



The Fiscal Decentralization Initiative
for Central and Eastern Europe

Fiscal Equalization in Armenia

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Table of Contents

A. Short Executive Summary: (Main Points, Main Recommendations).....	5
B. Introduction: General Background.....	5
B.1 Recent Developments in Local Government Reform	5
B.2 Basic Competencies of Local Governments, Including Own and Delegated Functions	6
B.3 Number and Size of Local Governments	7
B.4 Legal Autonomy of Local Governments with Respect to Budgeting, Expenditure and Revenue Raising Authority, Property Ownership, Borrowing etc.	8
C. Basic Structure of the Intergovernmental Finance System	9
C.1 Legal Basis of the Local Self-Government Finance System.....	9
C.2 Composition of Local Government Revenues and Expenditures	9
D. Financial Equalisation System	12
E. Conclusion	13
E.1 New Model of Financial Equalization for Armenia	14
References.....	16
Appendix 1.: Local Self-Government Macroeconomic Indicators	17
Appendix 2a.: Aggregate Revenues of Municipal Budgets of Armenia	18
Appendix 2b.: Aggregate Expenditures of Municipal Budgets of Armenia	19
Appendix 3.....	20

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A. Short Executive Summary: (Main Points, Main Recommendations)

The process of decentralization and formation of local self-government in Armenia started in 1995. Although the process, not surprisingly, resulted in an intergovernmental system and fiscal equalization system characterized by both strengths and weaknesses, the progress it achieved is still significant. Namely, subsidies to local governments envisage both the population of the municipality and income capacity, but most importantly, the formula for subsidy allocation is already employed. With a view towards further improvement of the fiscal equalization system in Armenia, this paper suggests an amendment of the formula and thus, a new model of financial equalization is provided. Important aspects of this new approach are standardized spending assessments and tax revenue collection levels. The proposed formula takes into account the financial needs and fiscal capacities of each municipality and will better support municipalities facing fiscal difficulties.

B. Introduction: General Background

B.1 Recent Developments in Local Government Reform

The Armenian system of local self-government exists under the influence and conditions typical to a country in transition, especially those found in post-Soviet countries. However, Armenia possesses her specificities and problems, which have a particular impact on the system of local self-government. The lack of systematic and complex approaches hinders the strengthening and reinforcement of the local self-government system.

In the general context of reforms, the process of decentralization and creation of local self-government started rather late, after adoption of the Constitution in 1995. Institutional and structural reforms, which relied on the Constitution of Armenia and the legislation on local self-government, formed the new public govern-

ment system. It separated local self-government from national (central) government, initiated a program of holding local elections and commenced the process of self-establishment within the new system of local self-government.

Local self-government reform continues today. The main directions of the reform are: establishment of inter-municipal unions, formation of a training system, capacity-building at the local government level, development of administrative supervision, transfer of property tax databases to the municipalities, transfer of state reserve land to municipal ownership and updating the administrative territorial borders of municipalities.

The draft amendment of the Law on Local Self-Government, which involves the issue of inter-municipal unions, is under Parliament reading. This draft concerns the conditions for the establishment of inter-municipal unions, the governance structures of these unions, their rights and responsibilities, relationships between the union and its constituent municipalities, etc.

Contradictory opinions arise regarding this draft. Some experts argue that this draft will limit the autonomy of local self-governments because too much responsibility is given to the executive director of the union and, in some cases, to the governor (marzpet) who is eligible to appoint the acting director. Overall, the draft raises some questions which the government is not ready to answer now. These questions are: how many inter-municipal unions can be formed on voluntary and mandatory bases? In which circumstances should the unions be established on a mandatory basis? How will the financial equalization system operate? To adopt an effective and successful law, further work is required and the opinions of different stakeholders should be taken into account.

The Law on Municipal Service was adopted at the end of 2004. The Law defines the scope of services, requirements posed thereto, rights and obligations of municipal servants, as well as job descriptions, training plans, certification processes, staff safety, social guarantees, et cetera. To implement this law, secondary

legislation is necessary. This process requires additional time and the law is expected to become effective at the end of 2006.

The formation of a municipal servants training system is also in process. Although the Training Strategy for Local Self-Government has been developed with the support of the Council of Europe, it is not adopted yet. It still requires establishing permanent training centers where municipal servants will receive regular training, and developing the training programs and curriculums.

The Law on Amendments and Additions of the Law on Local Self-Government (adopted on December 26, 2002) states that the local self-government shall assess and collect property and land taxes. The delegation of this right to municipalities creates a huge amount of work for implementation. Of primary importance is that the tax authorities and cadastre committee transmit the tax database and data on arrears to the municipalities. These works are currently underway but progress is very slow. It is still uncertain whether many small municipalities lacking the relevant capacities will be able to complete the mentioned work.

Overall, some may have an impression that the Government of Armenia tries to show that it performs its obligations to the Council of Europe rather than thinks about complex development of the local self-government system.

B.2 Basic Competencies of Local Governments, Including Own and Delegated Functions

The powers of local self-government bodies are own powers and those delegated by the State. Own powers are divided into mandatory and voluntary powers. Implementation of the powers vested to the State bodies can be transmitted to the municipalities as delegated powers in the order established by the law.

Mandatory powers and powers delegated by the State have priority for performance by the municipality. Voluntary powers are exercised by municipal council orders in accordance with funding provided by the municipal budget.

Local self-governments manage and/or provide the following public services:

- Water supply*, sewerage, irrigation, gas and central heating systems;
- Landscaping and municipality improvement;
- Employing and maintaining municipal buildings, including residential and non-residential buildings,

dormitories, administrative buildings and other municipality-owned structures;

- Proper maintenance of cemeteries*;
- Construction, maintenance and functioning of roads, bridges and other engineering structures within the municipality's jurisdiction;
- Construction, maintenance and functioning of sanitation facilities*;
- Functioning of municipal public transport*;
- Construction and functioning of irrigation systems;
- Waste collection and disposal.

The local government is responsible for water supply systems, including water treatment stations, supply networks, reservoirs and local water sources. But the central government issued Decree No. 49 (on March 3, 1999) to manage water supply systems for a fixed term of ten years, through the Armenian Water Supply and Sewerage Company owned by the central government. Another solution to problems arising from the decentralization of the water supply is to contract with foreign companies for the management of water supply systems, as has been done in Yerevan. The government is also making efforts to find resources from donor organizations for investment, renovation and decentralization of the water supply system. The process of directly measuring actual water consumption by residents started in 2003. The sewerage systems are old and badly maintained. Rates for sewage collection and treatment are set by municipal council and vary depending on whether the consumers are individuals or firms.

Since villages represent 93.6 percent of Armenian municipalities, agriculture is an issue of great local importance. Many municipalities have their own internal irrigation network, managed and maintained by the local government. Alternatively, associations of water consumers oversee the functioning and maintenance of irrigation systems. The central government supplies irrigation water¹ and sets the wholesale price based on the area to be irrigated. To encourage water saving, the government imposes a two-tier rate structure based

* Refers to services not provided by district heads.

¹ Irrigation water is the water used for the irrigation of agricultural land.

on consumption for water supplied to the irrigation associations².

Municipal councils approve the allocation of resources and land for cemeteries. Some municipalities have transferred the preservation, maintenance and servicing of cemeteries to specialized agencies on a contractual basis. Street cleaning and maintenance of public areas such as gardens and parks are financed from the municipal budget and performed by local government enterprises or contracted to private companies through public tenders. The municipal council determines the area to be cleaned and the rate per unit of area. Landscaping and municipal improvements are mainly carried out in cities, due to the lack of funds in villages. Public transportation, usually buses, is provided only in large and medium-sized cities, either by a municipality-owned public transportation enterprise or by the private sector. In both cases, fares are set by the council of municipal.

Local governments are also responsible for waste collection and disposal. Rates are set annually by the council. Some local governments negotiate contracts between private enterprises and municipal residents. In this case the company sets a fee, usually much lower than those charged by the municipality. Some municipalities own and manage landfills, which they maintain with municipal funds. Municipalities without landfills must pay a fee for using the landfill in another municipality. These fees are another source of budget revenues. However, many municipalities mismanage fee collections and thus, appropriate street cleaning funds to ensure proper functioning of waste management services. Sometimes street cleaning and waste collection are performed simultaneously.

Although heating supply is another mandatory responsibility of the local governments, most systems are in extremely poor condition, occasionally not functioning at all. Other municipalities are unable to collect user charges, forcing them to halt service altogether.

Municipal housing stock generally consists of apartment blocks (in cities only) and privately owned houses. Most apartment blocks have been privatized. Maintenance of non-privatized apartment blocks is provided on a contractual basis either by local government enterprises or by the private sector. The council of municipalities establishes and manages rent for municipality-owned non-residential space. Privatized apartment blocks create

condominiums, which are responsible for maintenance of these blocks.

The management and functioning of kindergartens is another mandatory responsibility of local self-government. The cost of running and maintaining kindergartens is paid for jointly by parents and the municipal budget. The council establishes the fee to be paid by parents and determines social groups eligible for reductions or waivers. Specialized education is also provided by local government. These educational institutions consist of music and fine arts schools, athletic schools and centers for enhancing children's technical and creative potential.

Although primary and secondary education is under the competence of the state government, which finances and administers institutions, employs teachers and administrators and determines curricula and performance standards; local government is involved in public schools management issues.

Maintenance of libraries and museums is entirely covered from local budgets. Although cultural institutions charge fees, they are not sufficient to cover their costs, creating a gap between the fees generated by cultural institutions and their operational expenses.

Health care is provided primarily by the central government. However, a few municipalities have primary health care clinics, which are covered from user fees and the local budget.

Other responsibilities of the local government include, but are not limited to: the development of commercial trade, restaurants, consumer services, public lighting and stray animal control; all regulated by council decision. The governor, being a representative of the central government, coordinates and monitors services provided by the central government in the region. The local government is eligible to open public tender for service provisions that facilitates private sector participation in the delivery of public services. In some cases, services are provided by stock companies, which are fully or partially owned by the local self-government. Overall, local authorities play a minor role in the economic development of the municipality, mostly due to the lack of financial resources.

B.3 Number and Size of Local Governments

Although the structure of the administrative and territorial units of local self-governments has been determined, their operational duties have still not been entirely defined. A large number of small and weak municipalities have been created which have no appropriate

² An Irrigation Association is a company formed and owned by irrigation water users.

capacity to deliver services to the population (see Table 1.). Practically, a single-tier local self-government is functional, and all the municipalities (with the exception of Yerevan district municipalities) function in the same legal framework. The absence of the second tier of local self-government renders the system incomplete. Due to this, local self-government is below a sufficient level in many municipalities. The experience of the past few years has showed that the current administrative and territorial divisions restricts further evolvement of decentralization and hinders the progress of local self-government.

B.4 Legal Autonomy of Local Governments with Respect to Budgeting, Expenditure and Revenue Raising Authority, Property Ownership, Borrowing etc.

Although constitutional and legislative guarantees of local self-government exist, there is a gap between legislation and practice, typical to nearly all former socialist countries. The Constitution provides the following general guarantees of local self-government: local autonomy and equal legal protection of all types of property including municipal property; the right to use municipal property, have its own independent municipal budget and the authority to address municipal problems; freedom of economic activity and competition; the right of citizens to express their will directly through free elections and referenda and indirectly through state and local self-governments; and division of powers between the legislative, executive and judicial branches of government, as well as between central government and local self-governments.

The following guarantees of local self-government are defined by legislation related to local government:

- Local governments shall be delegated any state powers that are more effectively exercised in municipalities;
- Local governments have the right to perform any activities of local interest not assigned to the state government, within the framework of the law;
- Judicial protection of municipal rights, interests and property;
- Local governments shall receive adequate funding for performance of their responsibilities;
- Financially weak municipalities shall be assisted through financial equalization;
- Local authorities shall provide public services in the manner they deem necessary, including tenders;
- Municipality heads shall manage local government staff within their jurisdiction;
- Transparency of local government activities.

These principles are not always upheld. For example, financial assistance from the state is irregular and often inadequate for adequately performing local government responsibilities. Additionally, although the Constitution ensures judicial protection of the rights of local government, there is no administrative court in Armenia. Litigation between different levels of public administration, although rare, is brought to general courts.

Municipal property rights are regulated by the Civil Code, Land Code and the Law on Local Self-Government. Local authorities possess substantial authority to manage local property, including the right to sell the property, which often provides a major source of municipal revenue. Municipal property consists of registered public assets (buildings and other facilities) and other

*Table 1.
The Municipalities by the Number of Population (Census of 2001)*

Population Groups	Number of Municipalities	%	Number of Population	%
Under 1,000	481	51.7	212,009	6.6
1,000–2,000	207	22.3	295,484	9.2
2,000–5,000	162	17.4	470,443	14.6
5,000–10,000	42	4.5	277,438	8.6
10,000–50,000	26	2.8	540,195	16.9
50,000–100,000	3	0.3	237,045	7.4
100,000–1,000,000	9	1.0	1,180,397	36.7
Over 1,000,000	—	—	—	—
Total	930	100.0	3,213,011	100.0

resources, including financial and other non-patrimonial properties (for instance, bonds). The inventory of municipal property was specified by Government Decisions No. 42 and No. 51, adopted in March 1997. According to these and subsequent decisions, the following items fall under the category of municipal property:

- Heating, sewerage, water supply and irrigation systems of municipal significance;
- Kindergartens, specialized schools, clubs, culture halls, libraries, streets, squares, parks, stadiums, bridges and monuments; landscaping, sanitation facilities, housing maintenance and similar organizations, and; administrative buildings;
- Non-privatized housing stock.

Local self-governments were legislatively granted the power to make their budgets and independently manage their financial resources. The Law on Budgetary System defines the regulations of budgetary relations as the activities of duly authorized institutions with legitimate power to construct the budgetary system, define its structure, distribute revenues among budgets (state and municipal), execute budgets, report and supervise budgetary processes, provide a budget classification system, introduce amendments and/or additions to the budgets.

One of the important functions of the regulation of budgetary relations is the distribution of revenues among various budgets. Municipal budget revenues and expenditure trends, like separation of the state budget from municipal budgets are clearly defined by the law.

The procedures for allocating relevant financial resources to ensure financial autonomy and implement statutory powers, as well as identifying the list of revenues and expenditures for conducting independent policies, are stipulated by the law, separately for operating and capital budgets.

C. Basic Structure of the Intergovernmental Finance System

C.1 Legal Basis of the Local Self-Government Finance System

Major laws regulating the local self-government finance system in Armenia are the Law on Local Self-Government, the Law on Budgetary System of Armenia, the Law on Local Duties and Fees and the Law on Financial Equalization.

The Law on Budgetary System of Armenia regulates local self-government finance systems and budgetary relations between the central and municipal budgets on the basis of unified state fiscal, monetary and taxation policies. The Armenian budget system involves the state budget and municipal budgets, which follows common procedures of developing draft budgets, classifying revenues and expenditures, accounting, reporting and implementation. Regulation of budgetary relations is based on the principles of unity, independence, balance and transparency of the budgets, as defined by law. The aggregate of the revenues and expenditures of the state budget, municipal budgets and social insurance budget forms the consolidated budget of Armenia.

The Law on Local Duties and Fees prescribes procedures for the implementation of and requirements for ten local duties and three local fees. The law stipulates that the municipal council has the right to set the rates of local duties and fees.

C.2 Composition of Local Government Revenues and Expenditures

To ensure that local self-government is able to provide assigned services, local budgets should forecast relevant revenues. Considering the degree of its autonomy, local self-government budget revenues fall into three categories:

- own revenues
- official transfers
- borrowings.

Own revenues are of two major types: (a) tax revenues and duties, and (b) non-tax revenues. Tax revenues are, in addition to others, generated from land taxes levied on land and property taxes levied on property, located within the administrative borders of the municipalities (exceptions are state and church property). Although legislation envisages income and profit tax sharing between the state and local budgets, this sharing does not take place in practice (income tax sharing was applied only twice, in 1998 and in 1999). Tax sharing is the central government's responsibility. Because central government budget revenues are reduced by sharing, the government does not accept this practice any more. All tax rates are set by legislation adopted by the National Assembly³. Only the rates of local duties and fees are

³ The National Assembly is the legislative branch of the Republic of Armenia.

set by local self-governments, but within the limits set in the national legislation.

The predominant share of own revenues of the municipalities is generated from tax revenues and duties (see Appendix 2a.). In observing the dynamics of aggregate budgets, two issues are to be taken into consideration. First, in 2000, income tax was eliminated from municipal revenues (revenues shown in Appendix 2a. after 2000 represent repayment of arrears accumulated from previous years). Second, in 2000–2002, state official transfers to local budgets were extremely irregular. Even facing the above circumstances, tax revenues and duties increased by 22.1% in 2004 compared to the previous year and totaled more than 30% of budget revenues (51.1% of own revenues). Out of that, property tax only increased by 26.6%. This was mainly attributed to transferring the authority to collect this tax to the municipalities. Considering that this took place in the middle of 2003, and only in the Yerevan districts and urban municipalities with regard to physical persons, it is obvious what a big opportunity there is to increase municipal tax revenues as the planned transfer to municipalities takes place.

An important indicator of what degree of autonomy the municipalities possess is the share of local duties and fees to be set by local government. Pursuant to the Law on Local Duties and Fees, municipalities are entitled to set ten types of duties and three types of fees. Despite the increase in absolute terms, the share of these inflows to local budgets is insignificant. For example, in 2004, it totaled to only 2.4%. Together with revenue subject to local rate setting by local governments, it is about 12.0% (Appendix 2a.). Overall, the following categories are set by local governments: local duties, local fees, land rental and real estate rentals.

Local budget revenues are classified as Revenues of Administrative Budgets and Revenues of Capital Budgets. About half of the capital budget revenues, until 2004, were allocations from administrative budgets. The largest portion of the remaining capital budget revenues reflects proceeds from the alienation of assets. Prior to 2002, i.e. enforcement of the new Law on Local Self-Governments and introduction of amendments to the Law on Budgetary System of Armenia, capital budget revenues were only receipts from the allocation of bonds issued by local authorities and other loans. After adoption of these laws, the mentioned allocation from the state budget became the source of financing the local budget deficit (before that, municipal budgets were not eligible to run deficits); however, like prior to the adoption of

the said laws, these resources could be used exclusively to fund capital expenditures. It is worth mentioning that municipalities are still not eligible to pursue financial relationships and loan arrangements. There were just several cases, from 1996 to 2004, when municipalities received loans, and no bonds were issued in any municipality due to weakness of the legislation, lack of relevant mechanisms, passive position of municipalities and so on.

Per capita average own revenues of local budgets was AMD 2,619 (about USD 5) in 2001 and AMD 4,021 (about USD 7) in 2003, which is very low. The per capita average total local budget revenue was AMD 6,337 in 2002, out of which AMD 7,061 was in urban municipalities and AMD 5,018 in rural ones.

The Law on Amendments and Additions (adopted on December 26, 2002) of the Law on Local Self-Government sets that local self-governments manage the assessment and collection of property and land taxes. Delegation of this power to municipalities created a huge volume of work to be done. First of all, tax authorities and cadastre committee needed to transfer the tax database and data on arrears to the municipalities. These works are currently underway but progress is very slow. Nevertheless this power has already been delegated to all urban municipalities and rural municipalities of big size. Thus, taxing power without determining tax rates will be the responsibility of local self-governments in the near future. Further, the performance of these mandatory powers by local self-governments will substantially contribute to the financial capacities of the municipalities.

Local self-governments have full autonomy to set fees on services delivered by the municipality, pursuant to the Law on Local Self-Government.

The functions of local self-governments are the major objectives of their activities implemented within the powers stipulated by the Constitution and legislation. Functions are preconditioned by the degree of decentralization, the role and significance of local self-government in public expenditures, the mission, objectives and goals of the local self-governments. Thus, functions of the local self-governments may vary from a country to country. However, when viewed in general and categorized they are almost identical.

Local self-governments carry out the following functions:

- Identification and recording of municipal problems and needs of the population, and the development of solutions;

- Identification of the required resources, measuring existing resources and searching for new ones;
- Elaboration of municipal development programs and their implementation;
- Delivery of public services in the municipalities;
- Municipality management functions, including management of assets and finances.

To perform the above functions, in addition to financial resources, it is of high importance to create the proper structural administrative units based on the size of the municipality and the specifics of the current situation.

Each function, as mentioned above, consists of numerous related ones. In large municipalities, they can be over one hundred. One of the most important indicators for evaluating the performance of a local self-government is full and timely implementation of their functions. Various studies ascertain that Armenian municipalities fulfill only a small portion of their obligations, i.e. around 30 percent. This is caused by a number of factors, the most important being that (a) all but twelve Yerevan districts' municipalities operate in the same legislative framework and have the same powers, irrespective of their size; and (b) municipalities face scarce financial resources.

Municipal budget expenditures provide evidence on the fulfillment of functions by local self-governments. According to the existing legislation, mandatory and delegated powers of local self-governments are the priorities for implementation. The delegated powers are entirely funded by the state. Voluntary powers will be implemented if there is sufficient municipal resources. There are some functions, the costs of which are reflected in the salary of the responsible official and other administrative costs (for example, preparation of relevant decisions by municipality councils). There are also functions, which in addition to the above, contain urgent costs (such as functions related to the delivery of public services), for their implementation.

Twenty delegated powers are assigned to local governments by legislation. Additionally, a few rules regulate the performance of such powers. In practice, not many of these powers are implemented. Only two delegated powers are performed with funds from the central budget.

A significant portion of local budget expenditures is attributed to administrative costs (see Appendix 2b). Although there is a trend of a capital budget increase in

both amount and as a share of the total budget (its share was 13 percentage points higher in 2004 compared to 2000), this share still remains quite low, i.e. 17%. Additionally, the overwhelming share of these expenditures is capital reconstruction expenses. It should also be stressed that 80% of local governments do not spend on capital expenditures at all.

Expenditures on service (education, culture, sports and so on) delivery, as a share of administrative budget expenditures, have decreased. On the contrary, staff maintenance costs increased. A drastic increase was recorded in 2003, which is primarily a consequence of transferring the right to decide on the number of employees to the heads of municipalities and municipal councils. Previously, the maximum number of staff was set by the central government and was determined by the municipality's population. As a result, overstaffing occurred in many local self-governments. Total salaries of the employees of local self-governments and other municipal institutions amounted to 31.6% (in 2003) of local budgets, which together with mandatory social insurance increased to 42.5%, although individual remuneration was very low. Additionally, the revenues of many small municipalities are spent entirely on salaries and mandatory social insurance, and in some cases, the revenues are not even enough to pay out salaries. This indicator discloses the discrepancy between the number of staff and services delivered.

Appendix 1 shows a gradual increase in the share of local expenditures of all public expenditures and of GDP. Still, these shares are very low. During the last five years, local expenditures as a share of public expenditure and GDP were 6–7%, 1.2–1.3%, respectively.

Legislation entitles local self-governments to full discretion on all expenditures. Official transfers are mainly unconditional subsidies and local self-governments decide on the spending themselves. In some cases, however, the central government puts pressure on the local self-governments about certain spending.

Local self-governments in Armenia are lacking revenue sources to finance assigned expenditures, thus hindering satisfactory and effective fulfillment of their responsibility. As a result, local self-governments face unfunded mandates, which are those mandatory and delegated powers defined by the law that are not performed, or are partially performed. Local governments face the challenge to improve municipal budgets' revenue collection and find additional revenue sources.

An important revenue source is subsidies allocated to local budgets from the state budget, which are classified according to the purposes of allocation:

Table 2.

Planned and Actual Yearly Allocations of Equalization Subsidies from the State Budget (mln AMD) from 1997 to 2004

	1999	2000	2001	2002	2003	2004
Planned	4,388.7	6,095.7	7,641.8	7,642.0	9,152.0	10,696.0
Actual	2,192.4	5,194.3	6,801.9	11,571.7*	9,159.8	10,696.0

Note: * Including debt of previous years.

- *Financial equalization subsidies*, allocated to local budgets under a financial equalization principle to cover recurrent expenses. These are discretionary subsidies.
- *Other subsidies*, allocated to support current local budget expenditures, untied to any program.
- *Subventions*, allocated to fund earmarked, targeted municipal programs.

In reality, the first type of subsidy is primarily used because the legislation does not regulate the procedure of subventions and other subsidies' allocation and thus, are rarely used.

D. Financial Equalization System

The municipalities of Armenia differ widely from each other in geographic, demographic, socio-economic and financial conditions, as well as in their opportunities to promote general development strategies. These differences have different impacts on municipalities, both positive and negative. To diminish negative effects and promote harmonious development of the municipalities, state involvement is crucial to lessen differences between rich and poor municipalities. A significant share of this involvement is attributed to official transfers from the state budget to local ones.

This type of financial equalization is important for interactions between different levels of government, as well as for strengthening and development of municipalities' financial capacities. It distributes duties and responsibilities between the central government and local self-government. Central authorities allocate funds defined by legislation to the municipalities facing financial difficulties, and the latter employ these funds to perform their objectives and other responsibilities defined by legislation. An effective financial equalization system would diminish the current polarization among municipalities.

Subsidies to local budgets are allocated according to the Law on Financial Equalization but use of these

funds is discretionary for local self-governments. This law stipulates that the state budget allocates subsidies to local budgets pursuant to the financial equalization formula with an aim towards harmonious development of municipalities and eliminating the variations in their financial capacities.

The minimum rate of subsidies is defined in the Law on Local Self-Government and is no less than four percent of the aggregate revenues of the consolidated budget, which is the aggregate of the state budget, municipal/local budgets and the mandatory social insurance budget of the previous financial year. The Law on State Budget of the Republic of Armenia, adopted each year, determines the yearly distribution of the state subsidies to particular municipalities.

Table 2. shows that planned subsidies are forecast to increase, while actual ones follow this trend but with breakpoints in 2002 due to the payment of arrears in that year. It should be mentioned that the state budget obligations to the municipalities were performed very badly. The situation improved only in 2002 when all the arrears to municipalities were repaid in full. Currently, subsidies to the municipalities are extended in accordance to the timetable approved by the central government. Even so, the subsidies to the municipalities are received at the end of the budget year, thus not spent during that year and forming local budget surpluses.

The first factor determining the amount of subsidies is the municipality population⁴. To be precise, there are the two types of municipalities: first, municipalities with a population of no more than three hundred, and second, municipalities with a population over three hundred. For the first type, the annual Law on State Budget of Armenia determines subsidies on a proportional basis. For the second type, the following two economic factors are to be considered:

⁴ Number of permanent population within municipalities provided by the National Statistical Service of Armenia as of January 1 of the previous budget year is employed.

- Per capita land and property taxes in the municipalities (hereinafter factor “a”);
- The municipal population (hereinafter, factor “b”).

The total amount of subsidies for this type is the combination of subsidies determined by each factor, namely, factor “a” determines that subsidies are no less than 25 percent of actual aggregate revenues from income, land and property taxes, and factor “b” determines that subsidies are no less than ten percent of the actual revenues from all income tax collected in the previous budget year. For the factor “a”, figures provided by the State Committee of the Real Property Cadastre of the Government of Armenia conducting property and tax accounting are used. Subsidies determined by factor “a” are envisaged for all municipalities of the second type that generate lower per capita land and property tax revenues than the aggregate of (a) republican per capita land and property taxes and (b) republican per capita subsidies to the municipalities determined by factor “a”. Appendix 3 gives the formula for this kind of subsidy.

Factor “b” determines the amount of subsidy to the municipality of the second type as the product of (a) the number of the municipality’s population and (b) a multiplier, which is the total amount of subsidies envisaged by factor “b” to the total number of population of all second type municipalities.

Thus, financial equalization subsidies are estimated in three ways. Subsidies for the first type of municipalities (way one) and subsidies determined by factor “b” for the second type of municipalities (way three) are similar. Namely, both subsidies are determined by only the number of municipal population. In the first case, municipalities of the first type receive an equal amount of subsidies independent of the actual number of the population, while in the second case, the amount of subsidy depends on the number of population of the respective municipality. Neither of these subsidies really applies equalization, while the other case (way three) is closer to capturing the principle of equalization, but encompasses only the fiscal capacities of the municipalities and neglects their financial needs.

Finally to summarize, it may be stipulated that the existing financial equalization formula does not fully serve the objective of equalization and requires further amendment.

E. Conclusion

The study of the intergovernmental finance system in Armenia shows that there is some success but there are also some problems which if urgently solved, may increase the effectiveness of the system.

The positive sides of the intergovernmental finance system are the following:

- Legislation determines local budget revenues and expenditures, and clearly differentiates state and municipal budgets;
- Legislation determines the allocation of equalization subsidies from the state budget to local budgets; actual allocations are according to legislation also;
- Legislation determines intergovernmental fiscal relations;
- Legislation transferred the power on setting all local duties and fees to local governments;
- Legislation clearly determines local budget processes.

The weaknesses of the intergovernmental finance system are the following:

- The revenues currently ascribed to local budgets do not enable municipalities to completely perform their duties;
- Legislation does not regulate allocation of subventions and other subsidies given in part D;
- Many municipalities cannot form capital budgets;
- The existing system of financial equalization does not entirely take into account the main principle of financial equalization - the protection of financially weaker municipalities. All municipalities get subsidies irrespective of their being poor or rich.

With the aim of enhancing the financial equalization system on the basis of the equalization principle, it is urgent to develop a new formula.

The design of the formula is arguably the most difficult issue, because it should reflect the objective of equalization. In general, the formula should reflect the following four objectives.

The first is to allocate subsidy funds to reflect the differences in municipal expenditure needs. Different countries have used many different indicators of expenditure needs, including the following:

- Population, i.e., a straight per capita distribution.
- Indicators of physical factors that may lead to greater costs of service provision, e.g., land area, population density, urbanization.
- Population groups which need additional expenditure, for example, the percentage of families living below the poverty line, pensioners, school children, etc.
- Indicators of infrastructure needs, such as miles of highways that require pavement, percentage of households with access to water supply, infrastructure needs to support economic development, etc.

The second objective is income or fiscal capacity equalization. In this case the formula attempts to provide more money to those jurisdictions that have a weaker capacity to raise taxes. The problem arises when trying to find an indicator that will enable us to allocate funds to those places with an inherently weaker fiscal capacity. There seem to be two general approaches:

- Allocate funds according to the level of average income in the local area, or according to the level of some indicator of the size of the tax base.
- Calculate the amount of money that could be raised if all appropriate tax bases were subjected to “normal” rates.

There is also a third approach that is to include a revenue mobilization effort directly in the formula. The goal here would be to provide local governments with some positive incentives to increase the overall level of revenue collection. And the fourth one is that the subsidy formula could reflect the balance between revenue raising capacity and expenditure needs.

Many countries use variants of this approach. Some countries define a standard level of expenditures according to a formula based on physical indicators of desired levels of service. This is related to a “normal” level of revenue mobilization based on the size of the tax base. Korea followed this tradition. Some school aid in the U.S. is defined by a formula that links minimum expenditure requirements with property tax revenues raised if a specified level of property tax effort is exerted. Some of the transition countries (Russia and China) have defined the required level of expenditures as the present value of the amount from the past years inflated to the present. The level of revenue needed to guarantee this expenditure level is the amount of the transfer.

E.1 New Model of Financial Equalization for Armenia

I offer a new equalization model for Armenia⁵. Estimated expenditures for the implementation of local government’s functions are the bases of the model. They are calculated by the Ministry of Finance and Economy of the Republic of Armenia.

The equalization formula will be as follows:

$$STR_i = (SSA - ABR_i) \times \frac{\Sigma STR}{\Sigma (SSA - ABR) \times K_j} \times K_i$$

where, STR_i is the subsidy transfer from the center to the i -th municipality, SSA – Standard Spending Assessment, ABR_i – Previous year operating budget revenues of i -th municipality, ΣSTR – Transfers from the center to all municipalities, ΣABR – Previous year operating budgets revenues (without subsidies) of those municipalities, revenues of which are less than SSA , K_i – coefficient, which shows the previous year’s tax revenues collection level of i -th municipality and is given by the formula below:

$$K_i = \frac{ATR_i}{CTR_i}$$

where, ATR_i and CTR_i are actual and calculated tax revenues, respectively, of the i -th municipality in the preceding year. To get the figure for calculated tax revenues, cadastre data is used and land and property taxes are summed to one hundred percent.

Those municipalities, whose previous year operating budget revenues without subsidies were less than SSA , are eligible to receive subsidies from the state budget. K_j is the coefficient, which shows the previous year tax revenue collection level for all eligible municipalities and is given by:

$$K_j = \frac{ATR}{CTR}$$

where, ATR and CTR are actual and calculated tax revenues, respectively, for eligible municipalities in the preceding year. To get the figure for calculated tax revenues, cadastre data is used and land and property taxes are summed to one hundred percent.

⁵ See also: *David Tumanyan Development of Financial Equalization System in Armenia* in the book, *Local Governments Reform in Armenia: Policy Options and Recommendations*: Yerevan 2004.

According to the current legislation of Armenia, SSA should be calculated in the following areas:

- general government expenditures,
- kindergartens,
- specialized schools,
- cultural organizations,
- maintenance and operation of roads, streets, bridges and other engineering structures under the municipality's jurisdiction,
- solid waste collection and improvement of the municipality,
- urban development,
- maintenance of housing stock owned by the municipality,
- public transport,
- heating.

For example, during the calculation of general government expenditures the number of local government employees and expenditures related to their payroll, business trips, heating, utilities, communication, electricity and other estimated expenditures should be considered;

kindergarten expenditures should be calculated on the basis of a child per capita estimate; specialized schools expenditure should be calculated on the basis of a pupil per capita; solid waste removal and improvement of the municipality should be calculated considering the number of citizens and unit territory, etc.

This framework will broaden if the scope of local government responsibilities is widened. Every year an authorized body⁶ of the Government will calculate SSA considering the government's socio-economic strategy, inflation rate, delegation of responsibilities to local governments, and forecasted average level of salaries in public sector. SSA is adopted by Government Decree.

Employment of the K coefficient will support increased tax revenue collection. The higher the degree of tax collection the greater will be the subsidy. The best result of equalization will be in cases of $\Sigma STR = \Sigma(SSA - ABR)$ and $k = 1$. In that case, all the municipalities which have operating budget revenues lower than SSA, will receive the missing part from the state budget for complete fulfillment of their functions. The proposed formula takes into account the financial needs for the current activities of each municipality and its fiscal capacities, and will better support financially weak municipalities.

⁶ Ministry of Finance and Economy of Armenia.

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Appendix 1

Local Self-Government Macroeconomic Indicators

	1997	1998	1999	2000	2001	2002	2003	2004
GDP (billion AMD)	804.3	955.4	987.4	1,031.3	1,175.5	1,362.5	1,623.3	1,893.4
National budget expenditures (NBE) (billion AMD)	146.9	204.6	242.6	222.9	244.4	263.9	312.7	333.9
NBE against GDP (%)	18.3	21.4	24.6	21.6	20.8	19.4	19.3	17.6
Municipal budgets total expenditures (MBE) (million AMD)	9,535.3	11,458.1	11,565.6	12,714.0	14,940.9	18,220.7	21,415.4	26,037.5
MBE against NBE (%)	6.5	5.6	4.8	5.7	6.1	6.9	6.8	7.8
MBE against GDP (%)	1.18	1.2	1.17	1.23	1.27	1.34	1.32	1.37
Municipal budgets total revenues (MBR) (million AMD)	9,941.9	12,329.1	11,702.1	13,854.6	15,281.1	20,360.1	22,826.1	27,101.6
Own revenues of municipal budgets (OR) (million AMD)	6,167.3	8,343.8	9,449.7	8,652.6	8,414.8	8,910.3	12,915.3	15,514.1
Official transfers (OT) (million AMD)	3,774.6	3,985.3	2,252.4	5,202.0	6,866.3	11,449.8*	9,910.8*	11,587.5
OT against MBR (%)	38.0	32.3	19.2	37.5	44.9	56.2	43.4	42.7
Per capita municipal budget total revenues (AMD)					4,756	6,337	7,106	
Per capita municipal budget total expenditures					4,650	5,671	6,667	

Annual average USD/AMD exchange rates are: 2000: USD 1 = AMD 560.0
 2001: USD 1 = AMD 555.1
 2002: USD 1 = AMD 573.4
 2003: USD 1 = AMD 578.8
 2004: USD 1 = AMD 533.5

Appendix 2a

Aggregate Revenues of Municipal Budgets of Armenia*

Revenues	2000		2001		2002		2003		2004	
	Amount (mln AMD)	%								
Revenues of administrative budget	13,712.3	99.0	14,841.1	97.1	19,255.5	94.6	21,416.5	93.8	22,759.7	84.0
<i>Tax revenues and duties</i>	6,690.3	48.3	5,221.2	34.2	5,310.3	26.1	6,794.0	29.8	8,296.3	30.6
• Land tax	1,454.2	10.5	1,667.8	10.9	1,504.1	7.4	2,015.8	8.8	2,341.6	8.6
• Property tax	2,601.2	18.8	2,811.4	18.4	3,062.2	15.0	3,960.7	17.3	5,016.5	18.5
• Income tax	1,410.6	10.2	28.3	0.2	8.4	0.0	0.006	0.0	0.0	0.0
• Other tax revenues	13.5	0.1	19.8	0.1	12.9	0.1	68.9	0.3	42.9	0.2
• Stamp duties	880.1	6.3	374.4	2.4	357.0	1.7	268.1	1.2	319.1	1.2
• Local duties	330.6	2.4	319.5	2.2	365.7	1.9	480.5	2.2	576.2	2.1
<i>Non-tax revenues</i>	1,645.1	11.9	1,665.6	10.9	2,248.7	11.0	2,937.0	12.9	3,583.6	13.2
• Land rentals	824.0	6.0	775.2	5.1	1,104.9	5.4	1,511.4	6.6	2,266.1	8.4
• Real estate rentals	88.9	0.6	88.5	0.6	60.2	0.3	85.3	0.4	89.9	0.3
• Local fees	184.7	1.3	124.6	0.8	148.4	0.7	249.3	1.1	75.6	0.3
• Other non-tax revenues	547.4	4.0	677.3	4.4	935.2	4.6	1,091.0	4.8	1,129.3	4.2
<i>Resources allocated to local self-governments for fulfillment of delegated powers</i>	0.0	0.0	0.0	0.0	0.0	0.0	62.8	0.3	330.2	1.2
<i>Official transfers</i>	5,202.0	37.5	6,866.3	44.9	11,449.8	56.2	9,910.8	43.4	10,879.8	40.1
<i>Retained balance of admin. budget</i>	174.9	1.3	1,088.0	7.1	246.7	1.3	1,774.7	7.7	—	—
Revenues of capital budget	587.7	1.0*	848.1	2.9*	1,888.2	5.4*	2,868.9	6.2*	5,381.8	16.0*
<i>Subvention</i>	0.0	0.0	1.5	0.0	55.0	0.3	169.6	0.7	646.6	2.4
<i>Earmarked allocations from other sources</i>	9.7	0.1	5.0	0.0	94.2	0.5	46.8	0.2	61.1	0.2
<i>Allocations from reserve funds of the administrative budget</i>	445.2	—	408.1	—	783.6	—	1,459.3	—	1,039.8	—
<i>Proceeds from alienation of property</i>	114.1	0.8	400.3	2.6	792.1	3.9	734.4	3.2	3,616.1	13.3
<i>Other revenues</i>	13.3	0.1	0.5	0.0	69.3	0.3	73.3	0.3	18.2	0.1
<i>Retained balance of the capital budget</i>	5.3	0.0	32.7	0.3	94.0	0.4	355.5	1.8	—	—
Revenues of administrative and capital budgets, total (excl. allocations from the reserve fund of the administrative budget)	13,854.6	100.0	15,281.1	100.0	20,360.1	100.0	22,826.1	100.0	27,101.6	100.0

Note: * Excluding allocations from the reserve fund of the administrative budgets

Source: Ministry of Finance and Economy of Armenia

Appendix 2b

Aggregate Expenditures of Municipal Budgets of Armenia

Expenditures	2000		2001		2002		2003		2004	
	Amount (mln AMD)	%	Amount (mln AMD)	%	Amount (mln AMD)	%	Amount (mln AMD)	%	Amount (mln AMD)	%
Administrative budget	12,566.3	95.4*	14,596.8	95.0*	17,396.0	91.2*	19,892.1	87.8*	22,482.5	82.4*
Administration	2,708.0	21.4	3,491.1	23.4	4,314.4	23.7	6,095.8	28.5	7,525.5	28.9
Education (kindergartens)	2,369.2	18.6	2,513.0	16.8	2,829.2	15.5	3,287.8	15.3	4,194.8	16.1
Health	1.1	0.0	1.2	0.0	2.3	0.0	3.9	0.0	14.1	0.1
Social security	65.3	0.5	161.9	1.1	349.8	1.9	408.8	1.9	634.8	2.4
Culture, sports	1,402.2	11.0	1,390.1	9.3	1,593.2	8.7	1,620.2	7.6	1,839.1	7.1
Communal and household	2,735.9	21.5	2,600.3	17.4	2,654.1	14.6	3,358.1	15.7	3,880.3	14.9
Construction and environmental protection	0.0	0.0	0.0	0.0	29.9	0.2	0.3	0.0	0.0	0.0
Transport and communication	94.9	0.7	111.6	0.7	142.0	0.8	164.3	0.8	220.9	0.8
Public ordinance	0.0	0.0	1.0	0.0	2.2	0.0	3.1	0.0	4.3	0.0
Defense	5.1	0.0	1.3	0.0	5.1	0.0	4.6	0.0	21.2	0.1
Other economic services	95.9	0.8	98.2	0.7	29.2	0.2	16.5	0.1	176.8	0.7
Expenses not classified among main directions:	3,088.7	20.9*	4,227.1	25.6*	5,444.6	25.6*	4,928.7	17.9*	3,970.7	11.3*
• Repayment of debts from previous years	1,355.7	10.7	2,227.1	14.9	2,764.5	15.2	1,946.7	9.1	1,209.5	4.6
• Fulfillment of delegated powers	47.5	0.4	16.2	0.1	18.6	0.1	74.3	0.3	195.8	0.7
• Repayment of budget borrowings	6.2	0.1	0.9	0.0	0.3	0.0	1.7	0.0	0.1	0.0
• Reserve fund	1,000.8	7.9	1,416.0	9.5	1,650.7	9.0	1,940.5	9.1	1,809.6	6.9
• Allocation to capital budget	445.3	3.5	408.1	2.7	783.6	4.3	1,095.7	5.1	1,039.8	4.0
• Other expenditures	678.5	5.3	566.9	3.8	1,010.5	5.5	965.5	4.5	755.7	2.9
Capital budget	593.0	4.6	752.1	5.0	1,608.4	8.8	2,619.1	12.2	4,594.8	17.6
Capital construction	89.0	0.7	111.5	0.7	142.8	0.8	182.1	0.9	641.4	2.5
Capital repair	361.6	2.8	471.0	3.2	987.4	5.4	1,626.2	7.6	2,525.0	9.7
Formation of material stocks	25.2	0.2	53.2	0.3	119.0	0.6	370.1	1.7	3.6	0.0
Other expenditures	117.2	0.9	116.4	0.8	359.1	2.0	440.7	2.0	1,424.8	5.4
Capital and administrative budgets, total (excluding reserve fund of administrative budget)	12,714.0	100	14,940.9	100	18,220.7	100	21,415.4	100	26,037.5	100

Note: * Excluding allocations from the reserve fund of the administrative budgets.

Appendix 3

Formula for Allocation of Subsidies under the Factor “a”

$$A = (M - H) \times B \times G$$

where, A is the amount of subsidy allocated to a community under the factor “a”; M is the per capita revenues from land and property taxes; are lower than the republican per capita total amount of land and property taxes and subsidies envisaged for communities under the factor “a” and, in turn, is estimated according to the formula below.

$$M = \frac{D + \Sigma(T + P)}{\Sigma B}$$

where, D is the total amount of subsidies to be allocated to the municipalities and determined by factor “a”; T and P are the estimated indicator of the land tax revenues and property tax revenues of an individual community, which does not belong to the municipalities having population

of no more than three hundred, budget applied in calculating subsidies for each budget year; B is the number of population of the community in question (which does not belong to the municipalities having population of no more than three hundred); H is per capita municipal revenues from land and property taxes of the municipality (which does not belong to the communities having population of no more than three hundred), which is less than the aggregate of the republican per capita (a) total amount of land and property taxes and (b) subsidies envisaged for communities under the factor “a”, and, in turn, is given by formula:

$$H = \frac{T + P}{B}$$

G is the average equalization ratio, calculated according to the following formula:

$$G = \frac{D}{\Sigma[(M - H) \times B]}$$