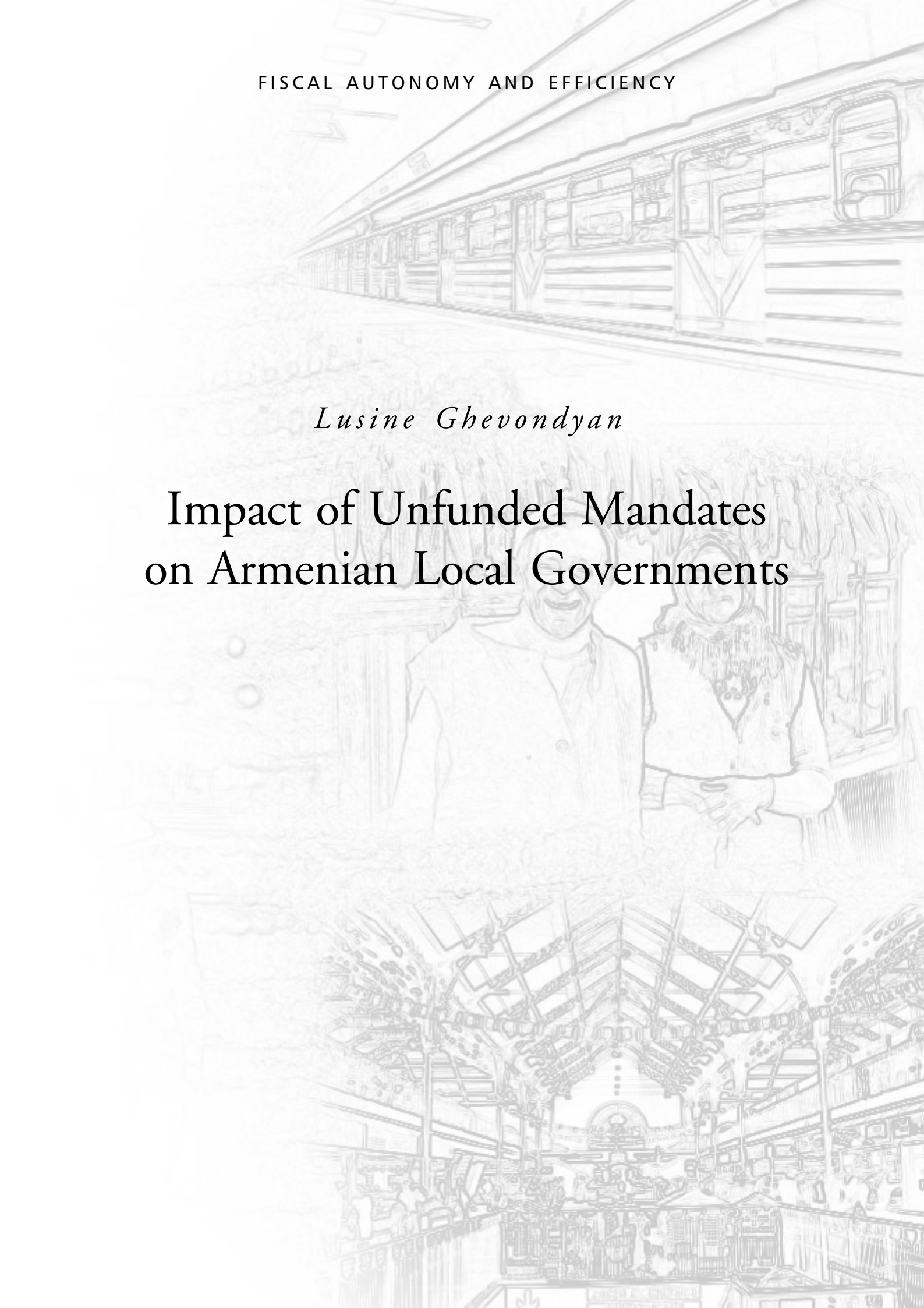


FISCAL AUTONOMY AND EFFICIENCY

Lusine Ghevondyan

Impact of Unfunded Mandates on Armenian Local Governments



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1. INTRODUCTION

The dissolution of the USSR provided a newly independent Armenia with a legacy of grossly inadequate public administration structures and a bankrupt economy. Within this framework, it has become clear that the establishment of a liberal democracy will require a dramatic reconceptualization of the entire public administration system. As the transition to a more democratic state progresses, certain policy issues with respect to intergovernmental relations should be addressed. Of primary importance are the allied questions of what services governments should provide, which governments should provide each service, and how should these services be paid for?

While fiscal decentralization of local governments should be encouraged, it is vitally important that local governments be assured of adequate financial and human resources before they are given responsibilities that may be too difficult for them to manage. The purpose of the proposed research is to study certain aspects of the fiscal capacity of local governments in the Republic of Armenia and, based on the experience of Western countries, to draft an applicable policy proposal on local governments' fiscal management models for Armenia.

"In the open ended questioning that followed the Q Sort exercise, five out of ten interviewees said they would like to see systems for *improving local revenue sources* given top priority in any municipal development program, three listed *budgeting systems*, and two identified *personnel systems*" (ICMA report, 1999').

These concerns reflect an environment in which fiscal decentralization has proceeded in an *ad-hoc* manner, resulting in too little focus on matching local government capacity to devolved responsibility. The issues involved in tying together fiscal decentralization and policy implementation capacity building are among the real priorities on the intergovernmental agenda in Armenia. Local governments suffer from a lack of sound intergovernmental financial arrangements. Local governments realize that they need additional funding from the central government to implement the growing number of social mandates and central government does not believe that it can find extra money. To assist in the develop-

ment of an understanding on these issues, the proposed research seeks to identify the kinds of intergovernmental fiscal relationships that should already exist between local governments and central governments at this stage in Armenia's transition.

Within this context, the research can be characterized as addressing the question: *What should the mechanisms of local governments' revenue management be in the process of implementing national policies and the national government's unfunded mandates?* The desired outcome of this research is an assessment of the fiscal effects of mandates (i.e., costs as a percent of locally raised revenues of municipalities).

A wide range of fiscal policy issues will be investigated in this research, with special emphasis on local government finances in present-day Armenia, such as functional responsibilities of local governments, revenue and expenditure assignments, the budgeting system, local revenue sources including transfers allocated to local governments, and local borrowings.

Inevitably, the issue of mandates leads to a discussion on the relative constitutional roles of the national, regional or local governments, as well as the practical means by which all of these governmental levels can work together to implement appropriate national and local policies. The research will illustrate approaches used in developed countries, in regard to such mandates, and how and to what extent they are applicable to the development of Armenia.

2. RESEARCH METHODOLOGY

Key concerns about local government budgets were identified based on preliminary information obtained from the Ministry of Finance, heads of Municipalities, and different governmental and non-governmental agencies dealing with local government issues. A questionnaire was composed based on those reports and the surveyed population was comprised of heads of Armenian municipalities (mayors and financial directors). The questionnaire was administered to seven municipal financial directors, which was followed by open discussions with the respective mayors. The cities surveyed were randomly selected from a list comprising all of Armenia's cities.

Furthermore, discussions were held with senior officials at the RA Ministry of Finance and Economy, the Ministry of State Revenues, and the Ministry of Territorial Affairs.

3. FUNCTIONAL RESPONSIBILITIES OF ARMENIA'S LOCAL GOVERNMENTS

One of the most important aspects of Armenian government is that Armenia is a unitary state and, as typical of all unitary states, most of the government functions are centralized. The share of local budgets in the consolidated budget is rather small at nearly 5%. This means that local governments in Armenia have few assigned responsibilities.

Armenia has a two-tier governance structure revolving on central and local levels. Local governments are political subdivisions of the state. Local governments lie in the boundaries of Marzes, which are Armenia's territorial-administrative units and are branches of the central government's administrative structure, not a separate tier of the state administration system. Yerevan holds the special status of Marz. The local population elects the head of local government while the government appoints the head of Marz.

The first step in the design of an intergovernmental relations system should be the clear assignment of functional responsibilities among the different levels of government.

During interviews held with the mayors of seven cities, five out of the seven interviewees mentioned that the primary problem comes from the fact that local governments do not have clearly defined functions, which creates an authority problem that in its turn complicates management. The legal, administrative, and fiscal relationships among different levels of government are problematic. The role of local governments vis-à-vis Marzes, state ministries, and legal enterprises delivering local public services is not clearly defined by law nor practice. The main attributed reason was that decentralization had been done in an *ad-hoc* manner.

Already defined in the draft Law on Local Self-governments is the following: the concept, bodies, general principles and powers of the local self-government; the legal, economic and fiscal bases of their activities; and the guaranties of the implementation and regulation of interrelations between the state and local self-government bodies. This law will also include recommendations from community leaders. It should also be noted that some of the mentioned items above are already specified in the current law, however not accurately. The new laws are currently being discussed in Parliament and will most probably be passed in November 2001 (UPDATE). According to the draft:

“Local Self-government is the power and the capacity defined and guaranteed by the RA Constitution and this law for local self-government bodies acting at their own responsibility

and independently as provided by the law, to manage the community's property and resolve the community's problems with an aim to improve welfare of the population.

“A community is a commonality of residents and administrative-territorial subdivisions, within the defined boundaries of which local self-government is implemented through the elected bodies.”²

The principles of local self-government are:

1. *General authority*—the right to carry out any autonomous activity in relation to the interests of the community that is not in contradiction of the law, if not otherwise prescribed by the law;
2. *Independence and self-responsibility* in performing local self-government;
3. *Correspondence between the powers* prescribed by the law and financial resources required for the enforcement of such powers;
4. Delegation of state powers to local self-government bodies if such powers can be more effectively exercised, and a compulsory guarantee of the adequate financial resources for its execution;
5. Judicial protection of the rights, legitimate interests and the property of the community;
6. Assistance to financially weak communities through financial equalization;
7. The right of the community, while implementing its powers, to affiliate with other communities pursuant to the procedure stipulated by the law for the purpose of resolving various problems;
8. Publicity and transparency of local self-government body activities.

While the law appears strong, there remain problems with its enforcement. A concern aired during the open discussions with heads of communities was that the law has a declarative nature; regardless of what the law says, its implementation is very low, especially in more remote regions of the country.

According to the current Law on Self-governments:

“the powers of local self-government bodies shall be divided into their own powers and powers delegated by the State.

“Own powers shall be divided into mandatory and voluntary powers.

“Mandatory powers and powers delegated by the State shall be subject to mandatory funding and regular performance.”³

Mandatory community powers can be implemented through budgetary and non-budgetary agencies and institutions.

From the statement mentioned above, one can derive a definition of unfunded mandates:

Unfunded mandates are those mandatory powers given to local governments that are not performed, or are partially performed, as a result of inadequate financing.

The following are mandatory responsibilities of Armenian local governments in the field of municipal services:

- The use and maintenance of non-privatized residential and non-residential buildings and associated facilities;
- The operation of water supply, sewage, irrigation, gas supply and central heating systems as well as other structures;
- Landscaping and site improvement in the community;
- Solid waste collection and disposal;
- Regulating the operation of community public transport;
- The proper maintenance of cemeteries;
- The construction, repair and operation of water and waste treatment plants;
- The construction, renovation and operation of irrigation systems;
- The construction, maintenance and operation of roads, bridges and other engineering structures in the community's jurisdiction.⁴

As perceived from the list, large responsibilities are distributed to local governments. However, a careful reading of the Law on Local Self-governments reveals references to other laws that often take away or severely limit those same powers and responsibilities apparently granted in the basic law. Moreover, local governments' non-institutionalized nature vis-à-vis the state makes the amount of informal discretionary prerogatives available to local officials uncertain. When these limited or ambiguous powers are considered in the context of very low fiscal capacity and a high level of dependency on state subventions and subsidies, local governments in Armenia are capable of little political, social, or fiscal impact.

In response to questions intended to clarify local governments' mandates, the mayors revealed that local governments have very few responsibilities and even those are not implemented because of insufficient financial resources. Most local governments are ineffective as governmental entities and are hampered by a lack of clear legal authority and fiscal capacity.⁵

The following table analyses the revenue sources of local governments' mandates in the city of Kapan.

Table 2.1
Local Government Mandates

Main Fields	Financed by			
	Local Budget	Central Budget	Out of Budget Please, Describe ⁶	Various Sources % of Which Are Local
Primary education	✓ (food basket)	✓ (salaries are paid from subsidies received from National Government)		
Central heating	✓ (maintenance costs)			
Local Roads	✓		✓ (GTZ Local Governments' Project)	
Culture, sport	✓	✓ (salaries are paid from subsidies received from National Government)		
Water supply			✓ (GTZ)	✓ (Hai Jrmughkayan JSC) 0% local
Sewage		State Agency attached to the Government		
Waste collection and management				Contracted 0% local
Capital investments				✓ (GTZ) 35% local

As we can see from the table above, local governments finance a very small portion of assigned responsibilities. In the case of primary education, the local government only provides food for kindergartens, which is taken from the tuition paid by parents. The quality of service is very low. In the city of Ijevan, the average food basket price as defined per child is from 17 to 57 Armenian Dram (3.09-10.3 US cents) per day. Meanwhile, the World Bank defines the poverty line at 217 Armenian Dram (39 US cents) per day. As clearly seen, this is below the minimum standards for the provision of the service. The draft of a new law on local self-government states that the law should define the minimum norms of implementation of mandatory services. In the city of Kapan, only 60.6% of salaries due are actually funded, even though they are financed from subsidies received from the central government.

4. REVENUE AND EXPENDITURE ASSIGNMENTS

4.1 Expenditure Assignment

A stable and meaningful decentralization requires an unambiguous and well-defined institutional framework in the assignment of expenditure responsibilities among the different levels of government together with the sufficient budgetary autonomy to carry out the assigned responsibilities at each level of government.⁷

However, there is no absolute best way for deciding which level of government should be responsible for a particular public service. As unitary systems become more decentralized, the failure to establish by law a clear assignment of expenditure responsibilities for each government can become a source of conflict between the central and subnational governments and can lead to an inefficient provision of public services. In situations where government budgets are tight, which is almost always the case, the lack of clear assignments leads to the under-provision of key public services. Responsibility for the provision of services should be at the lowest level of government compatible with the size of “benefit area” associated with those services. Subnational governments can provide public goods like roads and transportation services. The benefit area for those services is clearly the local community. Public goods such as national defense cannot be provided by local governments and should be left to the central government because the benefit area is the entire national territory. Leaving the supply of public services with wider benefit areas to smaller units of government is likely to result in the inefficient under-provision of services. However, there is not always one clear and perfect answer to service provi-

sion. Some public services, like primary education and primary health care, may be of a local nature by the size of their benefit area, but because of their relevance in welfare and income redistribution may also be considered a responsibility of the central government.

4.2 Revenue Assignment

Each level of government should be assigned taxes that are related to the benefits of its spending. Thus, the proper assignment of taxes that are related to benefits depends on the proper assignment of expenditure functions that was described above.

The efficient provision of public services is enhanced if consumption benefits are linked to the costs of provision via fees, service charges, or local taxes.

In Armenia, when services are self-supporting and linked directly to consumption benefits, the role of local governments is merely to facilitate the provision; they cannot directly affect rates charged for these services, as they are set by the central government. The collection rate is very low; therefore the quality of provision cannot be stated as satisfactory.

Inadequate provision of services may also be related to the size of local governments, thus begging the question: Is the size of local governments efficient? Most local governments in Armenia are too small, in regards to their fiscal and administrative capacities, to provide public services efficiently. Currently, there are 930 local governments in Armenia. Of the 930, there are many entities that are simply too small to support themselves. The large number of local governments results in inefficiencies, non-integrated development plans and *ad-hoc* allocation of resources. Few studies have been carried out to assess the fiscal cost of decentralization on the central government’s budget; that is, how much effort should central government put into treasury, budgeting, reporting and monitoring activities for a community with an annual budget of only \$200-\$3,000? The raised revenue probably does not cover salaries of the staff involved in administering and monitoring the local government. The size of the community can be looked at from the following perspective: can the local government in question guarantee the delivery of minimal social standards to the community? In Central Europe, territorial fragmentation is associated with administrative overhead costs (i.e., the smaller the local government, the higher percentage of revenue absorbed by administration). During a course on Intergovernmental Fiscal Relations provided at the Summer University of the Central European University, Budapest, Dr. Robert Ebel suggested the consideration of the following three adjustments: (1) the creation of districts to supplant some or all of small local government functions, (2) intergovernmental agreements to share services and responsibilities, and (3) the parliamentary revisiting of whether such governments

should be consolidated. Currently, the RA Ministry of Finance is working on a draft to consolidate some of the small local governments.

5. BUDGETING SYSTEM

A common theme in the decentralization process in countries undergoing transition is a focus on the revenue side of decentralization and neglect of a clearer assignment of expenditure responsibilities. Budgets are created based on what revenues can be projected and what expenditures can be financed. Few studies have been conducted on need assessment, meaning the need for revenues from the “demand” side (i.e., from the point of view of how much money is needed to fund necessary local services).

Assume that a municipality needs \$1,000,000 to perform all basic services at a 100% level with normal quality. According to the findings of KPMG Consulting, the difference between calculated (what the cost should be to perform basic services) and planned (the level of planned spending) expenditures amount to 36.4% of the total budget, then the planned budget would be ≈ \$640,000. It was calculated that the difference between Armenia’s actual budget and planned budget is 62%,⁸ which in dollars yields \$396,800. In addition, according to the results of the survey, budget performance is 48%. This means that execution of the actual budget is \$190,464. This amount is 19.04% of what is needed to fund all the services that local government are mandated to perform at a 100% level.

Local governments need to increase today’s actual budget (1,000,000 – 396,800 = 603,200) by 152% to be financially capable of implementing mandatory services. Survey results show that, on average, local revenues comprise 51% of the local government budget; meaning that in our example, out of the \$1,000,000 budget, \$510,000 would be own source revenues. But as calculated in the example, the actual budget is \$396,800, out of which local source revenues are \$202,368 (51%). Local governments need to raise their own source revenues by 152% (\$510,000 – \$202,368 = \$307,632). They need 152% (\$307,632) more in addition to the current budget figures in order to finance all basic mandatory services at a 100% level.

The calculations above are rough, as it is quite difficult for municipalities to estimate unit costs for services and to estimate the total amount of services needed. Nevertheless, as we can see from the calculations in the above example, local governments’ finances in Armenia are in a disastrous situation.

The following are possible explanations of this situation:

- 1) Local governments in Armenia set their local budgets as they wish. What has become obvious during the inter-

views with senior officials of the surveyed municipalities is that when preparing the budgets, most local governments omit budget estimates for those categories of expenditure that they determine cannot or will not be funded. They do not prepare their budgets based on what it would cost to fund all mandated services at a 100% level. Therefore, it is not possible to sum the totals of all local government budgets, as currently prepared, and arrive at an amount that is necessary for complete funding of municipally provided services.

- 2) Frequently, the budget, including projected revenues, is not correctly planned. First of all, as mentioned above, it does not reflect the real costs of the services to be provided. Second, it includes arrears from taxes that were not collected in the previous year. While it may seem correct, the reality shows that those arrears are never collected, whereas they are being carried out to the following budget year by year and provide incorrect revenue projections and incorrect budget estimates.

What are some solutions to this?

- 1) *Municipalities need to learn how to properly evaluate their financial expenses.* Today, municipalities have no way to estimate unit costs for services or the total amount of services needed. Therefore, it is essential that they know how to evaluate their financial expenses.
- 2) *They also need the ability to estimate their financial potential (i.e., reflect real and actual revenue potential and do not carry over uncollectable sums to the following budget.*

6. LOCAL REVENUE SOURCES

If fiscal decentralization is to be realized, then sub-national governments must control their “own” sources of revenue. Extracted from interviews with Armenian municipalities, the average percentage of own source revenue comprises 51% of their local budget.

The RA Law on Local Self-government sets the composition of local revenue sources:

A community budget must be composed of:

1. *land tax,*
2. *property tax,*
3. *proportion of other taxes stipulated by the law,**
4. *duties and other mandatory payments,*
5. *subventions and subsidies,*
6. *other sources not prohibited by law.⁹*

* (Currently, there are no shared taxes with local governments in Armenia)

Sub-national governments that lack independent sources of revenue can never truly enjoy fiscal autonomy; they are under the financial thumb of the central government. The question then becomes which revenue sources can and should be assigned to the sub-national level of government and how are these to be affected? Almost 90% of the interviewed mayors mentioned that they would like to have shares from state taxes. They all mentioned income tax and 80% of them mentioned Corporate Income Tax as well. There were definitely varied responses on this issue. The Finance Director of Giumri, a municipality located within Armenia's earthquake disaster zone, wished all taxes to remain in their local government as assistance to the disaster zone. The mayor of Giumri later stated that, "taxes collected from Guimri¹⁰ add up to only 0.5% of the national budget. Then we ask the central government to assist us in the recovery process. Since the city is in the earthquake disaster zone still, it is not fair to collect taxes from our region for the central government." In fact, the suggestion was to use those revenue sources to help the region recover from the earthquake disaster and make capital investments. Thirteen years has passed, but there is little progress in the construction of buildings, schools, kindergartens or other infrastructure in the disaster zone.

As we can see, tax sharing is encouraged and welcomed by the heads of the surveyed municipalities. In addition, when local self-governance was the recent topic on a nationally televised discussion program, as a supporting argument to my questionnaire, the heads of communities were all urging for some of the taxes to be shared. The primary tax mentioned was income tax.¹¹ It is worth noting that those suggestions are already included in the draft Law on Local Self-governments. The draft Law anticipates providing the following percentages of state taxes to local budgets:

1. 15% of income tax;
2. 2% of value added tax;
3. 30% of the profit tax.

The draft Law stipulates the following composition for the community budget:

4. 100% of land tax;
5. 100% of property tax;
6. 15% of income tax;
7. 2% of value added tax;
8. 30% of the profit tax;
9. Compulsory payments;
10. Deductions from other types of taxes defined by law;
11. State dues;
12. Subsidies from the state budget for the implementation of state delegated powers;

13. Subsidies from the state budget, as defined by law, for financial adjustment and other subsidies;
14. Local duties and fees;
15. Fines and penalties charged for breaches of the land tax and property tax legislation;
16. Subventions;
17. Rent payments for state property lands;
18. Rent payments for community property lands;
19. Profits generated from community lotteries with prizes;
20. Dividends from its share of agencies and institutions with community participation;
21. Alienation of community property and deductions from the privatization of state owned property located within the community's territory;
22. Resources acquired through loans and credits, as well as financial means received from the issuance of community bonds;
23. Other sources not prohibited by the law.

By comparing the two laws, we can see a huge difference between what is currently given to local governments from taxes and what is anticipated. On what principle is the specific share of the specific tax decided? In response, there is no answer found in the current or drafted legislation. It is doubtful that the rates mentioned in the draft law are based on scientific calculations of community needs. Rather, the guiding principle is most likely: "Let's ask for more and get at least something." Another concern involves the proposed mechanisms for tax sharing. Should the tax sharing be based on origin or formula? Here again we have a lack of clarity. This assumes that we know the tax sharing will add finances to local budgets, but a void exists in our public administration in regard to what mechanisms and which model to use. Tax sharing will promote economic activity in communities in terms of increased interest on the part of local governments in supporting enterprises and developing business, but it should have a strict model and be reliable in the long-term.

There is very little, if any, decentralization carried out in Armenia in terms of taxing power. Decentralization of taxing and spending power allows local governments to devise public finance schemes that meet the demand of their constituency. This will ultimately increase efficiency because local governments have better information than the central government about their residents' needs and their financial capacity. All of the survey respondents answered "yes" in response to the question, "Does your local government have the capacity to collect and manage those proposed revenue sources?" This is doubtful as it may require solving lots of administrative issues in local governments. But what could emerge is the realization that local governments can significantly raise the collection rate because they have a greater

interest in the collections, would know more about their residents and would administer some taxes more efficiently than the central government does.

6.1 Property Tax as the Main Source of Local Revenue

The overwhelming majority of taxes go to the central government's budget. However, beginning in the year 2000, all of the Property and Land Tax revenue remains in local budgets to form a local income base. In Armenia, property tax paid by both enterprises and individuals are turned over to local governments. The only share of property tax that goes to the state budget is the tax paid on property that is state owned. In total, State Taxes on Property and Land comprise only 0.2%. In 1999, 95% of the revenue raised through property taxes was turned over to local budgets and 15% of the Income Tax was transferred. However, as we can see from Table 2.2, relatively little revenues are produced through property taxes (only 0.2% of total revenues). Further, collection costs for the Property and Land Tax are high; the Tax Inspectorate reported that 20% of their operating costs is required to collect the equivalent of 2% of taxes.¹² Therefore, the Central Government is not interested in property taxes, though they are the main revenue source of local budgets. The administrative costs to the government, be it local government or state government, should not be underestimated when making recommendations. The central district tax offices are responsible for administering the property and

land tax, and as shown in Table 2.3, property and land taxes make up more than half of local budget revenues.

In all of the surveyed municipalities, administrative problems relating to Property and Land tax collection was mentioned as an issue that, if reformed, could improve the financial condition of local governments. For that reason, the collection process should be reformed to give more authority to the local governments for collection of property taxes. As local

Table 2.2

The Structure of Tax Revenue in the Republic of Armenia as a Percentage of Actual Receipts in February 2001

Tax	Revenues as a % of Total Revenues
Personal Income Tax	5.2
Corporate Income Tax	7.1
VAT	39.3
Property and Land Taxes	0.2
Excise Tax	17.1
Social Contributions	13.2
Customs duties	4.1
Presumptive Tax	2.5
Other revenues	11.3

SOURCE: The RA Ministry of Finance and Economy, Treasury Department.

Table 2.3

The Structure of Basic Local Revenue Sources as of 2000

Revenue Source	As % of Total Local Revenues		
	Sisian	Kapan	Giumri
Cities			
Total local revenues	44.8	49.4	59.6
Land Tax	20.4	18.3	15.4
Property Tax	32.8	51.3	42.5
Local Duties	12.3	7.8	11.2
State Duties	9.7	8.6	10.3
Local fees and charges	5.1	1.1	1.3
Other tax revenues	0.2	0.5	0.1
Other non tax revenues	10.3	11.6	12.9

SOURCE: Analyses of data from questionnaire.

governments are more informed about the specifics of their community, they can administer the tax more efficiently. Currently, the average collection rate of property and land taxes in the seven surveyed cities is 66.3% of projected collections. All of the municipal heads enthusiastically promised that if they had the tools to administer the property taxes, then the collection rate would increase twofold. Local governments should possess the administrative tools for collections (computers, software, databases) that allow for the monitoring of compliance. Currently, local governments assist tax offices by having contractors in their offices that distribute tax forms and collect the tax. They do not have any authority to fine, penalize or, if necessary, seize property. In sum, they do not have administrative authority. All of the community leaders asked for administrative authority during the discussions. While discussing this issue with the Deputy Minister of Finance,¹³ it was revealed that Parliament is debating a proposal to the draft law that would give Community Councils the authority to subsidize local taxpayers. Under 5% the Community Council can grant an exemption on property tax, while over 5% the Council can decide to subsidize the local taxpayer. The same is suggested to land tax. Parliamentarians have suggested to give the Community Council authority to make a decision on 100% of land tax exemptions; this would invite abuse of authority, but was fortunately rejected by the Ministry of Finance. Now the same proposal is being discussed to apply to both property and land taxes.

The other problem with the property and land tax is the discrepancy between the City Inventory and Cadastre. Some properties are not properly identified, registered and appraised. Identification of Properties is currently the responsibility of the State Cadastre Committee's local offices and is completely dependent on the registration process, which has incomplete data. The process to register all properties is expensive and time consuming. Based on a comparative analysis of data from the Housing Departments and State Cadastre Committees conducted by the Barents Group of KPMG consulting in March 2001, data on properties obtained from the Housing Departments (ZHEKs) is more realistic and reliable than data obtained from the State Cadastre Committees. Valuation is performed by the State Cadastre Committee and is almost always far from the real market value of the property. The Cadastre Committee has no interest in tax administration and derives no benefit from property tax revenue. Some of the properties are not appraised at all. According to the statistics provided by KPMG Consulting, 52.79% of all properties in the database have no valuation data. As we can see, this situation prevents over 50% of all possible tax bills from being produced. As a result, municipalities lose potential revenue! Still, Local governments have no *official* input into the property identification process and

any cooperation between local governments and State Cadastre is based mainly on personal relationships. If links are created among local tax offices, local governments and local State Cadastre Committees, then data can be shared among them and a common property database can be created. This may require time and financing, but in the long term it will eliminate the loss of over 50% of the potential tax bills. If the property is properly identified, then in theory, collection of the property tax will rise by up to 50%; this is without changing the tax rate and only as a result of improving property identification. The basis of property tax valuation should be improved as well. The valuation should be simplified and based on the market value, and it should not require expensive administrative tools. If the administration requires more money than the income collected by this tax, it will be worthless to change the current valuation administration. Sales transactions should be entered into the system in order to compare how much the cadastral value of the property deviates from the market value. The rates can be adjusted, but as mentioned by Mr. Arzumanyan, the RA Deputy Minister of Finance and Economy, the tax burden cannot be increased or will not gain political support and will not be approved by the Parliament. The new method should be approved to bring about the fair distribution of the tax burden, to prevent an increase in the tax burden and to justify administrative costs.

The Deputy Minister of Finance mentioned a serious concern regarding the valuation of the land tax. The Ministry uses the old Soviet methodology to assess the land, which is far from reality and the market value. The ministry had asked for methodological assistance in land tax valuation. The following are indicators that can help to define land value: zoning, irrigation factor, type of land, etc. The experts from KPMG Consulting are now working on a proposal to develop a land tax methodology.

6.2 Local Fees, Local Charges, Local Duties

Services provided by communities can be financed through benefit taxes. The efficient allocation of resources requires that local governments recover their expenses from the beneficiaries of their services.¹⁴ In this case, user charges and other local fees and taxes should be used to finance services provided by local governments. For both equity and efficiency reasons, tax payments should reflect the costs and benefits of public services. As mentioned before, the central governments should be responsible for expenditures whose benefits extend across national boundaries. Local governments should be responsible for the provision of goods and services that have a limited benefit area and are within the

boundaries of the given community. An example can be a tax on motor vehicles applied to the maintenance of roads.

It is noteworthy that many services provided by the governments produce “generalized benefits,” or benefits that cannot be closely identified with taxes on its beneficiaries. In this case, applying specific charges and fees might not be appropriate, but rather the use of more general taxes.

Local governments in the Republic of Armenia can levy local fees and local duties. It is the Community Council that decides what kind of duties and fees to levy as well as their rates.

The law clearly states that “*it is the responsibility of the Chief of a Community to bring motions to the Council for the establishment of local duties and charges.*”¹⁵

However, they are set in a range specified by the central government. The collection of local fees and duties is very difficult for local authorities. It is very important for local governments to set the rate for local taxes, as the rate determines the quality of the service provided. In the surveyed cities, the collection rate of local fees in the year 2000 was averaging 35% of collections due; in Giumri this number was 73%. The main reason for this finding is the financial incapability of the population. The government fails to pay salaries and people do not have money to pay for the services. As we can conclude from the figures in Table 2.3, the total amount of fees collected is negligible from the point of view of total revenues. There is limited agreement between central and local government on how infrastructure and utility services should be financed. Under the current financial conditions in most local governments, it is not possible to recover investment costs by user fees. In fact, it hardly covers the operating costs of utilities. In some municipalities, the local government even subsidizes utility users. The introduction of full cost recovery requires drastic improvements in the quality of services and *the ability of users to pay*. Capital investments in infrastructure are minimal, if they exist at all. Municipalities hope to get support from the World Bank or from other international organizations.

On average, local duties and charges account for 10.4% of *local revenues*. It is rather obvious that local governments have inherently deficient resources available to provide a meaningful level of local public services. As a result, improvement in the quality of services is rather negligible.

6.3 Utility Services

While local utilities, such as water or sewage services, may yield significant amounts of revenue for local governments, most of those utilities are not operated by local governments, but rather by quasi-independent government enterprises over which local governments have little or no control and from

which they receive no revenue. Fees charged from those services are not considered income for communities, but rather income of the enterprise that provides the service. Because the fees are paid late, if at all, the collected charges do not even cover operating costs. Besides, the systems are very old and need capital investments in order to maintain efficient operation.

Moreover, in the instances where services are self-supporting, the role of the local government is merely to facilitate the provision of the services. Examples of this are for gas, electricity supply and communications. The local governments cannot directly affect the rates charged for these services as they are set by the central government.

To the extent possible, utility services are basically private goods which should be financed through charges. These charges should meet all costs including capital costs. They should be determined locally, as costs of provision vary locally. The charges are to meet the costs of the service, not to subsidize public goods through the local budget. But as previously discussed, many consumers in Armenia cannot meet the full cost of the provided service. In light of this, a number of remedies can be considered:

- (1) cost savings through insulating sources of heat and reducing water leakage;
- (2) measures that enable and encourage consumers to reduce consumption (i.e., metered heating and metered water consumption);
- (3) targeted subsidies to low income consumers, but only if the service is a necessity;
- (4) Improve water management through a change of ownership.

USAID recently initiated a new project for Sustainable Water Management designed to develop Armenia’s capacity to promote sustainable water management for environmental quality and economic growth.

6.4 Property Management

The term local property management refers to the acquisition, use and sale of property owned by the local government.

“The community’s property includes kindergartens, utility communication systems, heating, water, sewer, irrigation, trash collection, gas companies together with their internal networks located within the territory of the community.

“The community’s property may include specialized schools, clubs, culture halls, theatres, cinemas, museums, libraries, exhibition halls, markets, health and transport

enterprises and organizations, streets, squares, bridges, recreation areas, cemeteries, water springs and transmission systems and other structures of community importance, as well as administrative buildings, educational, culture, sport and other objects and structures, enterprises, organizations, transportation means, other real and movable property located within the territory of community.

*“In transferring the property to community ownership, the land attached to the property will also be transferred by right of ownership.”*¹⁶

The Chief of Community should do the following:

- Assist in the maintenance of the real property cadastre;
- Allocate, revoke and lease state-owned lands located in the territory of the community in cases, and in a manner, specified by legislation.¹⁷

Local property management is underdeveloped in Armenia. Communities receive revenue from property management mainly from rent payments on property and land.

7. SUBSIDIES AND SUBVENTIONS

As already mentioned, the Law on Local Government imposes certain “mandatory” spending requirements.

*“Mandatory powers shall be funded on a mandatory basis from taxes, duties, other mandatory payments and subsidies allocated by the State.”*¹⁸

Local government mandatory services are funded through the central government budget. Nevertheless, about 43% of local government basic mandates remain unfunded. Local governments’ budgets are mostly dependent on subsidies received from the Central Government. Subsidies are not purpose oriented, that is, the local government can spend it for their own prioritized expenditures. At the same time, grants allocated to communities from the state budget are given for a specific purpose and are used for the provision of previously agreed upon services.

*“Financial equalization is aimed at promoting the harmonious development of communities through the existence of financial differences among the communities and enabling the implementation of their mandates.”*¹⁹

However, the funding is not given in a timely basis, nor is it complete. Even the incomplete funding received from the state comprises 40-60% of local budget revenue. For the year 2000, most of the interviewed local governments received only about 43-86% of planned funding from the Central Government. The range is very large and is an indication that personal relationships between Mayors and the Central Government are more important than the official intergov-

ernmental relations. The reality is that strong mayors are able to negotiate with the Central Government and receive their planned subsidies. The receipt of these funds depends on personal ties and personality. From the interviewed municipalities, none mentioned that they received subventions for capital investments. Sometimes, capital budgets are not even prepared because there are insufficient funds to cover the administrative budgets. A grant for capital investment from an international organization (GTZ) occurred in only one city.

Although local governments are informed of the estimated subsidy amount, they do not know when they will receive it, as it is not provided in a timely manner. This dynamic provides little incentive for local governments to develop accurate activity plans. As a result, the level of local budget execution is low which then hampers the implementation of vital services. According to the draft Law on Local Self-governments, subsidies should be provided quarterly and should take into account the seasonal characteristics of regions; the amount of the subsidy should be determined by accenting the spring and fall seasons. Even with the subsidies that local governments receive from the Central Government, local governments can hardly covers the salaries of their staff involved in local governmental administration. When analyzing the expenditures of Kapan’s local budget for 1999 and 2000, it becomes obvious that actual spending is almost 50% lower than the amount defined in its budget. While the payment of salaries is the first priority for any local government in Armenia, the debt for salaries in 2000 alone was 39.4%; according to data from the survey, all municipalities mentioned that the most burdensome unfunded mandate is the payment of salaries to theirs staff. If the population does not get salaries, then the result is they cannot pay taxes, and will consequently not get public services. This becomes a vicious circle. In the end, this situation creates disbelief and disinterest from the population in local governments.

In response to the question put to the municipal leaders about whether they think the Central Government’s equalization policy is right, the answer was a clear “no.”

The leaders responded that the formula is wrong because it is based on the population and *projected* level of property and land tax. Thus, it does not reflect the real income of the local government. Even this amount is not given in a timely manner, which means that local governments cannot forecast spending; as a result, they do not know when to do what, as they do not know when and how much they will receive from the total amount of the subsidy. In suggestions from municipalities regarding the drafting of a new Law on Local Self-governments, it is requested that if the Central Government fails to provide subsidies on time, the local governments can bring the case to court. At the same time, the Central Government can sue the local government if the services

provided do not satisfy minimal norms established by the RA Government given that adequate subsidies were provided.

According to the Law:

“The amount of subsidy for communities shall be determined based on the following factors characterizing their economic situation.

1. *Local community per capita land tax and property tax estimated revenues*
2. *Number of community population.”*²⁰

Subsidies are allocated to all communities with a lower per capita land tax and property tax revenue rate than the republic’s average revenue per capita land and property tax, or the marginal difference of the total amount of subsidy allocated to the communities.

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

- A – amount of subsidy
- M – index on the republic’s average per capita property tax and land tax revenues
- H – per capita land and property tax revenue of a given community
- B – population of the community
- G – average adjusting index

This is only a standard formula for revenue disparities and ignores cost differences. The key factor in the equation is G. This adjustment factor determines the extent to which the Government actually equalizes revenue. This in turn should reflect the following considerations. The first is how far the Government can afford to equalize localities; since the cost to Government will be the sum of A for all localities, this can only be reduced by G (i.e., if G is 0.5, the gap $(M-H) \times B^a$ will be halved and the cost to Government will be halved). The second question influencing the value of G is the degree of equalization. If local budgets are responsible for most of their educational costs, then a high degree of equalization for social and health care will be necessary to meet the current standards (i.e., G needs to be close to 1). But if these costs are largely met by the national budget or social insurance, and if local governments are mainly responsible for physical infrastructure, then a lower degree of equalization is needed. Higher local revenues per capita probably reflect a higher level of local activity, which will in turn necessitate higher levels of local expenditure (traffic on roads, more refuse etc). In such cases, G can be much lower. It would be wrong to keep G close to 1 and then fail to pay the subsidy, or pay them only to cronies. If the Government cannot afford to pay enough equalization subsidy, then this should be reflected in a lower G, so that local governments

are treated equally and know where they stand when they create their budgets.

8. LOANS AND BORROWINGS

There is considerable merit to the idea of establishing a sub-national development fund to promote lending to sub-national governments for long-term capital investment.²¹

For the purpose of timely execution of budget expenditures, the chief of the community, by the consent of the authorized state body and the decision of the local council, may receive short-term loans subject to repayment during the same budget year. However, none of the interviewed municipalities had experience in taking out loans or borrowing from the Central Government.

“For purposes of developing social sub-structures of the community through making investments, a chief of community, by the decision of the council, may sign a contract to receive loans. By consent of the state authorized body, a community can receive loans at 30% of the community annual budget appropriation, after the repayment of outstanding amounts on previous borrowings. Such resources shall compulsorily be transferred to the capital part of the community budget. Community property may not be subject for collateral in signing loan contracts.”

In case the that a community budget is balanced by borrowed resources, the community, jointly with the state authorized body, shall elaborate a program for the gradual phasing out of the deficit and repayment of loan obligations; the implementation of which shall be compulsory and lay the basis for compilation of future budgets. In this situation, the state authorized body shall perform permanent supervision of budget processes in the community.

Another source of financing may include local bond issuance, however, direct access to capital markets by local governments is premature and still has a long way to develop.

9. NON-PROFESSIONAL GOVERNING OF COMMUNITIES

Most of the community heads and members of Community Councils are not professionals, and have little understanding of the laws, budgeting or management of the community. The mayor of Sisian said himself that “he is not appropriate for this post and understands nothing about public governing, but since he was elected, he took the post.”

There are 27 items defined by the draft Law on Community Council responsibilities. These are the ones related to the community’s economic activity.

The Community Council shall:

1. *Approve the community's annual budget and the chief of community's annual statement on budget execution;*
 2. *Supervise the performance of the community budget and the use of loans and other financial resources received by the community;*
 3. *Approve amendments to the community budget and the use of the uncommitted resources of the budget;*
 4. *Determine the procedure and required financial resources for the implementation of voluntary responsibilities;...*
 5. *Take decision on the establishment, reorganization and liquidation of budgetary and non-budgetary agencies and organizations under community subordination;...*
 6. *Define the local duties and fees as defined by law;*
 7. *Define the rates for compulsory payments;*
 8. *Make decisions on the lease or alienation of property owned by the community; approve rent rates and the starting price of a property sold through auction.*²²
- 5) A time provision for subsidies (taking into account seasonal factors) from the Central Government, allowing local governments to make accurate fiscal plans.
 - 6) Create sound databases for the property and land tax, addressing the issues of property identification and property valuation.
 - 7) Create a network between the State Cadastre, local governments and local tax offices to share a common database for the property and land tax.
 - 8) Include sales transactions in the valuation system to compare the market value with the cadastral value.
 - 9) Decentralize revenue collection to give local governments the power to collect their property and land tax as well as the administrative tools to fulfill it.
 - 10) Improve the management and ownership system in regard to utility services,
 - 11) More effective use of local governments' property.
 - 12) Improve administrative mechanisms of law enforcement.
 - 13) The recommendation for national policy is to give priority to community development. There should be a strategic policy to achieve national economic development through the economic development of local communities.

In more remote communities in the country, one can hardly meet a qualified Chief of Community or Community Council that has an adequate understanding of laws, local government functions, responsibilities, and an understanding of local governments' roles. Therefore, a recommendation would be to have professional government officials who are well trained and who can effectively run the community. This could be realized through organized training sessions for Members of Community Councils to raise their awareness about their rights and responsibilities as well as tools for implementation. Unprofessional Community Councils promote the inefficient use the communities' scarce resources.

10. RECOMMENDATIONS

The following is a list of key findings from the research and recommendations on how to improve the current situation in Armenia in regard to local governments.

- 1) Clearly define the roles, responsibilities and accountability of local governments vis-à-vis Marzes (regional governments) and the Central Government.
- 2) Enlarge communities.
- 3) Appoint professional local government officials; organize training sessions for members of Community Councils.
- 4) Improve the budgeting system of local governments. Local Budgets should correctly include all necessary services that local governments are mandated to perform and reflect real costs of the services. Studies should be done on need assessment to better understand the community's needs as well as their costs.

NOTES

- ¹ Interviews with local government officials conducted by International City/County Management Association (ICMA) in Armenia in 1999
- ² Draft Law on Local Self-Government, Chapter I, Article 3, Article 4, December 5, 2000.
- ³ The Law of the Republic of Armenia on Local Self-Government, July 22, 1996, Article 6.
- ⁴ Exceptions to this list are electricity and gas supply lines that are owned and managed by state ministries, but now are put on the list to be privatized.
- ⁵ Baseline Study for Armenia Local Government Program, USAID, March 2000.
- ⁶ Can be grants from international organizations, NGOs or assistance from Diaspora Armenians.
- ⁷ The assignment of revenues and expenditures in Intergovernmental Fiscal Relations, Symposium on Fiscal Decentralization, Yerevan, Armenia (April 20-21, 1999).
- ⁸ "Report on Local Government Budgets," KPMG Consulting, March 2001.
- ⁹ The RA Law on Local Self-Government, Article 43: Sources of Formation of a Community Budget.
- ¹⁰ Giumri is the second largest city in Armenia after Yerevan. It was ruined during the earthquake in 1988. It is in the disaster zone and was partially recovered.

- ¹¹ National TV, “Orakarg” Discussion program, Topic: Crucial Problems of Local Self-Governments in Armenia, April 28, 2001.
- ¹² Interview was held with Robert Sahakyan, Deputy Head of Property and Land Tax Department in April 1999 by Lusine Ghevondyan, Joseph Eckert and Valery Chodsky; Source: Barents Group report on “Implementing a Market Based Property Tax System.”
- ¹³ Discussion held with the Deputy Minister of Finance, Mr. Arzumanyan on May 22, 2001.
- ¹⁴ Fiscal Decentralization and Intergovernmental Fiscal Relations, CEU Summer Program, Budapest 1999.
- ¹⁵ The Law of The Republic of Armenia on Local Self-Government, Article 26. The Activity of the Chief of a Community in the sphere of Finance.
- ¹⁶ The Draft of the RA Law on Local Self-Government, Article 48.
- ¹⁷ The Law of The Republic of Armenia on Local Self-Government, Article 30. The activity of the Chief of a Community is in the spheres of Planning, Building, Construction and Land use.
- ¹⁸ The RA Law on Local Self-Government, Article 44. Funding of Mandatory Powers.
- ¹⁹ The RA Law on Financial Equalization, Article 3. The Concept of Financial Equalization.
- ²⁰ The RA Law on Financial Equalization, Article 5. Main Factors for estimation of community subsidies.
- ²¹ Seminar on Intergovernmental Fiscal Relations and Local Financial Management, April, 1999, Armenia.
- ²² Draft Law on Local Self-government, Article 16. Powers of Community Council, December 5, 2000.

