeed, according to the Constitution the regional governments (marz) are responsible for implementing central government's regional policy and for coordinating the activities of regional services. In addition, the regional Governor can present a case to the central government for the removal of a local government leader (mayor or district head). While it is not indicated in the Constitution, it is understood that such a case should only be made for criminal or unconstitutional behavior.

First, it should be made clear that which is referred to as "regional government" in the Constitution, in actuality is not government at all, but rather an extension or a deconcentration of the central government's administration, and it is specifically a section of the executive branch of that central government. This is so because as the Governor is not elected by the people in the region he does not represent them as part of a democratic government. However, it might be considered that the intention of the Constitution is to create a regional Governor, reporting to central government in the interest of his local region. At the same time, while this does not represent true decentralization, in that no real power is actually devolved to local citizenry, some interlocutors indicate that the spirit of the new Constitution was to "bring the government closer to the people." What this does here is bring government administration closer to the people. To the extent that people, especially outside of Yerevan, are going to have greater access to central government administration, this can be seen as a step in the right direction.

At this point in time, the GOA is considering the deconcentration of many of central government functions to the regional government level. In such case, policies and regulations as well as certain financial control over these functions might remain in central government hands at the Ministerial level, while Governors would be responsible for the implementation of these programs. At the moment, some of those interviewed for this study indicated their expectation that the following services might be spun off to the Governors: public security, education, health care (mainly clinics and small hospitals, while large hospitals would remain under direct Ministry control), roads, water, social services.

IX. ISSUES IN THE ROLE OF REGIONAL ADMINISTRATION

Given this framework, the issues that face the government are:

- the nature of the Governors' fiscal relations with the central government
- the nature of Governors' relations with central government Ministries and Departments
- how to establish budget priorities in terms of a deconcentrated central government
- the role of budgetary transfers
- issues of fiscal autonomy for Governors
- issues in taxation for Governors.
- the role of public participation in the Governors' programs
- treasury operations
- audit of Governors' operations.

These are each discussed in turn.

Fiscal Relations with the Central Government:

If the activities that are contemplated are actually transferred to the Governors' management, it will of course be necessary to also transfer to them adequate resources. Hence, fiscal relations will require that financial resources will need to be transferred to the Governors via the national budget. In addition, however, control over employees who are at present functionaries of central Ministries will also have to be transferred to control of the regional Governors. The majority of these employees will be teachers and health workers. While the Governors should have management control over these people, it would not be reasonable to have their salaries paid out of Regional budgets. Instead, their salaries and other benefits, such as pensions, bonuses, health benefits, etc. should remain with the central government. The reason for this is to not overburden the administrative capacity of the Governors.

The Governors will require some management control so that they can respond to immediate needs without having to get central government approval for individual expenditures. Yet, the needs of the Governors, which need to include exigencies and miscellaneous categories, will need to be budgeted. The Governors' budgets should be

subject to Ministerial approval, especially with regard to the resources under their respective control, control of the Cabinet of Ministers, and National Assembly approval. Governors will not be independent of central government but will need to have the capacity to make decisions once their budgets are approved and passed into law along with the central government budget.

Relations with Ministries

While the Governors will provide management and supervision of schooling, some public health care, public security, etc., the individual Ministries will continue to be responsible for establishing policy with regard to national curricula, approved treatments, and practices and procedures. Salary levels will remain under the control of the central government.

Governors in cooperation with local government heads can present infrastructure investment proposals for Ministry approval and budgetary support.

Budget Priorities in a Deconcentrated the Central Government

Spending at the regional level should reflect the priorities of the central government. Central government needs to allocate resources among the regions according to its own objectives with respect to specific objectives. Of course, central government needs to consider the particular needs of the various regions. For instance, if a particular region is particularly poorly served in terms of basic health care, efforts to reverse this should be reflected in the central government's allocations to the region. Governors should be involved in the budgeting process, especially in lobbying for the interests of their own regions. However, since the Governors are not elected officials and since the Constitution specifies that they are responsible for carrying out, but not creating, regional policy, they should not have a greater than advisory role in the budget process.

Role of Budgetary Transfers

There is no particular reason for budgetary transfers to the regions. This is because transfers should be made for any of the following reasons: to encourage specific behavior by beneficiaries, or to compliment resources generated by beneficiaries. Since Governors are agents of the central government, and since their role according to the Constitution is to carry out the central government's regional policies, there is no need to provide them with transfers since by fiat they are to implement this policy. Also, since local governments have no taxing authority, there is little sense in providing transfers. Instead, regional Governors should be funded by the central budget and sector specific resources should be provided from central Ministries.

Fiscal Autonomy for Governors

The short answer is that there is no need for fiscal autonomy. The regional administrations do not represent a distinct level of government but merely an extension of central government administration. As one interlocutor says: they are a means for bringing central government closer to the people. The Constitution indicates that they are responsible for carrying out central government regional policy.

Taxation Authority

Taxation authority is not granted in the Constitution.

Public Participation in Regional Programs

By bringing the central government closer to the people through the establishment of the regional governments, the government also increases the opportunities for people to hold government accountable. Monthly meetings should be held with the regional Governor and the district leaders. The purpose of the monthly meetings would be to review the allocation of resources to the region. In addition, the regional Governor should hold open town meetings, where local district leaders could participate, but where the meeting should also be open to the general public.

Treasury Operations

Treasury operations refers to the management of cash and bank deposits, borrowing, receipts of taxes, fees, transfers and other revenues. At the moment the GOA has more than 800 bank accounts, over which it has not been able to establish effective daily control. This results in unwitting overdrafts, costing the government money that had not been budgeted for and for which the government had not planned. To reduce these difficulties, it would seem reasonable to not permit regional administrations to manage their own spending and accounts. However, this would be a complete disaster for regional administration. In creating a new treasury system the GOA should ensure that regional administration can manage funds and accounts with some flexibility. The GOA might prefer to make quarterly or monthly disbursements to regional administrations' accounts in anticipation of spending needs.

In terms of borrowing capacity, there is no authority expressed in the Constitution. However, as regional governments are merely an extension of central government and would need to operate their spending function based upon the cash management of the Ministry of Finance, it would be inconsistent to allow lending authority.

Audit of Governors' Operations

The GOA is presently creating a supreme audit function, most likely to be the function of a Controller General, which would be an "autonomous State institution". While it has not yet been determined exactly how this institution would operate, the regional governments, as part of the State, should also be subject to the Controller General's audits, as the new law may establish.

In the following chart the distribution of authorities of regional governments of a few countries are presented.

Comparative table on regional government authorities and elections								
Country	Taxation	Fees	Education	Health	Zoning	other services	Elected Mayor	Elected Councils
Armenia	none	none	may be transferred to regional control	may be transferred to regional control	none	maybe public security, roads, water, social affairs	not elected, chosen by PM. In Yerevan selected by President	none
El Salvador departamentos	none	none	none	none	none	coordinates technical assistance of Min. of Interior on municipal development	selected by President	none
US a typical state	income, sales, are the major sources	wide ranges of fees, for services, businesses, licenses	regulates public and private schooling, provides subsidies	may provide some public health, sets state standards and regulations of public and private	May set environmental, historic preservation, etc legislation, but most zoning is local	state police, courts, state roads, regulation	governor elected popularly	legislators elected from districts and sent to state capital
Colombia	none	none	region provides some fiscal oversight	region provides some fiscal oversight	na	na	selected by central government	na
Chile (1980s)	none	none	region manages funds and school supervision for central govt central funds	region manages funds and clinic supervision for central govt	na	na	named by Pinochet	na
Information based on author's familiarity, but documentation was not available at the time of this table preparation. Countries were selected based upon the author's familiarity								

X. MODELS OF FISCAL RELATIONS

The States of the world are structured in many different ways. In many cases the structure of the State is the result of historic happenstance rather than design. For instance, relatively large countries tend to be rather decentralized and usually started off as smaller, independent units. Two examples of this are the United States of America and Germany. Smaller countries usually, but certainly not always, have tended toward the unitary form of government, where central government is of primary importance and local government plays a small role. In these small, unitary form countries, where there is regional government, the regional government is often just an agent of the central government, as is the case in Armenia or El Salvador.

These large federal republics (eg., Germany and the US) often fall closer to the "local-choice" where the desires for governance are expressed at the local or regional level, a large share of resources are generally collected at the regional level, and spending is made at the regional or local level. In the US almost all important public education is funded at the local and state (as in the US has 50 states) level, half of the country's tax revenues are collected at these levels, and law enforcement and the administration of justice are overwhelmingly provided at this level. Nigeria, an African country that has had its independence for less than forty years, is also large (about 90 million people, of a diversity of tribes and languages -- about 250), and is a federal republic, where many public services are delivered by state (regions) and local governments. The US, Germany, and Nigeria follow to varying degrees, the local choice model.

Local administration in France is organized around 22 administrative regions and 96 metropolitan departments, and was highly centralized until the Mitterrand government implemented in 1982 a devolution plan, giving considerably more authority to regions and departments. Today, each department is administered by an elected departmental council. In addition, each department comprises *communes*, which total about 36,000 in the country. Each commune is headed by an elected mayor.

At the other extreme, is the unitary State, where local or regional government have little or no role to play in national affairs. El Salvador and Guatemala are two Central American examples of this type of government form, although there has been some movement toward decentralization to local municipalities.

Local government in El Salvador takes place in municipalities, where a municipality ("municipio" in Spanish) would be nearly equivalent to a hamaink in Armenia. Each municipio is led by a mayor as well as a council. The mayor is directly elected by the population, but the council is won by only one party. Basically, whichever party wins the most votes takes the council. In El Salvador local government, not including the capital city San Salvador, self-generated revenues are equivalent to about two coca-colas per person per year, i.e., insignificant. These insignificant revenues are supplemented by rather meager transfers from the Central Government. Last year these central government

transfers to local government came to less than one percent (about 0.25%) of the central government's total expenditures. There is also departmental government in El Salvador (this would be a marz in Armenia). Each department has a Governor who is appointed by the President. (The country has no Prime Minister.) The departmental Governor has almost no role, other than to rally local political forces and serve as a liaison between mayors, deputies of the National Assembly and the Executive branch of government.

Local revenues in Salvadoran municipios are derived from a primitive form of property tax.

This tax is applied in two ways: 1) to cover the costs of street lighting and pavement, property owners must pay a fee based upon the frontage of their property, and 2) to cover the costs of trash removal, property owners are assessed a fee based upon the total area of their property. These property fees are only collected on lots within the settled part of the municipio, i.e., only on lots in town. Municipios also generate fees from the registry of births, deaths and the issuance of national identity cards, as well as other documents.

Of course, the capital city, San Salvador, being quite large (about 1.5 million people -- similar to Yerevan) and more advanced than the other parts of the country, can generate more revenues than can other municipios. The capital has its own police force, although this is small and subordinated to the national police. Some other highly industrialized municipios have similar police forces, mainly to protect municipal property.

Colombia, in South America, had been a very centralized State. However, with political liberalization and the free election of mayors in the second half of the 1980s, the country has been moving headlong toward decentralization. Colombia represents one of the few countries to have actually set out by design to move from the highly centralized unitary model toward true decentralization. The Colombians are moving toward the "local choice" model for its municipal governments, while the regions and territories have also been decentralized, but toward the "principal-agent" model.

Central government's budget is divided among central government and local and regional governments, with local and regional governments receiving revenues equivalent to almost 50% of the total budget. These revenues are transferred to local and regional governments for specific as well as non-specified uses. In part, these revenues are based upon the size of the population, the degree of poverty, the schooling needs. (Schooling is provided by local government but is mostly centrally funded.) The Colombians have an Index of Unsatisfied Basic Needs. (In Spanish this is called an INBI.) This INBI is based upon annual survey data that include indicators of human development, such as: infant mortality, type of roofing on housing, adult literacy, incidence of various diseases. In part, local governments are free to spend this money as determined by themselves and their constituents, rather than by central government mandate.

The "principal-agent" model is found in Colombia's regional level of government and in Chile's local government structures, where the central government is the principal, deciding

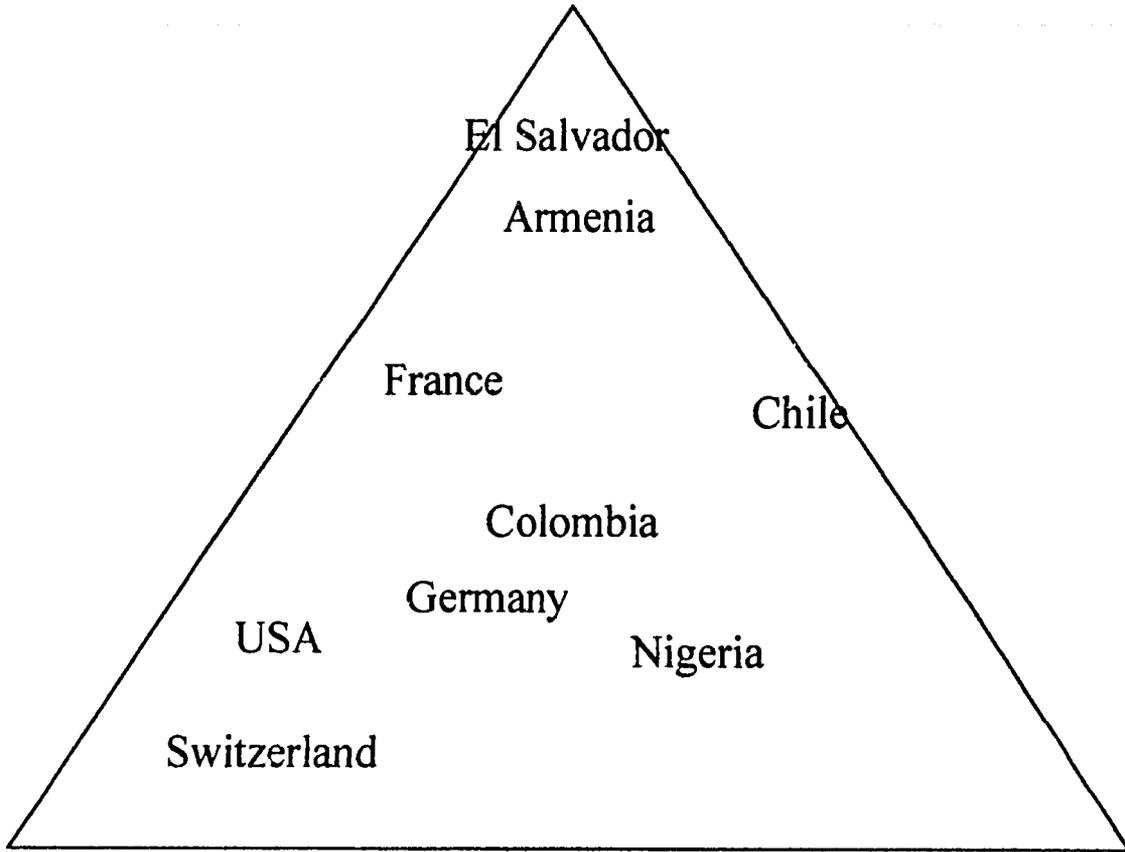
what should be done at the regional or local level and providing financing for these activities, while the subsidiary level of government serves as the agent of the central government, carrying out the funder's mandates.

Chile, during the 1980s, began an intense battle against poverty. It decided, in part, to combat poverty through both reducing the role of the State, but also better focusing the resources of the State in the fight against poverty. These resources were targeted on the needy rather than providing assistance to the general public, in particular, the general public did not need the assistance of the State to leave the grip of poverty. The Chileans focussed their battle on improving the basic education and health services provided to its people. The model it chose to do this was the principal-agent model. Under this arrangement, provincial and local government provided these basic services under the regulation of central government and with funds from the central government. At this time, neither local nor national government was elected. Indeed, the famous Pinochet government was in power. Today Chile's President and Congressmen are elected, but provincial government remains under central control.

Despite the undemocratic nature of the structure of government in Chile at the time, a number of innovations were introduced, and they are claimed to have been very successful. One particular innovation was how education was budgeted for. Under this plan, schools were paid a fixed amount per student attending their schools. Schools did not have to submit their budgets for approval, did not have to return overages to the government, and their salaries and spending were also not regulated. If they incurred losses that was their problem. If they incurred profits they could keep them and spend them as they pleased. Important in this scheme was the participation of private schools and the general competition for funding based on the ability of each school to attract and retain students, that was fostered. In essence, parents could send their children to almost any school they wished, as long as it met certain basic criteria. Hence, schools had to compete for students and their per student subvention.

The gamut of structures can be represented in a triangular chart, where the top corner represents a high degree of centralization, i.e., the unitary form of government. The bottom left corner represents a pure form of the local choice model of government, where local government is highly autonomous, its leadership is selected via local election, and where local government is accountable to the local electorate. The bottom right hand corner represents the principal-agent form of governance, where central government operates through to some extent the use of local or regional governments operating as central government extensions.

Centralized



El Salvador

Armenia

France

Chile

Colombia

Germany

USA

Nigeria

Switzerland

Local choice

Principal-agent

In this triangle, it is important to note, there is no indication of which model is best, most efficient, or in some other way, most desirable. Each model has its positive and negative aspects. For instance, in a large country, especially one with a variety of ethnic and language groups, the local choice model offers the often desired degree of regional autonomy. In a medium sized country a mixture of local choice and principal agent, with principal agency most being practiced at the regional rather than local level, often helps to manage the affairs of central government while providing many of the benefits of decentralization.

As was mentioned earlier, in most countries of the world, the model resulted from historical events rather than as a result of design. Yet, in the case of Armenia as well as the other NIS countries, there is a conscious need to restructure the State. Rejection of the Soviet system and its replacement with a more liberal Constitution coupled with the newly found independence, requires that Armenians, as with many of the ex-colonial countries of the post WWII era, contemplate the State structure that most suits their own desires and aspirations.

At the same time, however, there are a number of considerations that should be kept in mind when thinking about the desirability of creating new central-local fiscal relations. For instance, it is useful to consider the comparative advantages of each level of government in terms of revenue generation and spending, two of the most basic functions of government.

Given the state of flux in which we presently encounter Armenia, with four separate but related laws in the proposal and review stage it is a bit difficult to precisely classify the Armenian State according to this model.¹² However, given the direction that the GOA seems to be taking will put Armenia near the top and to the right of the triangle, where the central government controls almost all financial resources and distributes these resources to local government so that local government can meet central government mandates.

¹²These are laws on the following: 1) establishment of new regional structure, i.e. nine or ten plus one, for legislative approval by November 1, 1995, 2) regional administration, Nov. 1, 1995, 3) local government, by early 1996, and 4) management of Yerevan. In addition, the GOA is developing a new Budget System Law (for mid-1996), and is developing its treasury system, which will also need to be passed into law by end of 1996, as well as other laws, such as on privatization of certain functions and on the operation of the public sector's treasury system, which also need to be considered here and need to incorporate some of the ideas and recommendations of this analysis.

COMPARATIVE ADVANTAGES OF CENTRAL GOVERNMENT

In general, central governments have a comparative advantage over local government in the following taxation areas:

- Value-Added Taxes (VATs) should only be nationally based, locally run or differentiated VATs are generally fraught with distortions, fraud and are extremely difficult to administer.
- Income tax systems should be based on a national rather than a local system, although local income taxes may "piggy-back" on national systems.
- Certain pure or near pure "public goods" can be better provided by the central government¹³, such as:
 - = national defense
 - = certain types of economic and environmental regulation
 - = certain types of standard setting, for instance, rail road gauging or telecommunication and electricity standards
 - = international and diplomatic affairs.

COMPARATIVE ADVANTAGES OF LOCAL GOVERNMENT

In general, there are a number of things for which local government is better suited. Some examples are:

- Real estate taxation, because if linked to local administration and service provision it can be capitalized in property values
- Provision of certain local public goods, such as street lighting, urban street maintenance, and possibly local security (police and some courts)

¹³A public good is a good or service that consumption of which by one person does not reduce the amount of the good's consumption by another (non-rival) and cannot be reasonably charged for on marginal pricing bases.

XI. BASIC TENETS OF GOOD GOVERNMENT IN A DEMOCRATIC SOCIETY

When considering the optimal roles, functions and structure of the State, the following basic tenets should be applied:

- ▶ The State should concentrate its activities on the provision of PUBLIC GOODS. Public goods are goods and services that will not be provided by the private sector based upon market incentives. Public goods benefit all the people in society or in an area, yet consumption of the public good by one person does not reduce its availability for consumption by others. (This is the concept of "Non-Rivalry".) Prime examples of such public goods include:
 - = National defense
 - = Legal framework
 - = Conduct of international affairs
 - = Traffic control
 - = Street cleaning
 - = Highway maintenance, and
 - = Environmental regulation

- ▶ The State should ensure the provision of MERIT GOODS. These are goods or services that when consumed by one person benefits are enjoyed by others in society. For example, we are all better off when our countrymen have access to basic education. Another example is the control of endemic diseases, to ensure that certain diseases do not spread unchecked throughout the population. (Children are vaccinated so they do not spread diseases in school.)

- ▶ The State should apply the concept of SUBSIDIARITY, where the lower the level of government or State institution that can provide a public service, the better. The point of this concept is to bring government into the power of the people, to improve the communication of people's desires and also to raise accountability. For instance, while national defense should clearly be a central government affair, street maintenance should be provided by local government.

- ▶ Wherever possible, LONG RUN MARGINAL COST PRICING should be applied to the provision of services, although it may make sense to subsidize merit good consumption. For example, housing maintenance should be provided (if provided by

the State) at full cost recovery prices, while schooling might be provided at subsidized rates.

- ▶ The State needs to TARGET its resources, not providing general subsidies to the entire population, but rather focusing subsidies on those neediest in society. For example, electricity should not be subsidized for the general public, although specific subsidies might make sense in poor, rural areas.
- ▶ Not all State-funded activities actually need to be provided by the State. To the extent feasible, many activities should be provided by PRIVATE CONTRACTS or through PRIVATE CONCESSIONS.
- ▶ To the greatest extent possible, State activities should introduce ELEMENTS OF COMPETITION with CLIENT SATISFACTION and COST CONTAINMENT as major objectives.

XII. CONCLUSIONS AND RECOMMENDATIONS

There are a number of contradictions among people's perception of how the Armenian State works and how they would like it to function. There are no prior analyses prepared (at least none were made available during this consultancy) on the topic of central-local government fiscal relations in Armenia and so much of the information in this report had to be gleaned from conversations with a wide array of people. Also, the transition from the Soviet system of government to the current one was based on few laws that have been well defined. Indeed, law was not what regulated how government worked under the Soviet system. The recently enacted Constitution clearly attempts to establish a break with the past, but lawmaking has yet to catch up with Constitution making in Armenia, and the analyst must deal with a hodgepodge of proposed laws to try to find out where the country is and where it might be going.

In conversations with several counterparts within the Armenian government, and outside of government, too, it seems that there is considerable confusion over the structure of fiscal relations in the country. There is also considerable difference of opinion as to whether the country is centralized, decentralized, and in what way. There is also considerable disagreement as to the form that decentralization might or should take. Most agree that the government should be further decentralized, while others indicate that this does not seem to be the direction in which the country is moving.

My own interpretation is that the government is indeed quite centralized, and with the new Constitution and draft or proposed law on territorial administration and local self-government that the country seems to be approaching the principal-agent model. Yet, to some extent, it seems that there is considerable desire to strengthen the authorities and resource bases of local government, while at the same time spinning off from local

government some of the services that perhaps need not be provided by the public sector, at all. Yet, at the same time, I am told that the schools and kindergartens, which are currently under the jurisdiction of local government, will be transferred to central government jurisdiction.

Clearly, there exist considerable divergence of opinion on these issues, as well as considerable confusion. The intention of this study was to help put into perspective various options on how to restructure these fiscal relations. Within this vein, and based on the basic tenets expressed above, the following recommendations are presented as food for thought.

Discussion

This country is going through very fundamental reform of all its major economic and political institutions. While there is consensus on the need for change, indeed, nobody even questions that the change is inevitable, there is little consensus as to what the new Armenia will or should look like. People know they do not want the old soviet system but seem uncertain as to with what exactly it should be replaced. The President and the National Assembly are elected, but there seems to be little trust of local government, yet in the West local government has been the very building block of free societies. While there is considerable desire to move to a free enterprise, market based system, it seems there has been little consideration given as to the proper role of the State in a democratic, market based society. Which functions should be performed by the State and which by the private sector, the role of pricing for both privately and publicly provided goods and services, accountability in governance, and how to foster participation of the country's citizens and develop civil society, are issues that are both related to this study and which deserve much greater vetting and discussion.

- Implicit in the goal of increasing local government autonomy is the movement of the country from its current position in the triangle illustrated, as a highly centralized system of government, downward. How far down and how far left or right, truly needs to be discussed among civil society in Armenia and among the country's political and administrative authorities. Hence, the first recommendation is that conferences to discuss the benefits and costs of decentralization and deconcentration. Such a conference should include participation of foreign or national experts with knowledge of public finance and administration, fiscal federalism, and knowledgeable of experiences in other countries. Two such experts come to mind, Tarsicio Casteneda of Mission Social in the Government of Colombia or Anwar Shah of the World Bank.
- In a broader vein, the GOA needs to consider systematically the roles it would like to have the State and the private sector play in the country's economic and social development. This needs to be done with a good deal of discussion and consultation with civil society.

Local Revenues

Local autonomy implies access to resources that are controlled by the local government. Any plan to increase local autonomy that does not address the issues or does not allow for rights to revenues, either through municipal taxes, duties and fees or through legislated transfers from central government, would be without substance.

- The land tax should eventually be converted to a land-based municipal fee administered by the local government. The rates applied should also be locally established, although it might be reasonable for central government to establish a maximum rate.
- It is unlikely that local governments could at this time successfully take over the administration of the land tax. Hence, for the next several years this tax should continue to be supervised by the Tax Inspectorate, but the revenues should be transferred to local government. Also, the rates for the land/property tax should be established locally, with a proposal by local council and a local referendum, subject to a maximum rate to be established by central government legislation.
- The locally collected land-based municipal fee should fund locally provided services, such as local street paving, trash collection, and perhaps, eventually, police.
- The GOA needs to clearly lay out in a local government code the types of fees and duties that local governments will be permitted to carry out. Such a list should represent enabling rather than compelling legislation. This is not inconsistent with the 1992 Law on Taxes and Customs, but would serve to reinforce that law.

Regional revenues

- Regional governments should not have taxing authority.
- Regional administrations should not have the authority to raise revenues from fees, duties, or by any other means. They should be entirely funded through the central government budget.

Fiscal relations

Clearly specified local-central fiscal relations are an absolute essential in the drive toward greater local self-government. Such clearly specified relations are also necessary to ensure capable, accountable and flexible regional administration.

- The GOA needs to prepare a Budget System Law, which among other things, would establish with greater certainty how local governments will receive transfers from the central government. This should include:
 - * Transfers made as a certain percentage of total spending, this should be based upon an average of the recent three years
 - * To encourage greater efforts for local tax collections the GOA should design a mechanism that would provide partially matching transfers for revenues collected.
 - * Transfers probably should not be made in terms of shares of specific revenues, except if property and land tax administration are not transferred to direct district control.
- Regional budgets should be funded as part of the central government budget. Regional administration should not be treated as autonomous.
- Regional administrations should not receive transfers from central government.
- Local government budgets should be autonomous from central government control and authority.
- There is a need to encourage creative ways for local government to generate revenues. This can include more creative use of fees for services, especially in greater than cost plus pricing, licensing and permit fees, better pricing of water and heating services to generate a small profit for the municipality, street parking metering, municipal parking lots or licensing of private fee-based parking lots, and perhaps entertainment fees (such as a charge on hotels, theater, or restaurant dining).

Audit and public scrutiny

This is a particularly important set of recommendations since it: 1) reinforces the concept of local autonomy for the hamainken, 2) ensures that local government leaders (hamainkainpet) are held accountable to their constituencies, 3) ensures the accountability of Governors to central government, while 4) gives voice to the desires of people in the regions by "bringing central government closer to the people".

- Regional operations should be regularly audited by a supreme audit or controller general of the Republic, as would any other central government entity.
- Local government operations should be regularly audited by the same supreme audit

or controller general of the Republic, as a State entity.

- Local governments should be required to hold public budget hearings from the beginning to the end of their budget process.
- Local governments should publish and make publicly available all budget plans, receipts, forecasts, and other fiscal documentation.
- Local governments should be required to make all audit reports publicly available.
- Governors should discuss their budget submissions with local government leadership.
- Governors should hold public discussion on regional government several times per year.

Zoning and local development

- Local governments should be responsible for local land use zoning. This zoning would be subordinate to national environmental legislation.
- Regional administrations need not play a role in local zoning nor in national legislation.

Injecting market features into public services

- Condominium associations should contract for housing maintenance and repairs instead of local government. These services could be provided through contracting out the services that are now provided (poorly) by the zsheks.
- The zsheks should be privatized and forced to compete for the provision of housing repair and maintenance services.
- Since zsheks mainly provide labor services and have little in the way of equipment and facilities, it might make sense to turn the zsheks over to their present employees. The State should provide these employees with generous severance pay and perhaps some seed capital. (This might be in providing them with free rent for the new enterprise for a specific, fixed period of time.)
- Although there are indications that the GOA is considering recentralizing basic education, it might consider the Chilean model of per student funding and the injection of competition into the provision of schooling.

- Hospitals, which will probably be under Governors' management control, should have their management privatized through innovative contracts that explicitly tie pay to performance, and these contracts should be subject to periodic re-bidding. If hospitals remain under direct Ministry of Health direction the Ministry should also consider this manner of management control.
- Clinics, which also are likely to be under the Governors' purview, should also have their operations contracted out. It is possible that local non-government organizations could participate in the competition for providing these services. Clinic services might be contracted not on a fee for service basis but rather on a per person complete, basic coverage basis. Health services should include some degree of cost-recovery.
- The GOA needs to privatize and "demonopolize" the ownership, or at least the management, of several public enterprises. The following enterprises should be subject to privatization: 1) Haybnakkomtnt housing operations), 2) Hayjrmughkoyughi (water), and 3) Haykomjermoenergo (heating).

ANNEX I: DOCUMENTS REVIEWEDLaws and Proposed Laws

1992, About Taxes and Duties in the Republic of Armenia

1995, Constitution of the Republic of Armenia

1995, Draft Law on Territorial Administration and Local Self-Government

1995, Draft Law on Local Self-Government (Transition Period)

1995, Draft New Administrative-Territorial Division of the Republic of Armenia

Other documents

Bakshsian, G. and G. Gajewski, 1995, Some National Income and Product Accounting Problems in Armenia, A Country in Transition

Fisher, F., 1995, Providing Key Armenian Officials and other Relevant Stakeholders with Assistance in Formulating a Municipal Development Plan of Action

Fisher, F. 1995, Project Identification: Municipal Development Project, Armenia and Georgia

Government of Armenia, 1995, STATEMENT ON THE CURRENT SYSTEMS ACTING IN THE SPHERE OF SOCIAL AND ECONOMIC DEVELOPMENT, URBAN PLANNING, MUNICIPAL SERVICES, SOCIAL SECURITY, LEGALITY, AND PROTECTION OF LAW AND ORDER

IMF, 1993, Economic Reviews: Armenia

Maljanian, D. 1994, Proposed Municipal Management/Finance Reform Technical Assistance: Preliminary Legal and Institutional Assessment

World Bank, 1995, various Aide-Memoir: Municipal and Social Services Project

undated, untitled, paper on Armenia: political situation, shelter sector, population, and economy

ANNEX II: LIST OF PERSONS INTERVIEWED

Steve Anlian, ICMA/Armenia

Ray Morton, USAID project officer

Irina Vaniyan, Armenian economic consultant

Andranik Andreassian, Minister of Economy

Garagian Asarian, assist. to Minister of Territorial Administration

Ruben Barseghian, Minister of Territorial Administration

Armen Alaverdian, Deputy Director of the Tax Inspectorate

Vladimir Harutunian, Head of City Finance Dept.

Armen Mkrtchian, Finance Section of MOE, Deputy Dir.
and Vardan N. Movsesian, First Deputy Minister, MOE

Ashot Khachatrian, MOF, Budget Section, Director

Varujian Harutinian, Sect. for Territorial Policy

Arsen Karapetian, Dept. for Communal and Housing Affairs

Edic Yegorian, Head of the State and Legal Committee of National Assembly

Gregory Gajewski, Senior Economist

Yuri Bakhshian, 1st Deputy Mayor of Yerevan City, Mr. Sarkhsian, his advisor

Mr.Om Nigam, IMF Treasury Advisor

Grigor Voskerchian, Head of the City Council, Mayor

Garagen Shmavonian, Department of Territorial Administration

Hirachick Hofsepian, Regional Leader

Richard Winnie, ICMA legal advisor

**ANNEX III: COMMENTS ON THE DRAFT LAW
ON TERRITORIAL ADMINISTRATION
AND LOCAL SELF-GOVERNMENT**

Three laws rather than one: The present draft of this law actually present three separate issues: local government outside of Yerevan, the special case of Yerevan, and regional administration. While it would make sense to split this one law into three, there may be political or technical reasons that make it more expedient to present three separate laws. At any rate, the law or the laws require a PREAMBLE that would explain the spirit of the law and its intent prior to establishing the specific aspects of the law through its individual articles.

Accountability: The law as drafted does not always assert the appropriate degree of accountability, of local government to its local constituency, nor regional administration to central government.

Rule of law: The law at present suggests a number of ways of enforcement of the laws and the Constitution that rely upon administrative action rather than legal procedures.

Autonomy: Perhaps because there is no PREAMBLE to the law issues of autonomy are not appropriately dealt with. For instance, although Regional Administration is merely an extension of the central government the Marzpet seem overly empowered, whereas, local government, which is elected and supposedly is to have some autonomy, is often disempowered, where Regional or Central Government is granted overriding supervisory powers.

Local government is the least defined, the least empowered part of the State in this draft law, although local government is elected and supposedly the law seeks to establish "local self-government".

I suggest that articles 5 and 7 be combined into a single chapter (if not a separate law) with a PREAMBLE and subsequent articles.

The PREAMBLE might read something like:

The intent of this law is to establish the framework for legal, democratic and autonomous local self-government. This is legal since local governance is to be establish by the rule of law, and legal complaints are to be resolved through the legal system, particularly through constitutional courts. The system is democratic in that the mayor and the district councils are to be elected by their district constituencies and these duly elected officials are to be accountable to their

constituencies. Local self-government is to be autonomous in that it is to have the powers to generate the resources, either through local revenue efforts or legal rights to transfers from Central Government, which shall not be subject to political manipulation, nor is local government to be overly responsive to regional and local policies of the Central Government but rather to seek to implement the desires of its constituencies.

Add the following articles under this new chapter:

article #. The hamainkainpet is responsible for daily operations of local government, preparing budgets for district council approval and for the maintenance of all financial reporting. In the event of necessity, the hamainkainpet may hire department heads and other managers, but these positions must be budgeted for and financed from local revenues.

article #. The hamainkainpet, under the supervision of the Marzpet, may be subject to a recall vote upon written petition of 500,000 constituents or one-third of the hamiank's eligible voters.

article #. The haimainkainpet, or his financial manager, is responsible for preparing a draft budget, including projections of revenues and planned expenditures, for public discussion in open town meetings by _____date_____. Once public comment is heard by both the hamainkainpet and the district council, a second budget draft can be prepared, which is again discussed in a public forum. Afterward, these comments may be incorporated, and a final draft is proposed for district council approval. The district council must approve a budget before the next year's fiscal operations can begin.

article #. The hamainkainpet or his financial manager is responsible for maintaining good, acceptable financial management and reporting systems.

The hamainkainpet must provide the district council with a monthly reporting of financial and other operations.

article #. The hamainkner are subject to yearly audit by the nation's supreme audit agency (still to be formed) and these reports must be made available for public scrutiny.

article #. Rule of the hamainkner is subordinate to the Constitution and national law. Non-compliance with such legal bases is subject to legal action, which may be brought to Constitutional courts, by individual citizens, prosecutors of Central Government, Ministers of Government, or the marzpetner.

A PREAMBLE for Regional Administration should also be prepared. This might read something like the following:

The intent of this law is to establish a management system for the regional implementation of Central Government policies, within a legal and accountable

framework. Regional administration is an extension of the Central Government, with the intention of bringing Central Government closer to the Armenian people.

Include the following articles:

article #. The marzpetner are subject to review by the Minister for Territorial Administration, the President or the Prime Minister. Only the President or a court of law can remove a marzpet from office.

article #. Marzpetner are subject to the rule of law, and can be removed from office by a court of law for criminal prosecution or from civil or constitutional non-compliance. Constitutional court actions can be taken against a marzpet by any of his constituents, the President, the Prime Minister, the Minister of Territorial Administration, or hamainkainpetzner.

Modify article 8 to delete the following paragraph:

For failure to perform the Constitution and the laws of the Republic of Armenia...

Since this is an issue that should be dealt with by the rule of law it is inappropriate to make this an administrative power of a Central Government agent. However, art. 109 of the Constitution specifically indicates that the Regional Governor may recommend to the Government that a community leader (hamainkainpet) be removed from office "in cases provided for by law". It is necessary to indicate what this phrase means and how it should be implemented. My suggestion is that once a legal case is made and a determination is made that a hamainkainpet has performed in disaccord with the Constitution, that the marzpet then recommend to Government his removal.

Modify the final paragraph of article 8 to read:

Decisions and actions made by local self-government bodies may **ONLY** be appealed by state authorities in the court.

Create an article that states the following clarification:

Local Government is neither subordinate to nor superior to the Central Government, although all levels of government are subject to the Constitution and all secondary national laws.

Modify art. 11, by adding a second sentence, as follows:

These reports shall be made available for public scrutiny.

Modify art. 11, second paragraph should read:

A Regional Governor shall submit to the Government of the Republic of Armenia for discussion his proposals regarding an article of the State budget referring to the region.

Clarify art. 11 to state that the Governor does not have a vote, ever in the Government.

Article 12 is completely inconsistent with the concept of local self-government and local autonomy. It may make sense to have a loose supervision of local government operations, but this goes entirely too far. Any breach of law by local government should be a matter for legal action. In particular:

- rewrite the introductory paragraph.
- delete ss. a)
- delete ss c)
- modify ss e) as follows:

"as an *ex officio* participant, attend meetings of community councils, with the intent of explaining central government laws and regulations, and providing other input as the hamainkainpet or the community council may request."

Add the following paragraph to art. 15.

Certain additional duties are also required of the Chief of the Financial Department of a Region. These include, but are not limited to: ensuring the maintenance of good financial management and accounting in accordance with accepted standards, publication of financial information for public disposal, and providing full cooperation with the Supreme Audit Agency (after such an institution is created) in the audit of the Region's financial and real operations.

Insert into art. 17, adding a second sentence to paragraph 1, as follows:

The Minister for Territorial Administration may recommend candidates for Government approval for the positions of Regional Governor.

Rewrite paragraph 2, art. 17 as follows:

Vice-Governors shall be appointed and removed from office by the Regional Governor, subject to approval by the Minister for Territorial Administration

and the Government.

Insert into the third paragraph, art. 17, after of the Ministry of Internal Affairs:

Ministry of Health, Ministry of Education, Ministry of Urban Development,
Ministry of Finances, and other Ministries as becomes necessary and relevant
...

Article 17 should not specify ages, other than the person should not be a minor, and should not specify that higher education is required. This unnecessarily and unproductively restricts the authority of the Prime Minister, the President and the Government.