

## **A Simple Look on Local Self-government System in Armenia**

### **An Overview**

During the Soviet period Armenia was divided into 37 districts [1]. There were about 1000 settlements in Armenia, which consisted of 630 municipalities (rural soviets and town soviets). It is important to note that Armenia had not historical development of local governance and society was adopted on the principles and traditions of local government implemented in Soviet Union. After Soviet Union collapse it was evident that the remained structure could not carry out the tasks faced by communities and state. The first step was the adaptation of the Constitution and legislative field to the new conditions. Constitution of Armenia was adopted via referendum in 1995 [2]. One of the principles of Constitution was the establishment of local government in Armenia (Article 104) [3].

The post-Soviet local government system of Armenia was introduced in 1996. The Constitution, laws and regulations related to the sphere are the main legal basis for the system functioning. The legal framework includes also intergovernmental agreements between countries and international organizations. There are two levels of government in Armenia: central and local governments. Local government bodies (LGB) are accounted for 926, of which 871 are rural communities. It should be noted that rural and city municipalities are regulated by the same legal acts. The exception is Capital city Yerevan which is considered to be equal to Regional Administrations (11 Marzes including Yerevan) [4]. Regional administrations represent central government in regions and have all the functions of central government except defense, national security, justice and other functions of national importance.

Local authorities have delegated liabilities, and central government finances the implementation of these liabilities according to the Law on Local Self-Government. Yet this is only an article of the Law not actually realized, and local authorities implement their functions relying on municipal budget. The main responsibilities of local government involve water supply, renovation and maintenance of intercommunity roads, public light, kindergarten, social issues, and communal services.

Public services in Armenia are delivered in two directions: municipal and national levels. The financial source for provision of municipal level public services is municipal budget.

Local government councils and heads of communities are appointed through elections for 3 years. The heads and deputy-heads of communities, as well as the technical staff are not municipal servants. Both deputy-head and technical service staff are appointed by the head of community. Other staff members are municipal servants and selected on competitive basis.

Local government bodies are free for creating and spending their local budget, however, they have very limited functions in tax collection. They receive only Property and Land taxes, however, tax rates are defined by the central government.

Local government bodies can spend a limited amount of about 1.000.000 AMD (about 2.500 Euro) based on the Council's decision. More than 1.000.000 AMD can be spent according to the Law on Purchases [5].

One of the most important issues for the development of local government in Armenia is borrowing. Actually there is no such a practice in Armenian communities predominantly because of the underdeveloped stock market. The only measure of borrowing is State Bills the circulation of which is quite limited.

### **The Correspondence of the Activities of Local Self-Government With the Principles of European Charter**

The legislation framework of local government in Armenia meets to the requirements of European Charter on Local Self-Government and the Armenian reality. There are prescribed principles adequate to democratic values.

However, the practical realization of those principles is not so “clear”. The most important tasks are the transparency of the activities of local authorities and the elections of both the councils and heads of communities. The scope of local self-government and the protection of local authority boundaries have some problems connected with the mixed jurisdiction to the central government bodies. The problems of decentralization and devolution are evident especially in the field of finance.

The administrative structure and insufficient resources for implementation of the tasks of local authorities hamper the development of local government system. According to the Law on “Municipal Service System” [6] adopted in 2004, the municipalities should have the municipal servants who should be appointed in the result of exam. However, the institute of municipal service system as a part of public service does not function efficiently because of lack of such necessary factors as developed infrastructure of public administration, qualified professionals, financial resources etc.

The realization of administrative supervision of local authorities’ activities in Armenia, are carried out by the Ministry of Territorial Administration and the regional representatives of central government (Marzpetaran). The framework of responsibilities of “administrative supervision bodies” is defined by laws, in accordance of which they have a limited power on the activities of local government. These include monitoring of the budget execution; supervision on the decision-making processes for the compliance with the constitutional principles and the laws; controlling for an effective spending of state transfers for special tasks, etc.

The financial resources of local authorities are the main obstacles of local self-government development in the country. Several statistical data can explicitly show the problems. Rural communities could provide only 25-30 percent financial resources of their budget by own revenues, and city communities a little more [7]. The other part is provided by state budget. This shows the great dependence of municipalities on the state government. Municipalities are entitled with the power of collecting the Land and Property Taxes, while tax rates are defined by the central government. Other charges are of a little share in total financial revenues (about 2-3 percent of local budget). The significant part of local budgets is received from state budget via the financial equalization mechanism and subsidies [8]. About 70 percent of these funds are spent for the administration purposes.

The local authorities’ right of collaboration is prescribed by the law only in general and has no detailed regulations, which cause difficulties for development of internal and international cooperation. On the level of internal cooperation the creation of intercommunity unions is an important challenge, which will result in reduction of administrative expenditures and increase of the efficiency of capital investment and management. An international cooperation exists only for city communities and the relationships are based mainly on cultural and educational purposes.

### **Expenditure Assignment in Armenia**

The expenditure assignment is not the field of constitutional regulation and the main concepts are prescribed in the Law on Local Self-Government. Expenditure assignment include own and shared functions. According to the law, the local authorities are entitled with the expenditure assignment in the fields of water supply, irrigation, kindergarten, garbage collection, heating. Evidently local authorities have not a large framework of expenditure assignment. The basic role in this area takes the central government. In addition, the central government carries overall supervision of the local authorities’ expenditures. The central government carries out both the vertical and horizontal equalization. However, the equalization mechanism in Armenia is simple enough for being able to solve the problems of financial imbalances.

The central government assumes great financial responsibilities for social welfare. The activities of local authorities in social welfare have a “project adjustment” role. The central government does not transfer funds directly for the given tasks. The funds are assigned directly to local budgets and local authorities make the necessary spending. However the problem exists in regards of clearly defining and dividing the responsibilities between the central and local bodies.

The sub-national government has a broad range of activities in the field of public utilities. Local authorities base on two important circumstances during the regulation of public utilities. The first is that local bodies make decisions

regarding the public utilities, and the second one is that the private sector carries out the provision of public utilities.

Another important field of functions is capital infrastructure. The communities cannot ensure important and significant capital investments in the spheres of infrastructure and social welfare due to highly limited financial resources. So, the central government's role is great. The share of central government in local capital investment in 2007 was about 70 percent compared with the funds of local budgets [9].

The borrowing has a crucial meaning for the development of local government system in Armenia. The legislation is not very clear for making borrowing at local level. The general laws are adopted by National Assembly of RA, but other acts regulating the detailed mechanisms are not complete. The reasons are several. From one hand the low level of financial markets functioning. Another reason is the lack of financial organizations having "long money" and willing to cooperating with local governments. This is indirectly connected with the central government function of capital investment, which limits the opportunities of local bodies to participate in big projects.

The legal field in Armenia does not define the debt limits for sub-national government. The absence of this principle in the laws means the supervision of central government over the financial resources and insufficient level of financial decentralization.

The undeveloped status in borrowing and bond issue spheres is also the result of undeveloped infrastructure of financial intermediaries. It is important to note that according to the Law on Shareholder Companies' the bond issue should be certified by the Ministry of Finance and Economy. It is evident that central government has a significant power in the financial processes of local bodies. However, this does not mean that central government should take the role of guarantor for local debts. Local authorities are formed via direct elections and have the framework of own responsibilities which is assumed to form and regulate own budgets. The case of guarantee will decrease the independence of local bodies.

The experience of sub-national development fund is not actual in Armenia. Very limited funds with reasonable rates are directed for purposes of agriculture development. A draft law for the creation of special funds for development of rural infrastructure is in discussion phase. According to the draft law the tax permissions will increase the effectiveness of both forming and spending of the funds in long term capital investment projects.

### **Sub-national Revenue Assignment in Armenia**

Like in many other countries, local self-government bodies in Armenia are imposed with the responsibilities out of their financial opportunities. As the state budget is not rich (\$2.5 billion for 2008) the local budgets also have very limited financial resources. Local governments have several sources of revenue to finance public expenditure. The revenue sources are of three types: own revenues, shared taxes and official transfers/grants. It should be mentioned, that Armenia does not implement local own taxes. Shared taxes in Armenia include Land Tax-100%, Property Tax-100%, Income Tax-15%, and Profit Tax-15%. The collection of land tax and property tax are imposed to local government, but the central government levies the income tax and the profit tax. However, since 2002 local budgets do not receive shared revenues from income and profit taxes. The main problem is disagreement between central and local authorities on the issue of origin-based or destination-based tax accounting.

Own revenues include local duties and charges, land and real estate rentals, as well as revenues from privatization. The latter has played an important role especially after the 2000. All own revenues are about 25 percent of totals in recent years.

The other great part of local revenues is official (state) transfer/grant. It has two main objectives: reduce both vertical fiscal imbalances and horizontal disparities. The significant annual resources of official transfers are troubling; they are about 55 percent in local budget. In this case, the independence of local authorities is at risk.

The tax assignment justification on the ground of redistribution and stabilization is not deeply applied in the economic relations of Armenia. All tax rates are stable and the progressive (except individual income tax), regressive taxation, or other tax instruments in order to reduce the differences of income between sub-national jurisdictions do not exist. The progressive individual income tax implements very limited stabilization function and

this measure is not sufficiently effective, as the apportionment of this tax is very little (10% in state budget) within the total tax revenues.

The revenue assignment is not justifiable by the benefit principle. In order to discuss this principle, it is necessary to consider market mechanism. It is evident that market mechanism generally produces an efficient allocation of resources. However, the market is not free because of two main reasons: internal and external. The internal reason is the high monopolization of the economy. According to the international organizations' assessments, about 40 percent of the economy's real sector is highly monopolized. The external factors of market failures are external economic effects, which arise because of politically instable situation in South Caucasus over the last two decades. As the market mechanism is closely connected with benefit principle of taxation, the principle is not introduced in necessary level. Tax payments do not reflect costs and benefits of public services. For example, the property tax is wholly assigned to the local government. About 60 percent of this tax in rural communities includes resources collected from cars. However, these resources mainly directed to administrative expenditures of the local government. Therefore, the local government is not assigned taxes that are related to the benefits of its spending.

The principle of subsidiary in taxation is partially performed in economic policy. Local governments are assigned with power of collection and expenditure of land tax and property tax, but have no authorities to define tax base and tax rate.

Local government efficiency is one of the problematic issues in Armenia. As they have limited power in revenue assignment, and own revenues are not appropriate with public expenditure, taxpayers (the population in general) are not very interested in activities of local bodies. Public interests are oriented generally to the central government. So the public control to the activities of local government "is limited by law", and accountability of local authorities is in insufficient level.

Tax exporting and tax competition have no great impact over the local revenues in Armenia. The reason is that own revenues is very little in sub-national governments. Local governments receive the significant part of revenues for the public expenditure as shared taxes and official transfers/grants. Competitions from producers located in different or the same sub-national government jurisdiction, as well as tax shifting to consumers is not the subject of great economic or financial imbalance.

Tax administration for local governments came into force only 2002 for land tax and property tax. By this point of view, the revenue assignment methods in Armenia cannot provide fiscal decentralization for the public expenditure prescribed by the laws.

Overall, we may say that the revenue assignment is not correspondent with democratic development and public needs in Armenia. It is important to note that now Armenia is in the process of financial decentralization, and amendments have been made in corresponding laws, which define many functions of local government for this purpose, but still there is a need for developing the mechanisms for implementation.

### **Intergovernmental Transfers in Armenia**

Intergovernmental transfers have immeasurable role for local government in Armenia. As own revenues are very little for maintaining the local infrastructure, as well as implementing the public administration and investing in social projects, the transfers shared by central government are very important to provide effective functioning of the local government system. There are two types of transfers:

- transfers with no specified direction of spending (subsidy)
- transfers for special projects.

The total amount of first type of transfer (subsidy) is defined by law. It consists of 4% of total state budget revenue. The second one has no a stable quantity and is defined in the result of negotiations between central and local governments. The share of annual transfers is more than 40% in total local budgets. Within this revenue the share of first type of transfers are much more. Although the total amount of transfers increase for each year the proportion of grants in local revenue sources tend to reduce. The reason is the tendency of own revenues increase.

It should be noted that the general purpose of intergovernmental fiscal relation is political and strategic control over the activities of local authorities. The factors of vertical and horizontal imbalances are not accounted deeply in the calculation of grant sharing.

There exists differences in fiscal capacities and expenditure needs among regions, and these reasons brings difficulties in measuring the imbalance between the expenditure needs, expenditure responsibilities and revenue assignment.

The subsidies are shared by formula. There are two factors on which the formula is based:

- a – per capita land and property taxes in the community,
- b – number of population in the community.

Communities having population less than 300 people receive subsidies not in accordance with the formula, but the annual Law on State Budget of Republic of Armenia.

Subsidies under “a” factor are shared for all community budgets where per capita revenues from land and property taxes are lower than the state per capita of total amount of land and property taxes and subsidies designed for communities under factor “a”. Based on this principle the amount of a subsidy to be shared to an individual community (except those with population less than 300 people) is defined with the following formula:

$$S_i = (R_r - R_i) \times P \times E$$

Where

$S_i$  – the amount of subsidy shared to community “i” under the factor “a”,

$R_r$  – the republican per capita of total amount of land and property taxes and subsidies designed for communities under the factor “a”,

$R_i$  – per capita of total amount of land and property taxes of the community which is lower than the republican per capita of total amount of land and property taxes and subsidies designed for communities under the factor “a”,

$P$  – the number of population of the community,

$E$  – the average equalization ratio, calculated according to the formula including factors such as earthquake zone, border community, mountainous region, etc.

Subsidies under the factor “b” are designed for all local governments (except those with population less than 300 people), multiplying the number of population by per capita subsidy.

Thus, intergovernmental transfers in Armenia are estimated in three ways: the subsidies for communities with less than 300 people population, subsidies under the factor “a”, and subsidies under the factor “b”. After the final estimation the communities receive subsidy. This type of grant estimated as unconditional matching transfers.

Transfers for special projects have conditional nature. Law does not regulate these transfers, and the only regulation is the order of the Minister of Finance and Economy of RA (renamed into Minister of Finance since 22 April 2008). Transfers for special projects are intended to increase the economic and social imbalances between poor and rich communities. In Armenian case there are many communities having poor budgets for providing significant local services solely without subsidies or grants for special projects. These factors have tendency to limit local governments’ independence. It should be noted that equalization system is only intend for solving the issues of fiscal capacity and expenditure needs, and far from stimulate of effort to raise own revenues.

Thus, the transfer system in Armenia is implemented according to revenue sharing formula based scheme. However, there is also a little part of transfers allocated out of formula, such as constant amount assigned to the communities with population less than 300 people, and transfers for special projects received in the result of negotiations.

## Conclusion

One of the essential tasks of local government in Armenia remains the field of social responsibilities. This sphere has dual subordinate between central and local governments and unclear division of responsibilities. The main problem is the cooperation between local government and state enterprises carried out the social responsibilities.

The existence of national standards set for social welfare, education, health and sanitation is not correspondent with international ones.

Fiscal autonomy has not high degree in Armenia. As mentioned above, tax assignment could not provide sufficient expenditure for public services. Own revenues are very little for fiscal autonomy; they are about 20 percent. The control over the marginal revenues is less because of administrative resources. Sub-national governments do not legislate and implement their own sources of revenues. In addition, they have not an authority to impose surcharges on the taxes levied by the central government.

The main factors of vertical fiscal imbalance and horizontal disparities are the centralized nature of finances and poor national resources. For neutralization of vertical fiscal imbalance and horizontal disparities, official transfers/grants are used. The experience of sharing intergovernmental official transfers/grants is very poor in Armenia.

It is evident that there is a problem in equalization grant scheme regarding the calculation and efficiency. Grants violate the incentives of local governments to rise own revenues. As local authorities receive transfers not depended of their effort, and the less own revenues the more transfers will be (according to the formula), they have no incentive to manage own revenue collection better. Grants discourage also the improvement of local services efficiency, which is the result of poor local budgets.

On another hand transfer system in Armenia has great stabilization impact. Since 2000, Communities receive stable revenues having opportunity to plan their annual budgets and reduce political and economic risks.

One of the most crucial problems in Armenian grant system is the measurement and administration of the grant. Now central government, local authorities and professional organization discuss the draft Law on Financial Equalization to introduce the new approach of calculating the expenditure need factors. There will be own revenue raising incentive factors in the base of grant formula calculation also. However, there is a lack of methodological, informational, statistical and technical capacity for providing the efficient ongoing of this process.

## **Literature**

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