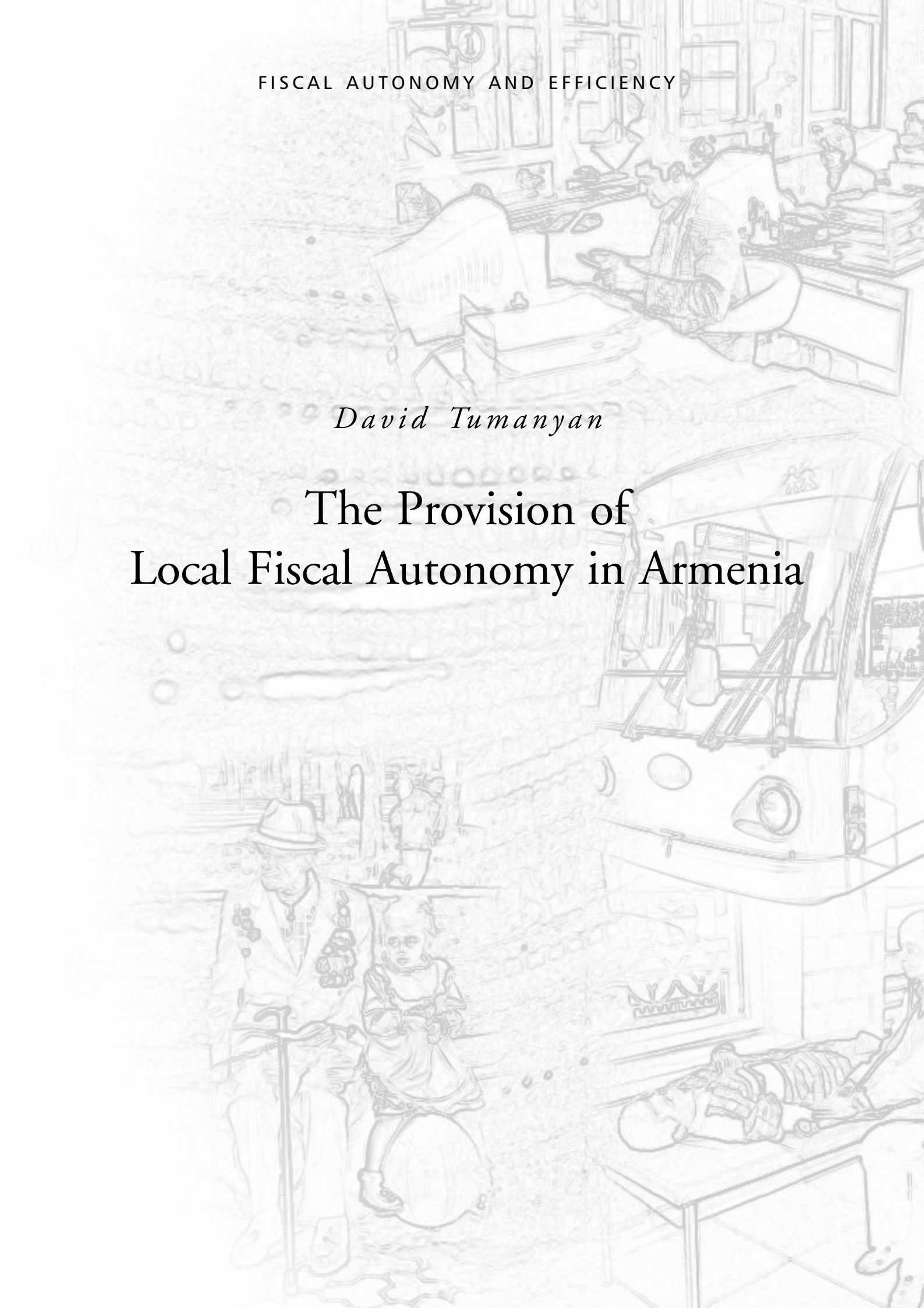


FISCAL AUTONOMY AND EFFICIENCY

David Tumanyan

The Provision of Local Fiscal Autonomy in Armenia



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1. INTRODUCTION

It is very important for the newly independent states to develop a strategy for state building and the implementation of public administration reforms. In the mid-1990s, Armenia began the implementation of its decentralization process and the formation of a new local self-government system. Although the new system has been formed, it still has many problems that require solutions. Among these issues to be resolved are the implementation of fiscal decentralization, provision of local governments' fiscal autonomy and regulation of intergovernmental fiscal relations. The research explores these aspects of Armenia's local self-government system.

The main aim of the research is to find a model that will strengthen local governments' fiscal autonomy and fiscal capacity. In pursuit of this aim, the existing system of local self-government is analyzed and the role of local self-government in the public administration system is clarified. On this basis, recommendations for the further development of the local self-government system are proposed.

2. LOCAL SELF-GOVERNMENT IN THE PUBLIC ADMINISTRATION SYSTEM

The main characteristic of the local self-government system in post-Soviet countries is the formation of a system as a result of governance decentralization. This means that certain functions of the central government are given to local governments without administrative supervision; so local governments are part of the Public Administration system. Each country defines its own framework of powers and politico-administrative models for local self-government.

For newly independent states, the foundation of the local self-government system is an important part of state building. Local self-government reform does in fact mean the redistribution of powers between the state and local self-government bodies. But this definition of the reform's purpose is very simple, though widely held. The main goal of the local self-government reforms is the consolidation of democracy and civic society; meaning the approach to local self-government reforms must be serious and systematic.

The constitution, which was adopted on July 5, 1995, became the legal foundation for local self-government reforms in Armenia. It is necessary to mention that the reforms were greeted with poor readiness on the part of the country. There had not previously been a clear ideology of state building. The absence of a clear strategy reduced the effectiveness of the reforms. The lack of readiness was reflected not only in state authorities' activities, but also in local authorities themselves, particularly in their deep-rooted disposition of dependency. In initiating local self-government reforms, the state must give enough independence to local governments in order to solve local matters. The state must form local self-governments, on one hand, and defend them from the state, on the other.

The state authorities have the following powers in the sphere of local self-government:

- adoption and amendment of laws concerning local self-government;
- legal regulation of state property assigned to community property;
- provision of necessary financial and material means for local governments to fulfill certain responsibilities in accordance to legislation;
- regulation of relations between the state budget and communities' budgets;
- reimbursement of expenditures for the implementation of powers delegated to the local governments by the state;
- protection and regulation of the rights of citizens exercising local self-government;
- provision of state guarantees for local government financial independence;
- definition of state guarantee governing citizens' election rights during the local elections;
- definition of regulations for the juridical defense of local government powers;
- definition and regulation of the amenability of local governments for legal violations.

There is a two-tier governance system in Armenia. Armenia is a unitary country, which is reflected in its administrative structure. Most of the administrative powers belong

to the Government. Territorial administrative units are “marzes,” which are branches of the central government administrative structure and are not a separate tier of the public administration system. A marz is an administrative subdivision of the State, which has some characteristics of a local government, but is not classified as such because there are no elected marz officials or bodies by the marz inhabitants, nor does it have its own budget.

A marz is governed by the marzpet, which implements the territorial policy of the Government in the marz.

Bodies of local self-government include the community elders (council) and the head of the community (the city mayor, village head or district head). The members of the community elect community elders and the head of the community to three-year periods through general, equal and direct elections by secret ballot. In Armenia, local self-government bodies are political subdivisions of the State and are created by the State. The head of a community performs double functions, both as an autonomous government body and as a representative of the State authority in place. All Armenian communities lie within the boundaries of a marz.

As shown in Table 3.1, there is large number of communities. Half of the communities have a population of less than 1,000 people.

At first sight, it appears that legislation gives broad powers to local self-government bodies. For example, the Law on Local Self-government states that, “Local self-government is the right and capacity of local self-government bodies acting at their own responsibility, to dispose of the community’s property and to resolve the problems of community importance with a view to improving the well-being of the population.” This article is taken from European Charter

on Local Self-government. But in actuality, there is ambiguity in the legislation. One law defines the powers of local self-government bodies and the other law limits those powers. It is no secret that powers without finance are not real powers. Existing community budget revenues are insufficient to allow local self-government bodies to realize their own powers. The laws also give broad powers to the Central Government in regard to local self-government issues. For example, the Government defines the list of property owned by the communities.

In Armenia, laws mainly regulate local self-government, but the central and regional governments are regulated by decrees from the President of the Republic. The development of the entire government system, including local government, requires the legislative regulation of relationships between different levels of government.

Current legislation partly regulates the relationship between local self-governments and the Central Government.

If a community budget’s actual revenues do not cover mandatory services, or perform duties delegated by the State in an unsatisfactory manner, then the Government may dismiss the head of that community upon submission of the respective region’s marzpet (or if in Yerevan, upon the submission of the mayor of Yerevan). Until the newly elected head of the community accepts the office, the Prime Minister appoints a substitute mayor, or a substitute head of district in the case of Yerevan, and the regional marzpet appoints a substitute head of village.

Armenia’s new judicial system is currently in the making. There are few cases where the mayors appeal to the courts in defense of their rights. However, in some cases they found success in such appeals.

Table 3.1
Number of Communities by Population Size

Population Size Categories	Number of Communities	[%]	Number of Inhabitants (1 January 1999)	[%]
Below 1,000	465	50	197,831	5.3
1,000-2,000	217	23.3	302,481	8.1
2,000-5,000	168	18.1	508,333	13.7
5,000-10,000	35	3.8	234,381	6.3
10,000-50,000	30	3.2	666,000	18.0
50,000-100,000	5	0.5	291,700	7.9
100,000-1,000,000	10	1.1	1,508,000	40.7
Above 1,000,000	—	—	—	—
Total	930	100.0	3,708,726	100.0

Local self-government bodies also may be entitled to file appeals against State authority decisions and actions that infringe on the rights of the community. Community elders can demand from State authorities and officers any information regarding the goals of the community that are not specified by law as secret. State authorities and officers obliged to meet such demands.

Decisions and actions of local self-government bodies may be appealed to a court by the respective Regional Marzpet, or if in Yerevan, by the Mayor of Yerevan.

In practice, legal rights are not realized. The Marzpet's traditional power acts to reinforce its perception as a centralized and authoritarian government, rather than that of a local democracy with powers to effect change and deliver public services; this perception was developed under the former system of government when the Governor was recognized as the Regional Secretary of the Communist Party.

The Marzpet often uses administrative methods in its relations with the local self-government bodies.

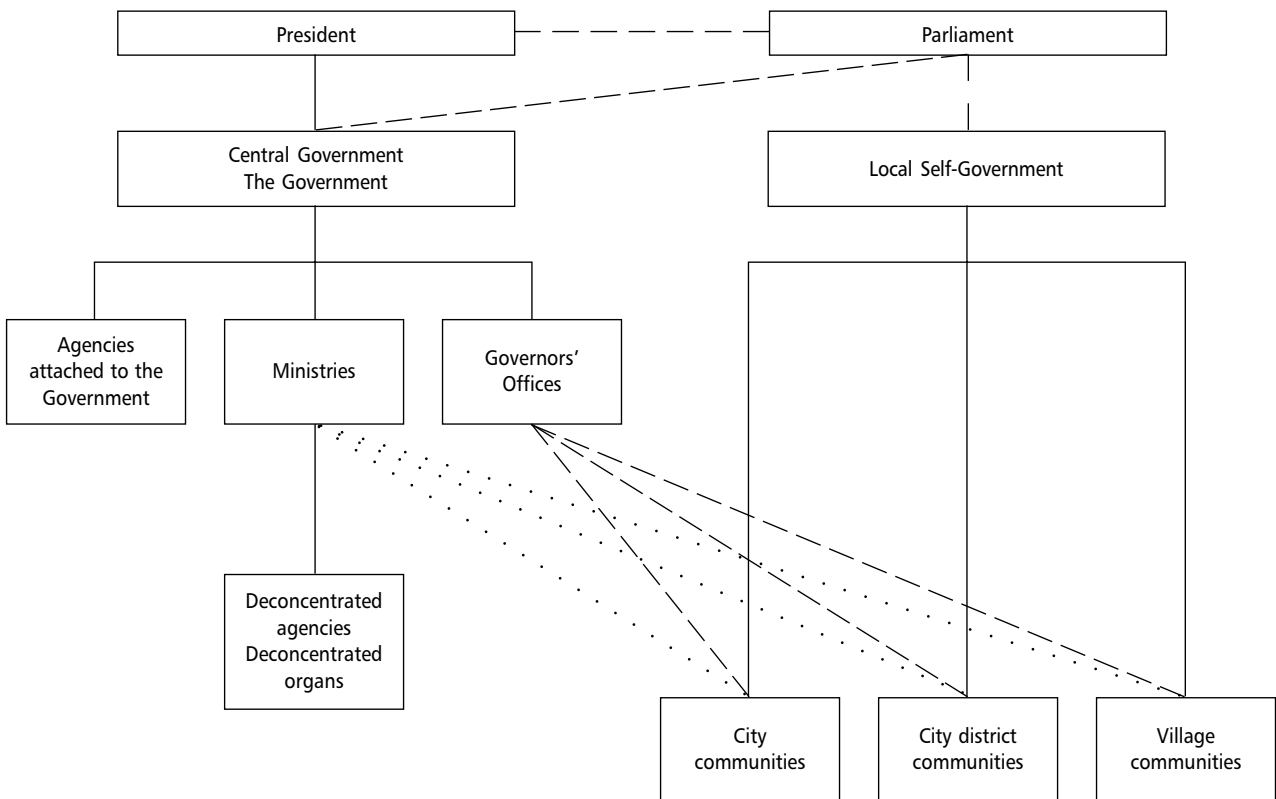
In some cases, relations between the central and local governments are that of a partnership. The State provides

health care, primary, secondary and higher education, social services, pension and unemployment security. The law enables the local self-government bodies to provide similar services on a voluntary basis, providing they have the required financial resources. Though the financial capacity of local self-government bodies is very limited, they try to utilize these voluntary powers.

The law regulates relations between the central government, local authorities and private sector organizations. The land, trading organizations, public catering and servicing as well as small and medium size industrial enterprises are mostly privatized. Some of the industrial enterprises do not work as a result of the country's economic situation, while others function normally.

The local political-administrative system in Armenia typifies the mayor-council form of governance, particularly of the "strong-mayor" variety. The council (community elders) has legislative functions, but not a chairman. The mayor presides over council sessions and has a deliberative vote, which has a significant impact on council decision-making.

Figure 3.1
Structure of Armenian Government System



NOTE: Solid lines indicate subordination; dashed lines indicate supervision; dotted lines indicate the Ministry of Finance is the principal source of funding for local self-governments.

The head of a community is its executive. He or she implements power on the principle of individual leadership. The head of a community exercises responsibilities through his or her staff, enterprises and organizations that are subordinate to the community. No later than one month after the acceptance of office, the head must submit the staff structure to the community elders for approval. If the community elders do not accept the structure of the staff presented by the head of the community, the former may offer recommendations. If agreement cannot be reached, then the community elders can submit to the marzpet a motion calling for the dismissal of the head of a community.

The community head's staff is a legal entity and has a seal bearing the State Emblem of the Republic of Armenia on its name. It is composed of a deputy head of a community, a secretary of the staff and its different divisions. The number of staff employees is defined by Government Decision No. 372 adopted on December 6, 1996. It is defined in accordance to the number of the community's residents.

The head of a community may not simultaneously occupy any other State post, perform any other paid work, except for creative, scientific and pedagogical activities. The head of a community:

- forms his staff and approves its charter;
- establishes a list of staff and official salaries for the staff members;
- appoints and removes staff officers, as well as the directors of enterprises and organizations subordinate to the community;
- submits a draft three-year program of the community's development and a draft annual budget to the community elders for review;
- passes decisions and issues orders within the head of the community's jurisdiction;
- reports to the respective regional governor on issues regarding the organization of civil defense and measures to reduce epidemics as well as technological and natural disasters;
- exercises other powers specified by the Law on Local Self-government;
- coordinates the execution of the community elders' decisions.

The head of a community has mandatory and delegated powers in the following spheres: finance, protection of the rights of citizens, protection of public security, defense, planning, development, construction and land use, public utilities and provision amenities, transport, trade and services, education and culture, public health, physical culture and sport, agriculture, nature and environment protection.

Though the legislation gives certain powers to local governments, they are rarely fully realized in practice.

3. LOCAL GOVERNMENT POWER: THE POSSIBILITIES FOR EXPANSION

3.1 Local Governments' Powers

Local governments' powers are characterized by the allocation of government functions. The decentralization process defines a framework of powers and responsibilities for each level of government. It is necessary to mention that the implementation of each function requires certain material, financial and labor resources. Clearly, the existence of financial resources is very important. In many cases the lack or insufficiency of financial resources prevents the fulfillment of a particular function.

Local governments have the following responsibilities:

- operation of water supply, sewerage, irrigation, gas supply and central heating systems and community structures;
- planting and improving the community;
- use and maintenance of non-privatized residential buildings and non-residential premises, dormitories, administrative buildings and other structures owned by the community;
- ensuring the proper maintenance of cemeteries (this service is not exercised by the head of the district community);
- construction, reconstruction and operation of roads, bridges and other engineering structures under the community's jurisdiction;
- construction, maintenance and operation of sanitation facilities (this service is not exercised by the head of the district community);
- regulating the operation of public transport in the community (this service is not exercised by the head of the district community);
- construction, reconstruction and operation of the community's irrigation systems;
- collection and disposal of waste.

The operation and management of water treatment stations, distribution networks, reservoirs and local water sources were transferred to the communities. The water-supply facilities in most of the communities are 30-40 years old, causing much water loss. The amount of water consumed by residents is not measured, but rather estimated by dividing the total volume of water supplied to a community by

the number of residents in the community. The wholesale price for water, from the source to the community treatment plant, is set by the central government at 30AMD/m³. The community elders set the retail price, usually within the price range of 30 to 60AMD/m³. The collection of water service fees is very low. A community's debt to the Central Government for the supply of bulk water often exceeds local budget revenues. To recover the fees for bulk water supplied to local governments, the Central Government issued a decree (Decree No. 49, March 13, 1999) to rent its water supply systems to the central government's Armenian Water Supply and Sewerage Company for 10 years under a fixed term contract.

The sewerage systems are old and badly maintained. Community elders set the rates for sewage collection and treatment, which vary for different communities and consumer categories: residents and other users.

Planting and improving the community are mandatory responsibilities of local self-government bodies, but they are mainly fulfilled in city communities. The village communities can not provide such services due to the lack of funds.

The housing stock consists of multi-apartment buildings and privately owned houses. The multi-apartment buildings are found only in the cities and most of them have been privatized. Maintenance of the non-privatized multi-apartment housing stock is a mandatory responsibility of the local self-government bodies and is provided on a contractual basis either by the local community's enterprises or through the private sector. In the case of the latter, the service charge is set through negotiations between the local self-governments and the private enterprises. The community elders set rents and maintain non-residential space owned by the community. The privatized multi-apartment housing is composed of 582 condominiums, including 3,835 blocks.

Community elders approve the allocation of resources, as well as the procedures and size of the land for cemeteries. Some communities have transferred the preservation, maintenance and servicing of cemeteries to specialized agencies on a contractual basis.

The community budget allocates money for the cleaning of streets and other areas such as gardens and parks. The community elders determine the rate and total surface area to be cleaned. The street cleaning is done by either local government enterprises or by private enterprises selected through a public tender.

Public transportation is only provided in large- and medium-sized cities. This service is provided either by a public transportation enterprise owned by the community or the private sector. In both cases, the community elders set the fares for public transportation.

Village communities represent 93.6% of the total number of communities in Armenia. Agriculture plays a signifi-

cant role in these communities and proper irrigation systems remain a major issue. Many communities have their own internal irrigation pipeline network. Local self-government bodies fulfill the maintenance and management needs of the irrigation systems. Water user associations often organize the operation and maintenance of irrigation systems. The Central Government supplies and sets the wholesale price for irrigation water, which are based on the size of the parcel of land. For water supplied to the irrigation associations, a two-tier rate structure based on consumption is used to encourage conservation.

Refuse collection and disposal is the mandatory responsibility of local self-government bodies. The rates are set annually by community elders. Rates differ from community to community, and are under AMD 100 per capital/month on average. In some communities, refuse removal is performed by the private sector through agreements negotiated between the private sector and community residents. In such cases, the community elders do not set the service rates. In general, these rates are lower than the other local charges. Most communities own their own refuse landfills and the community budget funds their maintenance and operation.

Those communities that do not have landfills pay a fee in order to use another community's landfill. The fees charged for the use of landfills are an additional source of budget revenue for those communities that own them. The collection of charges is poorly managed in many communities. To ensure that collection and disposal is not disrupted, communities often use funds allocated for street cleaning to support the refuse management budget. Street cleaning and refuse collection is sometimes performed simultaneously.

Heating supply is a mandatory responsibility of the local self-government bodies. Most of the systems are in very poor condition or may not even function at all. As few of them function, communities are unable to collect user charges. This has forced a number of these communities to abort the service altogether.

The management and operation of kindergartens is a mandatory responsibility of the local self-government bodies. The cost of operating and maintaining kindergartens is covered jointly by parents and the community budget. The amount of fees paid by the parents is set by the community elders, and varies in different communities. Community elders also define groups of residents whose children may attend kindergartens free of charge or with some discount. A number of kindergartens have closed, mainly because the number of children attending kindergartens has decreased.

Local self-government bodies provide specialized education, which includes music and fine arts schools, athletics schools and centers for enhancing the technical and creative potential of children. Community elders set the fees for each

service and determine the number of students that are entitled to these services free of charge. Part of the costs is covered by the community budget. In most small communities, such specialized services are not offered and children of these communities are taken to neighboring communities. The fees for these services vary and are primarily based on the demand for a given service. Some communities provide these services free of charge.

The maintenance costs of libraries and museums are entirely covered by community budgets. Cultural centers charge fees for their services, however, these fees are not sufficient to cover their maintenance and the deficit is covered by the community budget.

Healthcare is provided primarily by the central government. Some communities have primary health care stations, the costs of which are covered by the community budget and by users' fees.

The development of commercial trade, restaurants, consumer services, public lighting and stray animal control is the responsibility of local self-government bodies. Provision of these services is regulated by the community elders' decisions.

The economic role of the local authorities is small, and due to the absence of financial resources, many local authorities do not directly examine economic issues.

3.2 Why the Need to Expand?

At first sight, it seems that the responsibilities mentioned above are numerous and their main problem is financing and proper fulfillment by local governments. However, it is difficult to arrive at such a conclusion, especially in transition countries. The functions implemented by the central government and local governments are nearly on the same level, and there are not any essential differences concerning their valuable functioning. This is why the correct distribution of public services is very important and directly effects the efficient performance of valuable functions. Three important circumstances must be taken into consideration:

- traditions of the country;
- peculiarities of state building;
- international experience.

As seen in Table 3.2, the powers of Armenia's local governments are few in comparison to many former socialist countries.

At the same time, it is necessary to take into consideration that the widening of local governments' responsibilities will support their strengthening and development.

It is important to mention that the widening of local governments' responsibilities needs to be done in a step-by-

step manner, taking into consideration the differences between urban and rural communities.

3.3 Education

Schools are currently the property of the Central Government. However, many communities, especially those in rural communities, support the schools situated in their area.

Traditionally, schools and churches have always formed the center of Armenian community. Strong communities have been created around strong schools. The head of each community is very interested in the maintenance and development of it's the community's school. Transferring the schools to community property would support their development. Of course, it must be taken into consideration that this is a complex issue and fiscal decentralization should be prioritized.

Studying the experiences of different countries where the communities participate in school management and maintenance reveals different models.

The first model: the responsibility for building and maintaining schools is given to local governments. This model is found in Austria, Belgium, France, Germany, Italy, the Netherlands, Estonia, Latvia, Hungary and Lithuania.

The second model: the Central Government is responsible for the schools. This model is found in Slovakia and CIS countries.

The third model: this is a mixed model, where schools can be subordinate to both the state and local governments: primary schools are under local government control and secondary schools are subordinated to the Central Government. This model is used in the Czech Republic and Slovenia.

In the countries mentioned above, curriculum and academic standards are subject to Central Government control.

Armenian schools correspond to the second model. Responsibility for schools is distributed between the Central Government and territorial government bodies. In the field of education, including schools, the basis of organization of public policy is the public program of education development, which is confirmed by the Central Government. The school plan and academic curriculum guide the education process in the schools, which is worked out and confirmed by the Ministry of Education and Science. Territorial administrative bodies provide the schools with construction and maintenance support. Teacher employment and remuneration are regulated by the Central Government.

An experiment carried out since October 1998 reveals that 57 schools are under the management of communities without the right to sell the building or its inventory. Their highest administrative body for the schools is the council, which has five to nine members as determined by the local government. Candidates for the council are nominated by:

Table 3.2
Distribution of Powers Between Tiers of Government by Sphere¹

Countries	Kindergartens		Primary Education		Secondary Education		Social Welfare		Health Service		Culture, Leisure, Sports		Water Supply and Sewage		Electricity		Public Transport		Town Planning		Local Police	
	CG	LG RG	CG	LG RG	CG	LG RG	CG	LG RG	CG	LG RG	CG	LG RG	CG	LG RG	CG	LG RG	CG	LG RG	CG	LG RG	CG	LG RG
Armenia		✓	✓		✓		✓		✓		✓	✓		✓		✓	✓		✓		✓	
Czech Rep.	✓	✓	✓	✓	✓	✓		✓		✓		✓		✓		✓		✓		✓	✓	✓
Estonia		✓		✓		✓		✓	✓	✓	✓	✓		✓	✓			✓		✓	✓	
Latvia	✓		✓		✓		✓	✓	✓	✓	✓		✓	✓	✓	✓	✓		✓		✓	
Hungary		✓		✓		✓		✓		✓		✓		✓			✓	✓		✓	✓	
Lithuania	✓	✓	✓	✓	✓	✓		✓	✓	✓	✓	✓		✓	✓			✓		✓	✓	✓
Poland		✓		✓		✓		✓	✓	✓	✓	✓		✓		✓		✓		✓	✓	✓
Slovakia		✓		✓		✓		✓	✓	✓	✓	✓	✓	✓	✓			✓		✓		✓
Slovenia		✓	✓	✓	✓		✓	✓	✓		✓	✓	✓	✓	✓		✓	✓		✓	✓	

CG – Central Government
 LG – Local Government
 RG – Regional Government

- a) the school's council of teachers (30%);
- b) the school's council of parents (30%);
- c) the local government (40%).

The council elects the school's executive director in accordance with competitive conditions defined by the Ministry of Education and Science. The school's financial sources include both budgetary and non-budgetary means. Since September 1, 1999, the schools have included experimental programs financed by the state budget through local governments based on the number of students. The school is a legal entity and has a bank account. The school's non-budgetary financial sources are:

- a) means received from the rent of the school's facilities;
- b) the school's paid services;
- c) donations;
- d) means received from activities which are permitted by the legislation of Armenia and do not violate the school's statute.

The Ministry of Education and Science study shows that the experiment has a positive yield: the degree of schools' sovereignty has greatly increased, the efficiency of budgetary expenditures has risen and the teaching staff has rationalized.

In our opinion, the next step for school system reforms should be enlarging the number of schools included in the reform program, and in the future, the schools should be given to the communities as a property.

3.4 Tax Collection

It is necessary to enlarge the local governments' responsibilities in the sphere of taxation. The responsibility of community tax collection should be given to the local governments and written into law. Currently, the Armenian Government requires local governments to organize their property tax performance and accounting. They work together with the Tax Agency in accordance with the normative acts adopted by the Agency. Studies show that the State Tax Agency is not interested in community budgets' tax revenue collection, revealing that the primary interested party is local governments. The delegation of tax collection to local governments implies the existence of coinciding personnel. This problem does not exist in city communities. In these communities, local governments define and levy local duties and fees. These charges actually work are like tax collection and can successfully be done by local governments. Some problems in regard to community enlargement can arise in small and middle-sized rural communities. It is easier to find specialists to solve the problems associated with enlarging rural communities.

It is very important to give the tax collection work to communities at this time because the level of tax collection in 2000 is decreasing in comparison from the previous year. On the whole, data from year 2000 community budgets show that community budgets' own revenue have reduced. This is not only the result of the population's bad condition, but also the low image of local authorities.

3.5 Police

The creation of community police is very important for inflating the role and image of local governments. While local authorities should at least have forces for public security, the police is fully subordinate to the Central Government. In this case, the experience of France, Germany and Italy is applicable; municipal police and national police exist in a parallel fashion, with municipal police responsible for traffic and bylaw enforcement.

On the whole, it is difficult to imagine an authority without a police force. The absence of this force fuels a feeling of inferiority among the authorities while giving a weak impression to the population. Our studies, meetings with the representatives at local authorities show that the question of creating a municipal police has already been placed on the table. This responsibility must be given to the communities step by step with communities of more than 20,000 people receiving a force first, followed by those communities with a population of 10,000-20,000 people.

3.6 Social Security

The social security system is wholly a state function in Armenia. The Central Government's territorial subdivisions provide social services to the population. In the sphere of social security, the local governments only have voluntary responsibilities. It is clear that the Central Government can not have territorial subdivisions in all communities. Social security is closer to local authorities and it is not accidental that in many countries, local authorities have some responsibilities in this sphere. With the proper legal base, local governments could provide social services to the population more efficiently than the central government. This especially refers to the improvement of social conditions for invalids, families that have lost a sponsor and other needy groups. It is important to delegate family benefits to local governments. The Central Government should only define the nature of the beneficiary families and the size of their benefits from the central budget. Other considerations, including the definition of additional amounts of benefits from the community budgets, should be decided by local governments. The

means that the provision of family benefits must be given to communities in the form of grants-in-aid. The role of local governments should be gradually increased in regard to the formation of these means.

Registration services for acts of civil status are accountable to the Central Government and are located in urban communities; rural communities cannot always make use of these services for various reasons. It is not uncommon for births and deaths to not be registered. These registration responsibilities should be given to local governments. As a result, counting the population will be done more accurately, communities will have equal conditions and many of them will benefit from additional budget revenues. Also, state duties on the registration of civil status acts are considered as revenue for the communities where the registration offices are situated. If these registration responsibilities are given to the local communities, then each local government will receive income while performing these services. This kind of practice existed during the Soviet years and should be restored.

The relationship between the passport offices and local governments should be clarified in order to improve the accuracy of counting the population. Passport offices are subdivisions of the Ministry of Interior Affairs and work separately from local governments. They should perform services in agreement with local governments and/or with their knowledge. If the mentioned responsibilities are delegated to local governments, then it will promote the strengthening and increasing local government's prestige among the population.

4. LOCAL BUDGET EXPENDITURE

Local governments must be provided with the appropriate financial means in order to fulfill their responsibilities and

functions. This requires a combination of political decentralization and fiscal decentralization. The result of this combination conducted in an irrational manner may be "unfunded" or partly-funded local functions.

The degree to which these functions are fully performed by local governments can be seen in the share of local budget expenditures in the consolidated budget. The size of this share represents the extent to which local governments' functions are performed completely.

It must be mentioned that the percentage of local budget expenditures in the consolidated budget is rather small, equaling nearly 5% in Armenia. This becomes clear when compared to both Western and Central and Eastern European countries. (See Table 3.3)

The detailed analysis of these indicators reveals that the framework of local governments' responsibilities is narrow and performed incompletely.

For the purpose of insuring that the responsibilities and financing of local governments correspond, community budgets are divided into two constituent parts:

- administrative budget, and
- capital budget.

Each part of a community budget has its own revenues and expenditures. The percentage for the capital budget is very small. Capital budget expenditures were 4.7% in 2000, meaning that many functions connected with the maintenance of communities' property are not fulfilled. Capital repairs for buildings have not been implemented for a long time. As a result, many kindergartens, specialized schools, clubs, culture halls and libraries are in bad condition. The same situation is present in the streets, squares, resting zones and bridges. Capital construction represented only 15% of

Table 3.3
The Share of Local Budgets in Consolidated Budget Expenditures²

Countries	National Budget Expenditures [%]	Local Budgets Expenditures [%]
Estonia (1998)	69.4	30.6
Latvia (1998)	74.8	25.2
Lithuania (1997)	77.1	22.9
Poland (1997)	73.2	26.8
Czech Republic (1997)	83.4	16.6
Slovakia (1998)	73.4	26.6
Hungary (1997)	74.5	25.5
Slovenia (1998)	90.8	9.2

the capital budget in 2000, which is a very small sum in absolute numbers. In addition, many communities do not even create capital budgets.

Even if the share of current expenditures is great, it does not mean that all functions connected with current expenditures are fulfilled.

About 40% of total community budget expenditures consist of wages and transfers to the social security fund (which is a mandatory payment). It is important to mention that local budgets reflect a lag time on wages payable of nearly six months. If this debt is paid wholly, the share of wages and social fund transfers would be much bigger.

The main expenditure areas are the maintenance of local governments, housing stock and public utilities, pre-school education, culture and sport. There are areas in which local governments have mandatory responsibilities.

In general, the lack of financial resources does not allow local governments to effectively fulfill their expenditure assignments in all realms of local government responsibility. In this respect, the most urgent problem is the need to increase community revenue collection and search for additional revenue sources.

5. LOCAL BUDGET REVENUE

Like most countries, Armenia's local self-governments have more assigned expenditures than revenue sources to finance them. The result of this vertical imbalance is that localities generally depend on transfers from the State. A problem of local finance is that not all of the local governments are the same; the localities vary in their size and setting (urban com-

Table 3.4
Community Budget Expenditures in Armenia

Expenditures	1997		1998		1999		2000	
	Amount [Mln. AMD]	[%]	Amount [Mln. AMD]	[%]	Amount [Mln. AMD]	[%]	Amount [Mln. AMD]	[%]
Administration	2,205.5	23.1	2,222.3	19.4	2,723.8	23.5	2,708.0	21.3
Housing Stock and Public Utilities	2,727.2	28.6	3,273.2	28.6	2,286.9	19.8	2,735.9	21.5
Social security and Insurance							65.3	0.5
Transport and Communication					70.1	0.6	94.9	0.7
Other Branches of Economy	438.2	4.6	748.9	6.6	973.7	8.4	95.9	0.8
Education	2,191.4	23.0	2,593.8	22.6	2,483.2	21.5	2,369.2	18.6
Culture and Sports	1,414.5	14.8	1,608.1	14.0	1,608.0	13.9	1,402.2	11.1
Other Expenditures, of which:	558.5	5.9	1,011.8	8.8	1,419.9	12.3	3,242.6	25.5
• Payment of Previous Year Debts	97.8	1.0	27.4	0.2	460.9	4.0	1,355.7	10.7
• Payment of State Budget Loans			0.3	0.0	9.2	0.1	6.2	0.1
Total, of which:	9,535.3	100.0	11,458.1	100.0	11,565.6	100.0	12,714.0	100.0
• Compensation of Employees	3,248.0	34.1	3,281.8	28.6	3,908.4	33.8	3,739.2	29.4
• Investments	78.2	0.8	61.4	0.5	93.5	0.8	139.3	1.1
• Capital Repairs	977.7	10.3	2,450.2	21.4	532.6	4.6	453.8	3.6

Table 3.5
Community Budget Revenues in Armenia

Type of Revenue	1997		1998		1999		2000	
	Amount [Mln. AMD]	[%]	Amount [Mln. AMD]	[%]	Amount [Mln. AMD]	[%]	Amount [Mln. AMD]	[%]
Taxes	4,302.3	43.3	6,056.6	49.1	6,689.2	57.2	6,690.3	48.3
• Income Tax	—	—	1,754.0	14.2	1,298.2	11.1	1,410.6	10.2
• Land Tax	2,109.3	21.2	1,161.9	9.4	1,436.0	12.3	1,454.2	10.5
• Property Tax	735.5	7.4	1,567.6	12.7	2,407.0	20.6	2,601.2	18.8
• State Duties	1,457.5	14.7	1,573.1	12.8	1,263.9	10.8	880.2	6.3
• Local Duties	—	—	—	—	282.4	2.4	330.6	2.4
• Other Tax revenues	—	—	—	—	1.7	0	13.5	0.1
Non Tax revenues	1,773.7	17.8	2,085.7	16.9	1,766.3	15.1	1,782.1	12.9
• Land Rent Payment	746.2	7.5	785.4	6.4	695.0	5.9	824.0	5.9
• Property Rent Payment	—	—	—	—	120.1	1.0	88.9	0.6
• Local Fees	—	—	—	—	108.9	1.0	184.7	1.3
• Other Non Tax Revenues	1,027.5	10.3	1,300.3	10.5	842.3	7.2	684.5	5.1
Total Income	6,076.0	61.1	8,142.3	66.0	8,455.5	72.3	8,472.4	61.2
Residual Revenue to Cover Expenses	91.3	0.9	341.5	2.8	994.2	8.5	180.2	1.3
Transfers and Subsidies	3,774.6	38.0	3,845.3	31.2	2,252.4	19.2	5,202.0	37.5
• Subsidies from State Budget	3,753.0	37.8	3,690.3	29.9	2,192.4	18.7	5,194.3	37.5
• Transfers from Other Community Budgets	7.0	0	0	0	60.0	0.5	1.9	0
• Short-time Loans	14.6	0.2	15.0	0.1	0	0	0	0
• Other transfers	0	0	0	0	0	0	5.8	0
Subventions	0	0	140.0	1.2	0	0	0	0
Total	9,941.9	100.0	12,329.1	100.0	11,702.1	100.0	13,854.6	100.0

munities versus rural ones). Providing local services in the absence of a well-designed revenue and transfer system gives rise to a horizontal imbalance. Another problem is the low degree of local budget implementation. For example, local budgets were implemented 53.2% of the time in 2000.

The main sources of community budget revenue are:

- centrally established taxes and duties;
- subsidies from the State budget;
- local duties and fees;
- land rent and property rent payments;
- revenue from community property sales.

Two kinds of State duties contribute to community budget revenues:

- duties for registering Acts of Civil Status, issuing duplicates of citizen certificates for the respective Acts, mak-

Table 3.6
Tax Sharing in Different Countries³

Countries	Taxes							
	VAT	Property Tax	Sales Tax	Payroll Tax	Motor Fuel Taxes	Personnel Income Tax	Corporate Profit Tax	Motor Vehicle Tax
Russia	+						+	
China	+							
Indonesia		+						
Dominican Republic	+							
Peru			+					
Mexico				+				
Brazil					+			
Estonia						+		
Lithuania						+	+	
Poland						+	+	
Hungary						+		+

ing alterations to Acts of Civil Status records and issuing restoration certificates;

- duties for rendering notary services by the Notary

Offices, issuing copies of documents certified by a notary, drafting contracts and applications by notary agencies, issuing copies of official documents and making extracts from those documents.

The share of state duties in community budget revenues is more than 10%.

If a local community even has a capital budget, the revenue in the budget is very small.

6. INTRODUCTION OF TAX-SHARING MODELS

Tax sharing is widely practiced in developing and transition economies. Two questions arise in the design of a tax-sharing model: (1) Which tax should be shared? and (2) What percentage of the tax should be shared? In general, the central government allocates a percentage of its national collections from some taxes to the provincial/local government sector.

Each country decides the type and percentage of taxes to be shared.

As Table 3.6 shows, the number of shared taxes is great. Concerning the percentage of the tax to be shared, countries vary widely in their choices. In many countries, the percentage is defined every year. For example, in Hungary the local

share of the personal income tax has declined from 50% to 15% while Estonia allocates 56% of personal income tax to sub-national governments. China and Russia allocate about 25% of VAT collections to sub-national governments.

There are two methods of tax sharing between central and local governments. The first is the origin method, where each local government gets a fixed share of the tax collected within its borders. The second method is formula based, where a fixed share of the national yield is divided between local governments on a formula basis. The first is simpler method.

The laws on Budgetary System and Local Self-government provide an opportunity for the use of tax-sharing models in Armenia's budgetary system. The type and share of local budget tax revenue is fixed in these laws. It is also possible each year to define a share of taxes as local budget revenue in the Annual State Budget Law.

In the first year (1997) of the new local self-government system, centrally established taxes paid to community budgets were the land and property taxes. The income tax was added later (see Table 3.7), but only 15% was paid to community budgets. The State Tax Agency collects all taxes in Armenia. The principle of sharing was put to use in order to increase the State Tax Agency's incentive to collect taxes. However, the amount of income tax is very small (or does not exist) in rural communities, which is why, since 2000, all income tax revenue accrues to the State Budget, and the amount of subsidies from the State Budget to the community budgets was increased. Land and property taxes have remained as the only community budget tax revenue and are

Table 3.7

Share of Centrally Established Taxes Paid to Community Budgets in Armenia, 1997-2000 (%)

Year	Income Tax	Land Tax	Property Tax
1997	—	100	100
1998	15	95	95
1999	15	95	95
2000	—	100	100

fully paid to the community budget. As the origin method was used in 1998 and 1999, the role of local government bodies in tax collection matters has increased.

The tax-sharing model must not only serve as a source of budget revenue, but also stimulate economic activity in the communities. Local governments can directly or indirectly impact the development of economic activity. The main aim of any tax-sharing model must be community economic development. This is a vital goal, as it will increase the incentive of local authorities to support the development of small and medium-sized businesses.

If the VAT and corporate tax are considered part of local revenue, then local-government support to local enterprises will increase.

The use of tax sharing in Armenia will strengthen the fiscal position of local governments and provide the necessary financing for fulfillment of their functional responsibilities. At the same time, it may support the development of local economic activity. If a tax-sharing model is used, the next issue to be decided is the particular taxes to be shared. The primary taxes to be used include the personal income tax, the corporate profit tax and the VAT. However, the percentage of these taxes to be shared will vary. When Armenia used the personal income tax, 15% of the tax was transferred to local budgets. The local share of corporate profit tax might be 10% while the percentage of the VAT might be about 2%. Tax sharing model is foreseen in the draft Law on Local Self-government. It is necessary to mention that tax sharing should not be subject to annual changes, but rather be used for a long period.

7. ROLE OF LOCAL DUTIES AND FEES IN THE PROVISION OF FISCAL AUTONOMY

To properly understand local duties and fees, it necessary to know which mandatory payments are made to the local budget by the population and/or economic entity as well as their applicable rates. The types of the local duties and fees and their corresponding rates vary widely among local governments. An analysis of local duties and fees (the term "local tax" is used

in some countries) in transition countries reveals the presence of many differences concerning the types of local taxes, fees or duties. For example, Hungary has six types of local taxes and duties while there are fifteen in Ukraine (see Table 3.6).

A characteristic of democratic local governance is the right to impose local duties and fees. On December 26, 1997, the Law on Local Duties and Fees was adopted in Armenia, prescribing procedures for the implementation of and requirements for nine local duties and three local fees. Under the law, community elders have the right to set rates within a defined range.

Local duties are levied on the following items:

- a license to construct, strengthen or reconstruct a building and other civil engineering facilities (including temporary), or to change the exterior of a building;
- a license to demolish a building or other civil engineering entity;
- a license to sell alcohol and/or tobacco products;
- a license for open-air trade activities (except trade in markets, fairs and in temporary or non-temporary engineered construction);
- a license to operate public facilities for gambling, catering, saunas and other night amusement facilities after midnight ;
- a license to keep a non- domesticated animal in Yerevan and other urban communities;
- a license to place an external advertisement in the community;
- obtaining copies of documents from the community archive;
- a license to operate a passenger taxi (except route taxis) in the community (except district communities in urban areas).

Local fees are assessed on the following activities:

- setting up and confirming technical and economic conditions and executive documents for the construction of a new building, or changing the exterior of an existing one—involving services provided by the local self-government body;

- participating in auctions and tenders organized by the local self-government—in order to cover their costs;
- measuring, reclaiming and renting local government lands—including services provided by the local self-government body.

Local duties and fees have been defined since the middle of 1998, mainly in urban communities. Their share of the community budgets' revenue was already 3.4% in 1999.

Although local duties and fees increased in absolute numbers in 2000, their share in local budgets' revenue stayed nearly the same. Also, the implementation of local duties and fees increased, from 46.5% in 1999 to 63% in 2000. It is necessary to mention that local budget targets were achieved 49.7% in 1999 and 53.2% in 2000, representing great progress in this area. At the same time, there is a much room for improving the collection of local duties and fees.

Another issue is widening the framework of local duties and fees. It is necessary to mention that not all duties and fees are used in all communities. Each community is unique, and on this basis chooses to employ different types of local duties and fees. A larger framework of local duties and fees enables greater choice for local governments.

In practical terms, Armenia could add the following duties and fees to the local framework: fees on parking, the use of the local government symbols and for resorts.

Transport Parking Fees: Each community may have areas for parking. The need for these places is great in urban communities. The payers of this fee are drivers who park their cars in allocated places as defined by local governments. The amount of the fee should depend to the actual time of use.

Fees on use of the local government Symbols: Of course the number of communities that have their own symbols is not great. However, some legal entities do exist that use, or want to use, the community symbols in the production of goods, in the execution their work, or in the extension of their services. This area should be regulated.

Resort Fees: Many communities have resort areas that could serve as an additional source of revenue to the local budget. This resort fee could be levied on individuals who are visiting a holiday resort area. There could be exceptions for certain users of the resort area, such as children and pensioners.

8. LOCAL GOVERNMENT PROPERTY MANAGEMENT AS A SOURCE OF LOCAL REVENUE

Property management is the process of making and implementing decisions in regard to the purchase, use and sale of property. The use and sale of property is considered as reve-

nue to the annual budget. However, buying property is an expenditure, the use of which may give a future income. The role of the owner includes property management, which includes the collection of income.

When the owner is the local government, property management has its own peculiarities. This activity is closely connected to other fields of activity, such as:

- community land policy and the allocation of lots for constructing buildings,
- provision of public services,
- financial management and accountability.

During the implementation of local government property management, it is necessary to take into consideration the fields of activities mentioned above.

The community's property consists of inventory, financial means (budget), as well as inventory and non-inventory rights. The list of each community's inventory was defined by Government Decisions No. 42 and No. 51, respectively adopted on March 13, 1997 and March 14, 1997. These decisions, and others made later, provide communities with:

- the inventory of heating, sewerage, water-supply and irrigation systems;
- kindergartens, specialized schools, clubs, culture halls, libraries, streets, squares, resting zones, stadiums, bridges, monuments located in the community, planting, sanitation, house repair as well as administrative buildings;
- non-privatized housing stock.

The communities control few enterprises. At the end of 1999, 108 out of 43,184 registered juridical persons belonged to communities. Community enterprises are practically non-existent in rural communities. The data on community enterprises is provided in Table 3.9.

Communities also hold 34% of the stock in each of the 50 companies. They are mainly municipal enterprises, with the local authorities retaining the rights to manage their local property.

Local government property management is a new sphere of activity in Armenia, with many associated problems. First at all, a complex approach is needed to develop a long-term plan. The main reason for this problem is the absence of a theoretical concept of local government property management. Another problem is the unsatisfactory number of specialists and a weak legal foundation. The Law on State Registration of Property Rights was adopted on April 30, 1999 and currently guides the registration process. This process, however, is very slow, requiring the submission of an application and necessary documents as well as a registration payment to the State Committee of Cadastre. The registration fee is

Table 3.8
Local Taxes (Duties, Fees) in Central and Eastern European Countries⁴

Czech Republic's Local Fees	Estonia's Local Taxes	Hungary's Local Taxes	Ukraine's Local Taxes and Duties	Latvia's Local Duties
<ul style="list-style-type: none"> • dog fees • resort and recreation fees on visitors • tax on use of public space • fees on entry tickets • fees on recreational units • motor vehicle entry fees • fees on gambling machines 	<ul style="list-style-type: none"> • poll tax • local income tax • sales tax • boat tax • commercial and advertising tax • tax on closing roads and streets • motor vehicle tax • tax on keeping animals • entertainment tax 	<ul style="list-style-type: none"> • business tax • communal tax on private individuals • communal tax on entrepreneurs • land parcel tax (tax on undeveloped plots) • building tax • tourism tax 	<ul style="list-style-type: none"> • tax on advertising • Municipal tax duties • hotel fees • transport parking fees • marketplace fees • fees for permission to lease a private apartment • resort fees • fees charged for use of region's symbols (flags, crests, etc.) • auction fees, lottery fees and clearance sale fees • fees for driving within the territory of frontier regions; charged from transport, when driving abroad • fees for permission to establish trade and service facilities • fees for permission to establish production and non-production facilities, private residency and garages in densely populated area • fee for permission to place office premises of legal entities in central parts of populated areas and in buildings, which have historical and architect value • fees for dog possession • fees charged for acquisition of foreign currencies in cash 	<ul style="list-style-type: none"> • local government services • entertainment in public places • tourism • trade in public places • keeping certain animals • transportation across special zones • advertisement in public places • ownership of boats, motor-boats and yachts • use of the local government symbols

Table 3.9
 Characteristics of Community Enterprises in Armenia in 1999

Enterprises Belonging to	Number	Registered Fund [million AMD]	Number of Employees
Yerevan District Communities	52	222.26	4,463
Urban Communities	47	326.16	2,273
Rural Communities	9	22.83	362
Total	108	571.25	7,098

high for many local governments, discouraging them from applying to the Committee for registration with the effect of very few local governments having registered their property.

Local governments do, however, receive income from property management, which is considered as local budget revenue. There are two types of administrative budget revenues that are connected to property management: land rent and property rent. Land rent payments comprised 5.9% of local budget revenues in 1999 and 2000. Property rent payments were less, equaling 1% in 1999 and 0.6% in 2000. Only the income from the sale of property is associated with property management in the governments' capital budget revenues. This figure totaled AMD 114,1 million in 2000, which represents 0.9% of local budget revenue.

For the development and improvement of local government property management, it is important to take into consideration the following issues:

- structure of the property management unit or office in the community head's staff;
- organization of property management officials for service training;
- time frame for the registration of local governments' property;
- efficient use of local governments' property.

In general, revenue received from local government property management is not large, but with proper management, could be a stable source of income to the local budget.

9. STATE BUDGET TRANSFER MECHANISMS

Intergovernmental transfers are an indivisible part of local governments' financial system in all countries. In countries such as Sweden and Denmark, the majority of local governments' revenue comes from local sources, while in countries

such as Great Britain and Bulgaria, the majority of their revenue comes from state transfers. In Armenia, state transfers are an important part of communities' financial means, providing for the maintenance of inventory and buildings as well as the fulfillment and development of primary community services.

The total amount of equalization subsidies in the state budget has its own budget line and is paid immediately upon adoption by the National Assembly. This means that the community transfers are defended and considered to be mandatory payments regardless of the state budgets' implementation level. The Ministry of Finance and Economy, according to the Law on Financial Equalization, distributes the subsidy amount as defined in the state budget. The aggregate amount of subsidies planned for the communities is equal to the total amount of subsidies defined in the state budget. At the beginning of the fiscal year, the Ministry of Finance and Economy distributes a quarter of the subsidies and requests that the Treasury fulfills the payments. All communities anticipate a proportional quarterly distribution, and with normal collection of state budget revenue, the subsidies are transferred accordingly.

This mechanism is partly defined by the law and partly by the Ministry of Economy and Finance. In reality, the situation is far from ideal, with some communities receiving the subsidies earlier and others later. The equalization subsidies are given to the communities irregularly and with systematic delays during the whole year. Most of the subsidies are transferred at the end of the current year, primarily within the last ten days of December.

The selection mechanism for those communities that receive the subsidies earlier is unknown.

The percentage of state transfers in community budgets is around 37% (Table 3.7). This percentage was less in 1999 because the State budget did not fulfill its duties. In 1999, the state decided to allocate AMD 4,388.7 million in equalization subsidies and AMD 86.1 million in subventions, but only AMD 2,192.4 million in subsidies was actually allocated. The other part was drawn up as debt and transferred in 2000.

At the end of 2000, the total debt to the community budgets grew to AMD 3,397.1 million.

Another problem is that sometimes the subsidies are given for distinct purposes; for example, the subsidies are given if the head of the community agrees to pay the water, heating or electricity debts from these subsidies.

It is necessary to amend existing legislation to improve the mechanism for state transfers. Another improvement would be establishing that the total amount of each community's subsidy must be distributed into quarters and months. Further, the law must define that in the case of the state budget not being implemented, communities should receive subsidies in proportional sizes. There should not be preferred communities and subsidy allocation should not depend on the will of a public official.

As the legislation does not regulate the mechanism for allocating subventions, it is necessary to work out clear criteria guiding which communities can apply to the Ministry of Finance and Economy. The selection of communities should take place on a competitive basis, with the winner chosen according to the total amount of subventions defined in the State budget.

10. THE FINANCIAL EQUALIZATION SYSTEM

Equalization has an important place in intergovernmental fiscal relations. The different varieties of inter-government transfers include grants, shared taxes, subventions and subsidies. While all of these types of transfers are used to implement equalization, subsidies and grants are the most common financial instruments.

All countries experience fiscal disparities among regions, with the average income in the richest places many times greater than in the poorest regions. If countries are to equalize their regional financial capacity differences, inter-governmental

transfers must be used. As a rule, equalization payments are unconditional. Recipient local governments are free to spend the funds on local public services according to their own priorities.

In most countries, equalization subsidies are in the form of transfers from the central government to the local governments. This is the case in countries such as Canada, Australia, the United Kingdom, Japan, Korea, Hungary, Latvia, etc. In countries such as Germany and Sweden, the equalization transfer is made from states with above-average fiscal capacities to states with below-average fiscal capacities. In other countries, equalization subsidies take the form of general revenue sharing.

There are three ways⁵ that governments approach regional demands for special treatment. The first is individually negotiated payments between the central and regional governments. The second is special fiscal regimes that grant rights to certain regions for taxation and expenditures. The third is a formula-based system designed with equalization objectives. While most countries address regional issues with some kind of formula distribution, only a few countries include components in their formulas for dealing with demands made by a specific region. A subsidy formula employs objectives, such quantitative criteria for allocating the pool of revenues among eligible local government units. The objectives of a formula subsidy are to gain transparency and certainty in the distribution of subsidies. This objective promotes a sense of fairness, in that all know the exact criteria by which distributions are made and there is flexibility that distributions may be changed as the needs for public expenditure change. In short, formulas are meant to remove subjectivity.

The following questions are raised in regard to equalization:

- What are the limits of equalization? How much of the gap between rich and poor communities should be eliminated?

Table 3.10

Local Budgets Revenues With or Without Any Subsidies from the State in Armenia [Thousand AMD]

	1997		1998		1999		2000	
	Amount	%	Amount	%	Amount	%	Amount	%
Local Budgets without any subsidies from the State	6,188,920.2	62.25	8,498,763.5	68.9	9,509,740.8	81.3	8,660,320.2	62.5
Local Budgets including the subsidies from the State	9,941,968.5	100.0	12,329,077.6	100.0	11,702,161.8	100.0	13,854,639.1	100.0
Subsidies from the State budget to the local budgets	3,753,048.3	37.75	3,830,314.1	31.1	2,192,421.0	18.7	5,194,318.9	37.5

- What services do local governments deliver and what is the level of their fulfillment?
- What distribution formula is used to allocate funds among the local governments?
- What is the mechanism for equalization?
- How will equalization be monitored? What equalization index will be chosen to measure the effectiveness of the system?

The main components of the equalization formula are the elements of the formula, the data necessary to implement the formula and the conditions of the formula. All three components are important considerations in the design of equalization subsidies.

Formula design is arguably the most difficult issue, because it introduces the question the equalization program's goals. The formula should reflect its objectives. In general, a formula might reflect the four objectives outlined below.

The first objective is to allocate the subsidies in a manner that reflects regional differences in expenditure needs. Different countries have used different indicators of expenditure needs, including:

- Population, i.e., a straight per capita distribution.
- Physical factors that may lead to greater provision costs, e.g., land area, population density, urbanization.
- Concentrations of high cost population groups in local government areas, such as the percent of families living below the poverty line, the percent of people on pensions, the percent of school aged children, etc.
- Infrastructure needs, such as miles of paved highways, the percent of households with access to adequate water supply, to support economic development, etc.

The second objective is the equalization of income or fiscal capacity. In this pursuit, the formula subsidy attempts to provide more money to those jurisdictions that have a weak capacity to raise taxes. There seem to be two general approaches:

- Allocate funds according to the level of average income in the local area or according to 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.

The third objective is to include a tax effort provision directly in the formula. The goal here would be to provide local governments with effective incentives to increase the overall level of revenue mobilization. One option is to introduce a measure of tax effort directly in the formula. The second is using an index, an approach previously employed in India. Another approach is to require the maintenance of

a level of revenue mobilization as a condition for receiving the subsidy.

The fourth objective is that the subsidy formula reflects the balance between revenue raising capacity and expenditure needs. Many countries use variants of this approach. Some countries, for example, define a standard level of expenditures according to a formula based on physical indicators for desired levels of service. This is related to a "normal" level of revenue mobilization based on the size of the tax base and has been used in countries such as Korea. Some school aid in the U.S. is defined by a formula that links minimum expenditure requirements with property tax revenues if a specified level of property tax effort is exerted. Some of the transition countries, such as Russia and China, have defined the required level of expenditures as equivalent to some past amount inflated to the present. The level of revenue needed to guarantee this expenditure level is the amount of the transfer.

A major constraint in designing a formula subsidy system is finding data to implement and update the system. Some data is simply not available, while other forms of available data might be limited in terms of timeliness. For example, some data is available only in the census year and must be used in the interim period without adjustment. Some data is limited in terms of geographic coverage. There are also problems concerning the reliability of the data, even if gathered by official bodies.

Formula subsidy systems must be monitored on a regular basis. Monitoring involves oversight of formula elements and the actual subsidy distributions as well as each local government's financial outcomes.

Dr. Jun Ma has summarized four types of equalization formulas found below:⁶

Formula A

Formulas that consider the equalization of fiscal capacities and the expenditure needs of different regions (Australia, Germany, Japan, Korea, United Kingdom). This formula is:

$$TR_i = N_i - C_i - OTR_i$$

Where, N_i – fiscal need of the i-th region,
 C_i – is the fiscal capacity of the i-th region,
 OTR_i – other transfers the i-th region receives from the center,
 TR_i – transfer from the center to the i-th region.

This formula states that the central government transfer will fill the gap between each region's fiscal need and fiscal capacity to ensure that a region with reasonable tax effort will be able to provide a reasonable level of public services.

Formula B

Formulas that only consider the equalization of fiscal capacity (Canada). This formula ignores the potentially large differences in special expenditure needs across regions. A typical formula of this type is as follows:

$$TR_i = P_i(B/P - B_i/P_i) \cdot t$$

Where, P_i – population of the i -th region,
 B – total tax base of the country,
 P – total population of the country,
 B_i – tax base of the i -th region.
 t – country’s average effective tax rate on the tax base.

This formula states that the central government transfer will bring the fiscal capacity of the below-average region up to the national average. A variation of this formula exists in countries’ use of a different “average” per capita tax base.

Formula C

Equalization formulas based on “needs” indicators (India, Italy, Spain). Typical indicators used to determine regions’ fiscal needs include:

- Per capita income level,
- Poverty incidence,
- Unemployment rate,
- Population density,
- Area,
- Infant mortality,
- Life expectancy,
- School enrollment rate,
- Infrastructure (e.g., length of roads and railways),
- Other indicators of development level (e.g., electricity consumption and number of telephone lines).

There are varieties of indicators that can reflect the fiscal needs of regions, and the choices are very much dependent on the central government’s objectives and local governments’ responsibilities.

Formula D

Equalization formulas based on an equal per capita basis (Germany, Canada, Indonesia). The simplest equal per capita transfer formula is as follows:

$$TR_i = P_i(TT/P)$$

Where, TT – total amount of transfer,
 P – total population eligible for the transfer program.

Equal per capita transfers cannot fully equalize, but they can mitigate regional disparity in fiscal capacity.

The existing equalization system in Armenia includes elements of Formula B and Formula D. The amount of equalization subsidies is calculated separately:

1. the communities, which have more than 300 inhabitants;
2. the communities, which do not have more than 300 inhabitants.

The amount of the subsidies to budgets of communities with more than 300 inhabitants is determined by the following factors defining their economic situation:

- a) local community per capita land tax and property tax revenues (factor “a”);
- b) population of the community (factor “b”).

The total estimated amount of subsidies to budgets of communities with not more than 300 inhabitants and upon factor “a” must not be less than 25% of the total income tax, land tax and property tax actually collected during the previous fiscal year, and must be greater than 10% of the income tax actually collected during the previous fiscal year. The total estimated amount of subsidies upon factor “b” must not be less than 10% of the income actually collected during the previous fiscal year. Factor “a” subsidy is destined for the budgets of those communities with not more than 300 inhabitants, where per capita land tax and property tax revenue is lower than the average marginal per capita revenue for Armenia’s land tax, property tax and total amount of subsidy upon factor “a”. According to this principle, the subsidy destined for each community is determined by the following formula:

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

where A = amount of the subsidy allocated to the community upon factor “a”;

M = average per capita marginal revenue level of the Republic (besides the communities with not more than 300 inhabitants) land tax, property tax and total amount of subsidies upon factor “a”, which itself is determined by the following formula:

$$M = [D + \Sigma(T + P)] : (\Sigma B)$$

where D = total amount of subsidies allocated to communities based on factor “a”;

T = the calculated indicator of concrete community’s budget land tax for the calculation of each fiscal year’s subsidy;

- P = the calculated indicator of concrete community's budget property tax for the calculation of every fiscal year subsidy;
- B = concrete community's population;
- H = revenue level of concrete community per capita land tax and property tax, which is lower than average revenue marginal level of per capita of the Republic land tax, property tax and total amount of subsidies upon factor "a" and itself determines by the following formula:

$$H = (T + P) : B$$
- G = average regulating coefficient, which is determined by the following formula:

$$G = D : \Sigma[(M - H) \times B.$$

The factor "b" is used to provide a subsidy to all of the communities (besides the communities with less than 300 inhabitants) by multiplying the population and the value of the subsidy per capita. The latter is determined by the ratio of the total subsidy (under factor "b") to the country's population (besides those communities with not more than 300 inhabitants).

The subsidy to communities with not more than 300 inhabitants is calculated evenly; there are 172 communities with less than 300 inhabitants.

As seen above, equalization subsidies are given to communities in three ways. Equalization subsidies given to communities with not more than 300 inhabitants and factor "b" are rather close to each other. In the first case, all communities receive equal subsidies. In the second case, subsidies depend on the number of community inhabitants. The first case lacks a serious foundation, as there is no real indicator for the definition of a subsidy's size. In the third case, subsidies given to communities with factor "a" are similar to Formula B subsidies. This means that the communities' financial needs are not taken into consideration, but only the equalization of fiscal capacities is considered.

A new equalization model for Armenia is a modification of Formula A. The basis of the model is normative expenditures for the implementation of local government's functions, as calculated by the Ministry of Finance and Economy.

The equalization formula is as follows:

$$STR_i = (SSA - ABR_i) \cdot \frac{\Sigma STR_i}{\Sigma (SSA - ABR_i)} \cdot K$$

- Where, STR_i – Subsidy transfer from the center to the i-th community,
- SSA – Standard Spending Assessment,
- ABR_i – Previous year's administrative budget revenues of the i-th community,

$SSTR_i$ – Transfers from the center to all communities,

$SABR_i$ – Previous year's administrative budget revenues (without subsidies) of those communities with revenues less than SSA,

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

Where, ATR_i – i-th community budget's actual tax revenues from the previous year,

CTR_i – i-th community budget's calculated tax revenues from the previous year.

Those communities, whose administrative budget revenues (without subsidies) are less than SSA in the previous year, can receive subsidies from the state budget. According to Armenia's existing legislation, SSA should be calculated in the following fields:

- local governments,
- kindergartens,
- specialized schools,
- culture organizations,
- current repair and operation of roads, streets, bridges and other engineering structures in the community's jurisdiction,
- waste collection and disposal,
- planting and improving the community,
- current repair of housing stock owned by the community,
- sanitation,
- public transport,
- heating.

If local governments' responsibilities are widened, then this framework will be enlarged. The Government will calculate SSA each year, considering the Government's social-economic strategy, inflation rate, delegation of responsibilities to local governments and the public sector's average wage level.

The use of coefficient K will support an increase of tax revenue collection. The higher degree of tax collection, the greater the level of subsidy.

The best result of equalization will be in the cases of $\Sigma STR_i = \Sigma (SSA - ABR_i)$ and $k = 1$. In this case, the communities with administrative budget revenue less than SSA will receive the missing part from the state budget to completely fulfill their functions.

Communities should receive subventions from the state budget for capital expenditure performance.

11. CONCLUSION AND RECOMMENDATIONS

The new local self-government system has operated in Armenia since the end of 1996. The five years of experience has revealed the existence of many problems, the solutions of which are necessary for the continued development of the country's local self-government system, civic society and democracy.

One of the main problems is the implementation of fiscal decentralization and local governments' fiscal autonomy. Armenia assigns more expenditure functions to local self-governments than can be financed from their own revenue sources. This implies that an acceptable variant of fiscal decentralization has not yet been established.

As a result of this research, the following recommendations are offered:

1. To increase the role of local governments, it is necessary to widen their powers. Considering Armenian traditions, peculiarities of state building as well as international experience, it is proposed to give local governments the responsibilities of primary and secondary education, local tax collection, social security and the municipal policy development.
2. Armenia's use of a tax-sharing model in its budgetary system will strengthen the fiscal position of local governments, provide them with the necessary funding to fulfill their responsibilities and may also support economic development activity. The personal income tax, corporate profit tax and VAT should be shared.
3. In order to strengthen the fiscal capacity of local governments, it is important to use new local fees such as

transport parking fees, fees on use of the local government symbols and resort fees.

4. Special attention should be paid to local government property management because its income has the potential to be a stable source for local budgets.
5. The distribution of state transfers should have clear mechanisms that are defined by law. In addition, the total amount of each community's subsidy should be distributed quarterly and monthly on a competitive basis.
6. A new equalization formula, based on the fiscal needs of local governments and normative expenditures for the implementation of their functions, should be implemented in Armenia.

NOTES

- ¹ *Decentralization: Experiments and Reforms*, Edited by Tamas M. Horvath, LGI/OSI: Budapest, 2000.
- ² *Decentralization: Experiments and Reforms*, Edited by Tamas M. Horvath, LGI/OSI: Budapest, 2000.
- ³ *Decentralization: Experiments and Reforms*, Edited by Tamas M. Horvath, LGI/OSI: Budapest, 2000.
- ⁴ *Local and Regional Tax Administration in Transition Countries*, Edited by Mihaly Hogue, LGI/OSI: Budapest, 2000. *Decentralization: Experiments and Reforms*, Edited by Tamas M. Horvath, LGI/OSI: Budapest, 2000.
- ⁵ *Russia and Challenge of Fiscal Federalism*, Edited by Christine Wallich. Avebury: Washington D.C., 1994.
- ⁶ Jun Ma. *Intergovernmental Fiscal Transfer: A Comparison of Nine Countries*. Pelgrave-Macmillan: Washington D.C. 1997.