# Conclusions

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## B. General Background

### B.1 Recent Developments in Local Government Reforms

All three countries inherited an identical legislative history from the Soviet Union.

The start of the local government reforms, like the nature of the three countries, also varies. There are, however, substantial similarities as well. In Armenia, the stream of decentralization reforms and the formation of local self-governments started with the adoption of the Constitution in 1995, while in Georgia, the first elections held in 1991 served as a basis for introduction of local government institutions and the decentralization process.

Reforms in both countries, as well as in Azerbaijan are still in process. For a precise description of these reforms please refer to the respective paper.

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

Armenia and Georgia present descriptions of the mandatory and delegated powers of local self-government bodies. They provide almost identical public services. A description of expenditure items (see Appendix 2b of the paper provided by the author on Azerbaijan) shows that local governments also provide similar public services in Azerbaijan.

In Armenia, own mandatory powers and powers delegated by the State take priority while own voluntary powers are exercised by the municipal council according to the funding provided by the municipal budget. In Georgia, exclusive powers are the most important function of the local self-government and, accordingly, the key part of its activity must provide for the fulfillment of this authority. The European Charter of Local Self-Government covers the same principles. These exclusive competencies can be financed only by the local self-government without any agreement with the central government.

### B.3 Number and Size of Local Governments

In Armenia, a large number of small and weak municipalities have been created which have no appropriate capacity to deliver services to the population (see Table 1 in the respective paper). Practically, a single tier local self-government is functional, and all the municipalities (with some exception in the Yerevan district municipalities) function in the same legal framework. The absence of the second tier of local self-government renders the system incomplete, leaving an insufficient level of local self-government in many municipalities. The experience of the past few years showed that the current administrative and territorial division restricts further decentralization and hinders the progress of local self-government.

In Georgia, the situation is different: one might conditionally sort out three levels in the territorial system of Georgia: (a) upper (regional) level (capital, autonomous republic of Ajara and Abkhazia); (b) intermediate level (a region and six cities not subordinate to the region); and, (c) lower level (village, community, town, city). It should be mentioned that the current reforms in the country envisage a major consolidation of self-governing entities from existing 1,111 today (out of which, elections of representative bodies were held only in 998 units due to territorial conflicts) to 68 unit this autumn.

The Azerbaijan paper gives a list of 58 municipalities, showing major consolidation.

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

The legal autonomy of the local governments of Caucasian countries also varies, but the information provided makes it possible only to compare Georgia and Armenia. In Armenia, 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. In Georgia, the disposal of primary property, which can be used only to carry out public functions, is permitted, but only after it loses its function due to acquiring newer property.

With respect to budgeting, Armenia and Georgia follow similar practices. Local self-governments in Armenia were legislatively granted the power to form their budgets and independently manage their financial resources. Current reforms from May 2006 ensure a similar situation in Georgia, putting budget and financing exclusively under the authority of the self-governments. Local self-government (and not government) bodies in Georgia shall, within the scope of their competence, set limited tax rates and establish terms for payment of these taxes in compliance with the Code. National tax authorities monitor payment of local taxes. In Armenia, local self-government bodies are entitled to set not tax rates but local duties and fees, but only within the limits prescribed by national legislation.

Local self-government bodies of both countries are entitled to take a loan, but in Georgia loans are received from the state budget or budgets of autonomous republics, while in Armenia, from the state budget and commercial banks.

It should be noted here that the Law on Budgetary System of Azerbaijan adopted in 1997 ensures full independence of budgets at all levels. But, still cash flow financing has been accepted as a major principle between the central and local government tiers. This law stipulates that sub-national governments facing fiscal difficulties should receive financial aid from the central one, which can be in the form of a subsidy, subvention or grant. The legislation does not stipulate principles or criteria for distribution of subventions to the municipalities. The following two factors determine the provision of subsidies: (a) the municipal population and (b) the role of the region in the establishment of the country's financial power. State grants are non-purpose financial aids provided to cover deficits between local budgets receipts and expenditures.

## C. Basic Structure of the Intergovernmental Finance System

The most obvious way to reduce fiscal disparities is to provide transfers to regions that have a significant fiscal gap, which can be defined as the difference between fiscal needs (needs associated with expenditure responsibilities) and fiscal capacity (own source revenue potential and shared resource revenue potential), after taking into account targeted transfers, which are used to pursue other objectives.

### C.1 Revenues

Fiscal capacity of a sub-national government may be defined as the potential revenues that can be obtained from the tax bases assigned to the sub-national government if an average level of effort (by national standards) is applied to those tax bases. A variety of methods are used around the world to measure a state or region's fiscal capacity. One of them is the state's level of revenue collections or past year's revenue collections. The author of the Azerbaijan paper rightly mentions that financial potential is generally accepted as a basis for development of local government. To determine the financial position of a sub-national government, receipts and expenditures should be considered.

Each paper presents the composition of revenues of sub-national governments. Presenting each component of revenues by amount and in percentage terms (although over a different time period), the Azerbaijan and Armenian authors revealed that total revenues in both countries have been increasing, out of which the share of non-tax revenues also depicts the same trend (for exact figures please refer to Annex 2a of the respective country paper). While the composition of revenues of sub-national budgets still differs from country to country, there are some similar tax and non-tax revenues. Sub-national governments of all three countries collect property and land taxes. Profit tax is a source of income in the Georgian and Azerbaijan sub-national governments. Among non-tax revenues, all three countries acquire receipts from legal status changes[1] of land and other property owned by sub-national governments.

None of the countries use the tax-sharing mechanism as a source of revenue generation. It should be mentioned, however, that the legislation of Armenia envisages income and profit tax-sharing between the

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[1] This also differs from country to country: The Armenian author refers to "allocations from reserve funds of the administrative budget;" the Azeri author – "fees from the use of municipal property," "revenues from privatization and rent of municipal properties," and; the Georgian author – "fee from lease of property and land owned by local self-government," "fees from sale of property owned by local self-government."

state budget and local budgets. Nevertheless 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. Since central government budget revenues are reduced by sharing, the government does not accept this practice any more. All rates of these taxes are set by legislation adopted by the National Assembly[2].

Overall, in Armenia, the predominant share of own revenues of sub-national governments is generated from tax revenues and duties. Contrary to that, in Azerbaijan, although tax revenues were a major source of local government revenues in 2003, its share has been decreasing and only amounted to 25.2% in 2005 while its share of non-tax revenues was 65%.

The discretion level determines the efficiency of the system. The efficient provision of government services requires that the public sector satisfy the needs and preferences of taxpayers as well as possible. This can be provided by the following principle – responsibility for the provision of government services should take place at the lowest level of government that can efficiently provide this service.

Sub-national governments in Armenia and Georgia have a substantial level of discretion in rate setting.

Particularly, in Armenia, municipalities are entitled to set the rates of local duties and fees, and in Georgia, local self-government (not government) bodies set tax rates but, in both countries, within limits stipulated by national legislation. Revenue that is subject to local rate setting by local governments is about 9.6% in Armenia, which is a substantial share.

### C.2 Expenditure

The expenditure needs of a sub-national government may be defined as the funding necessary to cover all expenditure responsibilities assigned to the region at a standard level of service provision. In practice there are many options to measure the difference in expenditure needs across sub-national governments. First, expenditure needs can be measured from the bottom up, by costing the current expenditure obligations of local governments or costing a standardized basket of sub-national government services. Second, a simpler and more common approach is to estimate some type of index of relative expenditure need. A third way to establish the expenditure needs of local governments is to rely on historical expenditure patterns.

The Azerbaijan and Armenian papers present expenditure history, as well the expenditure components of sub-national governments. The time frame is different for the two statistics presented. The Armenian author presents figures for five years and the Azerbaijan author for just two years. Both figures show that the aggregate expenditure of sub-national governments has increased year on year.

Expenditure as a share of GDP or total public expenditure is incomparable because only the Armenian paper presented figures on that showing that this share has been increased from 1.18% in 1997 to 1.37% in 2004.

The most notable part in expenditure items is that a significant portion of local budget expenditures is attributed to administrative costs. This is the case in Azerbaijan and Armenia. Another point is the drastic increase in staff maintenance costs in Armenia, which the author explains was a consequence of transferring the right to decide on the number of employees to the heads of municipalities and municipality councils. This also resulted from previously inadequate staffing levels for the services the municipalities were required to deliver.

The Georgian author presents the fund allocation between exclusive and delegated functions. Particularly, the 2003 figures show that out of the total expenditures, less than 30% is allocated to implement exclusive authorities and more than 70% for delegated functions. This happened mainly due to the fact that there was no legal guarantee at the budget drafting and execution stage to provide funds to local self-government units for fulfillment of exclusive authorities.

The functions of local self-governments represent the major direction 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, the functions of the local self-governments may vary from country to country. However, when viewed in general and categorized they are almost identical. In our case, comparing these functions seems to be difficult, because the Armenian author presents the major directions of local government functions as well as their expenditure items, while the Georgian paper gives functional classification of expenditure items thus defining specific functions of the sub-national governments, but does not give figures for them. The paper presented by the author

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[2] The National Assembly is the legislative branch of the Republic of Armenia.

from Azerbaijan provides an even broader scope of the municipal activities – the realization of economic development, ecological and social programs. The Azerbaijan paper also gives figures for expenditure items. The main conclusions of such are given above.

The Armenian paper also gives a good example of the distribution of functions among national and local budgets. 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; the local government is involved in public schools management issues.

All authors point out that local governments lack revenue sources to finance assigned expenditures, thus hindering satisfactory and effective fulfillment of their responsibility. As a result, points out the Armenian author, local governments face unfunded mandates, which are those mandatory and delegated powers defined by law that are partially performed or not performed at all.

The legislative frameworks of all three countries differ. While in Armenia, the mandatory and delegated powers of local self-governments are the priorities in terms of implementation, out of which delegated powers are entirely funded from the state, voluntary power is only implemented if the municipal budget provides for such an opportunity. As mentioned above, in Georgia there is no legal guarantee at the budget drafting and execution stage, that local self-government units will have funds for the fulfillment of exclusive authorities. Nowadays, legislation entitles the local self-governments of Armenia full discretion over all expenditures. Official transfers are mainly unconditional subsidies and local self-governments decide on their spending themselves. In some cases, the government puts pressure on the local self-governments over certain expenses.

## D. Equalization Measures

What are equalization grants? A variety of approaches exist in which transfers can be allocated from the central government to local governments[3]. Equalization transfer is considered to be: (a) an unconditional, general purpose transfer, (2) where the total amount of the grant is typically, although not necessarily, determined by some funding rule, and (3) where the divisible pool of resources is distributed among eligible units based on a formula that considers the expenditure needs and/or the ability of the sub-national government to raise resources. The key feature of equalization grants is (4) its intended purpose: to equalize fiscal conditions among sub-national governments. This requires providing additional resources to the poorer jurisdictions.

What is to be achieved by giving equalization grants? First, in the absence of equalization transfers, some local governments would have insufficient resources to fulfill their responsibilities at a minimum desirable level (by national standards). In particular, equalization grants are important as they typically provide a sizable share of overall sub-national government resources. Second, equalization grants reduce horizontal fiscal imbalances in a country, or regional disparities and inequities, by compensating sub-national governments with greater fiscal need and smaller fiscal capacity. Third, equalization transfers are an important tool because they can be used by the government to pursue selective complementary objectives. In particular, equalization transfers can be used to stimulate fiscal efforts.

All three countries employ some kind of state to local government transfer, which differs from country to country. The legal basis and discretion level also vary.

Transfers form a critical component of virtually every system of intergovernmental fiscal relations. Since own source revenues falls short in providing local governments with adequate resources to fulfill their expenditure responsibilities, a system of transfers is needed to provide sub-national governments with additional resources.

Transfers can be designed to vary in three important aspects: (1) what local governments are allowed to spend money on (i.e., whether the grant is conditional, and if so, how much discretion the conditions leave); (2) the size of the transfer pool, and how the size of the pool is determined; and (3) how the available resources are distributed among the eligible governments.

A number of alternative transfers that could be considered in the design of a system of intergovernmental transfers include:

- Revenue sharing – Local governments could be allowed to keep a percentage of certain national revenues collected within their territories. Georgian legislation leaves 100 percent of income and profit taxes to the sub-national governments. Because revenue sharing does not give local governments

[3] Probably the most widely used taxonomy of transfer schemes is the one developed by Roy Bahl and Johanness Linn in Urban Public Finance in Developing Countries (New York: Oxford University Press, 1992).

discretion over either the tax rate or base, revenue sharing is considered a type of intergovernmental transfer.

- General purpose (unconditional) block grant – A grant that, due to its unconditional nature, provides local governments with an amount of policy discretion. Grants issued for equalization purposes are most often general purpose unconditional grants.
- Conditional grants (for which conditions can vary greatly from case to case) – A sectoral block grant (also called categorical grants) is a conditional block grant that comes with the condition that the funds must be spent in a specific sector, however, local governments maintain full control over how to spend the funds within each sector. Alternatively, specific purpose grants can define conditions very narrowly. Conditional grants by design limit the discretion of local government and as a rule should be used sparingly. However, conditional grants may be justified to promote national policy priorities or to prevent suboptimal funding of particular local governments activities.

Georgia uses three types of transfers: (a) purpose-oriented transfers for financing delegated authorities, (b) compensatory transfers, which after May 2006 are defined by a formula ensuring equalization, and (c) special transfers allocated for financing in case of natural disasters or other special cases. Before May 2006, the amounts of all three, and after that date, two out of the three transfers, were determined by negotiations between the central authority and the receiving local governments.

Armenia also uses three types of transfers which are classified according to the purpose of allocation: (a) financial equalization subsidies to cover recurrent expenses and are discretionary subsidies, (b) other subsidies allocated to support funding of current expenditures of local budgets, untied to any program, and (c) subventions, allocated funding earmarked for a targeted municipal program. In reality, only the first type of subsidy is mainly used because the legislation does not regulate the procedures of the latter two types of subsidies.

In Azerbaijan, to ensure fair and effective equalization of municipal budgets, the state commenced employing a number of methods such as, general purpose grants (subsidies), conditional grants (subventions), budget loans, etc. However, transfers from the state budget allocated for the purpose of equalization of municipal budgets are often spent without having a specific target. Legislation determines neither principles nor criteria for distribution of subventions to the municipalities. The following two factors determine the provision of subsidies: (a) municipal population and (b) the role of the region in the establishment of country's financial power. State grants are non-purpose financial aids provided to cover the imbalance between local budgets receipts and expenditures.

In Azerbaijan, although the Law on Budget states that a municipality facing financial difficulty should receive financial aid from the state, dependent on the population and the role of the region in establishment of country's financial capacity, in reality, the provision of these subsidies is discretionary. So called visual approaches (i.e. how close relationships are established between the local government and central government representatives) and not the subsidy allocation principle described above, prevail in the state financial aid allocation process. Since the legislation envisages that sub-national governments should not rely upon the central one, the actual amount of financial aid to municipalities decreases whenever the state budget faces financial difficulties.

***Funding Rule***

Several rules can be chosen for equalization. The actual determination of funds can be organized on an *ad hoc* basis, such as a particular level of funding specified in the annual budget, or it can be done in a more objective and stable basis as, for example, a percentage of central government revenues or certain taxes, with this percentage fixed for a number of years.

The first one, allowing changes to the overall level of funding annually, provides central governments with more flexibility to pursue macroeconomic stabilization policies. On the other hand, the use of the *ad hoc* rule causes uncertainty for sub-national government budgets. Until May 2006, Georgia and Azerbaijan used this rule to conduct transfers to local governments. In Georgia, before May 2006, the amount of all three, and, after that date, two out of the three transfers were determined by negotiations between the central authority and receiving local governments. In Azerbaijan, so called visual approaches and not the subsidy allocation principle envisaged by legislation, prevail in the state's financial aids allocation process.

The desirability of making revenue flows for sub-national governments more predictable suggests that the introduction of a temporary fixed rule for funding the equalization pool may be a superior alternative. A common version of this rule is to fund the equalization pool with a percentage of central government revenues and to fix the percentage for a number of years. Even this rule does not fully provide sub-national governments with predictable revenues, since the actual revenue performance of the central government is itself uncertain. Other rules may be adopted, one of which is to fix the size of the equalization pool as a share of central government *budgeted* revenues, as opposed to actual or realized revenues. None of the authors mention that their countries employ any of these methods.

A fundamental step when determining an equalization transfer is how to divide the equalization funds among the sub-national governments. Several types of rules can be followed for the distribution of available funds among sub-national governments. First, the apportionment of funds can be done on an *ad hoc* basis, like in Georgia and in actual provision in Azerbaijan. Second, the central government may use an "equal per capita" rule for distribution of funds for those sub-national governments that qualify. Or, the central government can use a more complex and explicitly stated formula.

Armenia is the only country out of the three which already used a formula to determine the amount of subsidies and employs two different approaches, according to the size of the municipality, for calculating them. For small municipalities, with a population of less than three hundred, municipality size is the main factor and all such municipalities receive an equal amount of subsidies irrespective of their exact size and fiscal status. For bigger municipalities, the per capita income of the local government is also considered, especially tax revenues, but ignores the municipalities' financial needs. More precisely, for this type, the following two economic factors are considered:

- Per capita land and property taxes in the municipality (hereinafter factor A);
- 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 land and property taxes, and, factor *B* determines that subsidies are no less that ten percent of the actual revenues from all income tax collected in the previous budget year. For factor *A*, the figures given by the relevant state authorities conducting property and tax accounting in Armenia are used. Subsidies determined by factor *A* are envisaged for all municipalities of the second type (with a population of more than three hundred), 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 of the respective paper 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) municipal 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.

In Georgia, in the current reforms of 2006, envisages utilizing a formula. The amount of equalization transfer allocated to the sub-national budget is grounded on (a) the difference between the average income potential of all sub-national governments and the average income potential of the sub-national government in question, (b) on population, and is corrected by multiplier that envisages (c.1.) a sub-national government allocation given by a high mountain ratio and, (c.2.) population density.

The general intent of an equalization mechanism is to compensate for fiscal disparities across regions. Fiscal disparities, as mentioned above, arise from two main sources. Regions may differ in their fiscal capacity, that is their economic base, and therefore in their ability to raise a particular level of revenue with standard rates and administrative efforts. Regions may also differ in their expenditure needs. Even when regions have the same fiscal capacity or ability to raise revenue, their costs to provide a standardized basket of public services accommodating a different set of needs arising from different demographic profiles or geographical conditions, may differ. In international practice, there are countries that use formulas to equalize both fiscal capacities and expenditure needs, countries that use a mechanism to equalize only fiscal capacity, and countries which equalize only expenditure needs differences across sub-national governments. None of the interested three countries have already used any measure of expenditure need equalization. Armenia, already advanced by utilizing a formula, has made further progress and suggests a new model for financial equalization. This model, together with the revenue side, is based on the estimated expenditures for the implementation of local government functions. (Please find the exact description of this model in Part E of the respective paper).

Since formulas were until 2005 used only in Armenia, the local governments of Georgia and Azerbaijan were consulted regarding the amount of transfers for the next budget year. Under current reforms, Georgia has already employed formula-based transfers and this is for the first year; thus, nothing is yet known about consulting opportunities.

Additionally, Azerbaijan also points out that some local governments are treated specially, particularly, the capital city.

To summarize, it can be stated that the existing financial equalization formula in Armenia and equalization measures in Georgia and Azerbaijan, do not fully serve the objective of equalization and may require further amendments.

### E. Wrap-up

Overall, the intergovernmental finance system and equalization system of any country, like any system in the world, possesses its strengths and weaknesses. The authors present different views on the positive and negative sides of the systems in their counties.

The main problem of the sub-national finance system of Azerbaijan is the low level of revenue mobilization that concerns both own revenues and state subsidies. This low collection level of taxes and fees is due to the absence of a proper registration system and calculation mechanism, as well as legal imperfections. Political factors can also not be avoided.

The Armenian author, in addition to above, presents insufficient revenues as one of the weaknesses of the intergovernmental finance system. Legislative drawbacks are also essential, but the most important is that the existing system of financial equalization does not entirely take into account the main principle of financial equalization – the protection of financially weaker municipalities. Among positives, it should be noted that legislation determines intergovernmental fiscal relations, budget processes, budget receipts and expenditures, as well as allocation of equalization subsidies. The important part is that legislation stipulates that local duties and fees are set by local governments.

The Georgian author points out several problems of intergovernmental finances, several of which have been further deepened by the changes made in Georgian legislation at the end of 2004. They mainly concerned receipts of sub-national governments that declined due to liberalization of the overall tax system. With respect to the financial equalization system, the drawbacks concern institutional and legislative issues: no formula for subsidy allocation is assigned and the regional Sakrebulo decides on the share remaining from state taxes that goes to local self-governments budgets.

Each author suggests reforms to improve the fiscal equalization mechanism. Progress in this respect is made by the author from Armenia who proposed a formula that concerns both expenditure needs and revenue potential. The Georgian author suggested a formula that was mostly based on expenditure differences but the government chose a slightly different formula that concerns both revenue potential and expenditure needs. In this version, fewer factors than those proposed by the Georgian author are taken into account for determining expenditure needs. The author from Azerbaijan suggests reforms to improve the fiscal capacity of sub-national governments without proposing a formula. These mainly concern the tax base and taxable principles, as well as modernization of the government subsidy allocation principle, which, should consider the poverty level of the respective municipality and envisage protected expenditure items.

All of the above suggests that the problems that municipalities have faced, in a broader sense, are similar: all three countries face obstacles in revenue mobilization, although, in a narrower sense, each author describes reasons specific to their country. Each author also presents their own view of how to improve the financial situation of sub-national governments in their respective country.