

STRENGTHENING INSTITUTIONAL FRAMEWORKS FOR LOCAL GOVERNANCE

Country Study for Preparing Local Finance Benchmarks: Armenia

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Political and administrative structure

Armenia obtained its independence from the Soviet Union back in 1991 and the successive years were those of radical reforms and transition to new political and economic systems. Within these reforms an important role was assigned to the establishment of local self-government system. The Constitution of the Republic of Armenia (RA), adopted in 1995 laid the first and most important legal base for this, guaranteeing local self-government in Armenia. Two other legal acts, the “Law on Local Self-government” and the “Law on Territorial-Administrative Division” followed after the adoption of Constitution setting the framework and main principles of the system. The first local self-government elections were held on 10 November, 1996 which is considered the official date of establishment of local self-government system in Armenia.

The RA Constitution stipulates that the territorial-administrative units of the country are the regions (marz) and communities (hamaynq). The overall territory of the country is divided into 10 regions (marzes) and the capital city, Yerevan. While the capital had a status of region originally, the amendments in the Constitution in 2005 changed the status of Yerevan, defining it as a community. The specifications of territorial administration and local self-government in the city are described in the “Law on Local Self-government in Yerevan”. Regions are in fact the second tiers of government and state governance is being held there. As such, regional authorities are a part of central government, implementing the regional policy of the central government and thus not having the authority to adopt their own budget and set taxes and fees. The respective central authority responsible for the development and implementation of regional and local policy is the Ministry of Territorial Administration and Emergency Situations of the Republic of Armenia.

The regions are further divided into urban and rural communities (municipalities). Communities are the lowest tiers of government and local self-government is being held at this level. Communities consist of one or more settlements, but the settlements are not separate administrative units. Local self-government authorities are the Head of the Community and Community Council. The Head of the Community is the Executive authority and the Community Council is the representative body of government. Both the head of community and community council members are elected for 4 years on the basis of majoritarian elections. The number of Community Council members depends on the population of the municipality and varies from 5 to 21 people. Yerevan as already mentioned above is a special case with proportional elections of local government authorities.

Nowadays, there are 915 communities in Armenia (866 rural and 49 urban), including the capital Yerevan. This number is large enough for a country with population of around three million people. As a result the average population per municipality is about 3500 people. Considering that the population of Yerevan is above 1 million, the average population per municipality (without Yerevan) is about 3000 people. 442 or 48% of above mentioned 915 municipalities have population of less than 1000 people, 197 or 22.7% less than 300 people, 75 or 8.6% - 301-500 people, 168 or 19.3% -501-1000 people.

<i>Population size</i>	<i>Number of elected local</i>	<i>Population</i>
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	<i>governments (municipalities)</i>	
<300	197	37241
301-500	75	30472
501-1,000	168	115453
1,001-10,000	432	1106887
10,001- 100000	40	588,190
>100000 (without Yerevan)	2	251940
Capital city	1	1,107,817
Total	915	3,238,000

In addition the municipalities vary greatly in territory, number of population, geographic conditions, as well as in socio-economic level of development, financial and human resources. In spite of the mentioned differences, all the communities have the same powers and responsibilities by the law. Majority of the above mentioned small municipalities, obviously lack financial, human resources, appropriate infrastructures, and as a consequence are not capable of meeting mandatory powers and deliver proper level of public services which is in immediate conflict with crucial interests of the population.

Local government functions

As already mentioned above, all municipalities in Armenia in spite of their size, population, resources, capabilities etc. are given the same competences by law. Yerevan is the only exception and the scope of competences of Yerevan authorities substantially varies from that of other 914 municipalities. However, though the city is regulated by separate law, separation of competences and responsibilities is similar to others.

Competences (functions) of local self-government bodies are stipulated by the “Law on local self-government” and divided into two main groups: own competences and delegated competences. Own competences in their turn are divided into mandatory and optional ones. The list of own mandatory competences, as well as their implementation mechanisms are regulated by the above-mentioned law. Though the law predetermines some optional competences as well, this list is not comprehensive and local self-government bodies are free to implement any activity which reflects the interests of community as optional competences. However, mandatory competences are prioritized and subjected to primary implementation.

In addition to own competences of local self-government bodies, some of the state functions can be transferred to local authorities as delegated competences/responsibilities. In contrary with own competences which are funded by local budgets, the funds for delegated responsibilities are completely allocated from the state budget.

The functions of local self-government bodies can be clustered in the following 14 fields:

1. Rights of citizens and economic entities: This group of own competences of local authorities include protection of rights and interests of the citizens and economic entities; registration of the population; regulation of assemblies. Within this field of competences the head of the community implements such delegated powers as determining tutelage and guardianship; organization of registration of civic acts and

ratification of testament in case of the absence of notary. Since 2013, under this cluster of activities a separate sub-group is added on public participation in local self-government. With this regard local authorities ensure the preconditions for citizen participation in local decision-making and organize public hearings and discussions of the most important local documents, including the community development plan and annual local budget.

2. Finance: The financial competences of local authorities include planning, development, approval, implementation and reporting of the community budget; setting the types and rates of local taxes, fees and charges within the higher and lower tax-rate limits; organization of collection of local taxes, fees, charges; ensure targeted spending of the budget; when agreed with the state designated agency (RA Ministry of Territorial Administration and Emergency Situations) make decisions of local credits, lending and issue local bonds.
3. Maintenance of public order: In this field local authorities do not possess own responsibilities, but are in charge of the delegated power to require the support of police for implementing their responsibilities and can inflict administrative responsibility in the cases of breaking the law.
4. Regulation of public events: Here the competences are limited to being informed of any public event happening in the community and in certain cases, set by law, prohibit these events.
5. Organization of Defence: Local authorities' mandatory responsibilities in this field mainly cover the registration of military servants, while as optional functions they can support to social protection of the families of military servants and organize youth education events on military-patriotic issues.
6. Urban development and public utilities: Mandatory own competences include the development and adoption of urban development plans, maps and documents; giving construction, re-construction and demolition authorizations; control of targeted use and protection of existing buildings; authorization for external advertising; organization of the work of public utilities; organization and management of water, sewerage, irrigation, heating systems; organization of scavenging, renovation and landscaping. As optional competences local authorities can implement construction/re-construction works of social buildings; organize protection and care of resort areas etc.
7. Land-use: As mandatory competencies local self-government bodies ensure the development of land sale annual and four-year plans; can sell or rent the land; prevent illegal land-use. Within the optional responsibilities local authorities can improve the existing land.
8. Transportation: Local governments are in charge of maintenance and protection of intercommunity roads and organization of intercommunity transportation.

9. Trade and services: In this field local authorities give authorization for selling excise products; authorization for organization of trade, entertainment, gaming and lottery.
10. Education, culture and youth work: The main mandatory competence in this sub-category is organization and management of the activities of public schools, kindergartens, cultural houses, libraries. Within optional competences local authorities can organize holiday, remembrance day events; support to the preservation of cultural heritage; raise the role of youth in the community etc.
11. Sport: In this field local self-government bodies organize the work of sport institutions in the community.
12. Labour and social protection: Local authorities are not given any own competences in this field, and the only delegated responsibility is the organization of local social support centers.
13. Agriculture and Veterinary: Local authorities' responsibilities include the operation, construction and renovation of irrigation systems; registration and authorization for having pets in urban areas;
14. Environment: The organization of protection of land, forest and water resources is a mandatory competence and as delegated responsibility local self-government bodies implement environmental protection and perseverance of local resources of pollution¹.

Overall, local authorities possess quite broad range of competences by law. However in many cases local governments lack enough resources, including not only financial capabilities but also human potential, developed infrastructure etc., which hinders the successful implementation of these competences and provision of basic public services.

Local government own and shared revenues

In parallel with the above-mentioned competences local self-government bodies are given the right to develop and adopt local budgets having the full responsibility for spending it. According to the RA law on "Budgetary System" of Armenia there are two levels of budget in the country. These two levels together represent the consolidated budget. The first level is the state budget, the revenues of which are generated from the following sources: 1) Tax revenues, 2) Charges, 3) Official transfers, 4) Other revenues. The second level respectively is the community budget (local budget).

Local budgets consist of two parts, namely the administrative or current budget and the capital budget. The administrative budget revenues include the following sources:

1. Tax revenues, which in their turn consist of

¹ The list of competencies of local authorities is provided based on the "Law on Local Self-government" (2002).

- ✓ local taxes
 - land tax
 - property tax
 - hotel tax
 - parking tax

Hotel tax is not being charged currently due to lack of regulation in the field. This is to say, that this tax type was added among local taxes in recent years and the law which will regulate the details is still under discussion. The one called parking tax is more often considered as fee and does not have considerable share in local budget. The main sources of local own revenues are the land tax and property tax.

- ✓ shares from state taxes and mandatory payments
 - shares from income tax
 - shares from profit tax
 - shares from environmental payments

Under this subgroup the law sets shares from income tax and profit tax as local revenues, but again in practice the communities do not benefit from this, as currently the share is set to 0%. The only shared source of revenue is currently the share from environmental payments. The share rate to be allocated from central level to local governments is set by the central government.

- ✓ penalties and fines.

2. User charges

- ✓ State charges
 - Charges for registration of civic acts
 - Charges for notary services

As described above, the mentioned activities are delegated responsibilities of local governments and therefore the revenues go to local budgets.

- ✓ Local charges, including mainly
 - Charges for authorisation for construction, re-construction, demolition,
 - Charges for authorisation to sell excise products,
 - Charges for authorization for organization of trade, entertainment, gaming and lottery
 - Charges for authorization of external advertising,
 - Charges for local transportation
 - Charges for pets etc.

Local charges are also among the main sources of local own revenues and an extensive list of local charges is set and regulated by separate law on “Local Charges and fees”. An new concept paper on local charges and fees, as well as amendments to the mentioned law are currently under discussion in the government with the purpose of adding new charges in order to raise own revenues of local self-government units.

3. Other revenues including local fees, revenues collected from the leasing of local property leasing, transfers from the central government for delegated responsibilities, deficit funding resources, including credits from the state budget and/or other municipalities, unused revenues of the administrative budget from the beginning of the year.
4. Revenues collected from selling local assets.
5. Official intergovernmental transfers (to be discussed separately below).

Overall, the current (administrative) budget can be spent for current expenditures related to own mandatory and optional competencies of local government units; for delegated responsibilities; payments for current lending as well as the lending expenditures to other local self-government units.

Main sources of the capital budget revenues are as follows:

1. Official transfers, including both the intergovernmental transfers from the state budget (capital subventions) and the ones received from other sources with the purpose of funding capital expenditures.
2. Revenues collected from selling local property (non-financial assets).
3. Deficit funding resources, which include loans from the state budget and other sources.
4. Other revenues, including unused revenues of the capital budget from the beginning of the year, as well as allocations to the capital budget from the reserved funds of the administrative budget, etc.

The revenues of capital budget are mainly spent for the following expenses: capital expenditures for own mandatory and optional competencies; credit payments and lending to other local self-government units. The structure of local government revenues is pictured in the Annex 6.

As already mentioned above, the considerable part of local budget revenues is generated from local taxes i.e. land and property taxes. The RA “Law on local self-government” stipulates that the Head of the community is presenting to the approval of Community council, the types and rates of local taxes, charges and fees, which means that local self-government bodies possess the autonomy of setting the tax base. However, the rates for both of currently existing local taxes are set by national legal acts, namely respective laws on “Land tax” and “Property tax”. One reason for this can be the fact that the above-mentioned laws have been adopted long before the existence of local self-government system. Similarly the above discussed laws stipulate tax relief cases for both citizens and/or organizations. Local authorities, nevertheless, can set tax relief for both land tax and property tax, but the local relief sum for each tax cannot exceed the 10% of planned local budget revenues of the ongoing year. Thus, according to the Organisation for Economic Co-operation and Development (OECD) taxonomy of taxes Armenian local government units’ authority for setting the tax rates corresponds to c.3. group. In other words local self-government units set tax reliefs, including tax allowances and tax credits.

In contrary to the case of land tax and property tax, local self-government bodies possess the autonomy for setting the rates of local user charges and fees. As already mentioned above, this field is regulated by separate law on “Local charges and fees”, which describes the types of both local charges and fees. However, it is important to note that the law also sets minimum and maximum limits for some charges and fees and only maximum limits for the remaining. Accordingly within the defined tax types and rate limits, local community council makes the final decision of setting the charge/fee rates.

Tax administration

Tax collection has originally been considered as state responsibility and since their establishment local self-government bodies have been implementing the collection of land tax and property tax as a delegated responsibility from the state. Since 2009, tax collection as well as the right for setting fines/penalties for late payments are given to local authorities as own mandatory competence.

Tax collection in the communities, especially in the rural ones has been problematic for local self-government units for a number of years. First of all, the local governments inherited the local tax databases with huge debts (not paid land and property taxes) accumulated over 90s. Besides, in rural small communities, which as mentioned above comprise a vast majority of all municipalities, the economic situation and living standards are often harsh and many families face difficulties for even paying the basic taxes. Moreover, as a result of socio-economic conditions, the level of migration is very high in many rural areas. Consequently, in many cases households, families owning the land and/or the property do not actually live in that community to pay the taxes.

Nowadays, in spite of certain progress tax collection is still not always smooth and remains an issue in many rural communities. The designated state agency of the field, RA Ministry of Territorial Administration and Emergency Situations, implements monthly monitoring of local budget revenues and huge attention here is paid to tax collection rates. Regional governments (marz level) receive this data from each municipality on monthly basis and deliver it to the Ministry. The monthly monitoring reports are open to public and are regularly published in the official website of the Ministry (<http://www.mta.gov.am/hy/budgetary-incomes/>)².

Practically, tax collection rates are often considered as a good indicator for evaluation of both local self-government bodies and regional governments. For example official annual evaluation of regional government authorities (Governors) is made by the Ministry and tax collection rates are among the evaluation criteria. Additionally, tax collection is a field where some communities display initiatives. For example some local governments use mobile applications to send reminder for paying local taxes. Consequently, tax collection can be among benchmark areas for communities (Annex 1).

² A huge database containing monthly, quarterly and annual reports on local budget revenues and expenditures since 2008, is available on the official website of the Ministry of Territorial Administration and Emergency Situations and is regularly updates on a monthly basis. However, the information is available in Armenian language only.

Intergovernmental transfers, fiscal equalization

Apart from own and shared revenues of municipalities, already discussed above, a considerable part of local budgets consists of transfers from the central government. In order to comprehend clearly the principles of intergovernmental transfers system in Armenia it is important to consider certain circumstances.

First of all, there are considerable vertical fiscal imbalances in Armenia. As already mentioned above, the majority of municipalities in the country are very small by the size of population. This generates problems in terms of financial resources. Despite the limited financial capabilities, all municipalities are given quite large scope of competences and as a result many local governments are not financially capable to meet their own responsibilities and provide proper level of public services. In other words expenditure responsibilities of many municipalities exceed greatly their own revenues.

Secondly, there are also huge disparities between the municipalities. Particularly, municipalities in Armenia vary greatly not only in terms of population (for example, while the smallest municipality in Syuniq region called Qashuni has population of around 20 people, the city of Gyumri with around 200 000 inhabitants is bigger 10 000 times), but also occupied territory, geography, natural resources and therefore in financial capacities and socio-economic level of development. In spite of all these disparities, all the municipalities, with the exception of capital Yerevan, have the same powers and responsibilities by law. This is in immediate conflict with crucial interests of the population in these smaller and therefore weaker municipalities, taking into consideration, that regardless of the fact in which part of the country a person lives, one has the right for basic public services.

Thus it can be concluded that the funds from central government are mainly transferred to local government level considering the above-mentioned important factors. This is to say that on one hand, the state government uses intergovernmental transfers with the purpose of decreasing this unevenness of revenues and expenditures. On the other hand, intergovernmental transfers in Armenia aim at reducing these huge horizontal disparities among the municipalities.

According to the RA law on "Budgetary system" as well as law on "Local Self-Government" there are two main types of transfers from state budget to local budgets in Armenia.

- ✓ Financial equalization grants
- ✓ Other grants and subventions

The proportion of subventions and financial equalization grants in total amount of intergovernmental transfers is far not balanced. Financial equalization grants have much bigger share in total intergovernmental grants compared with subventions. Moreover, it is the capital Yerevan that receives a considerable amount of subventions, while regions get much less (Annex 7).

Subventions

Subventions are conditional transfers from the state budget to the local ones with specific purposes. In most of the cases with these transfers the central government of Armenia

encourages capital investments in certain sectors, which are prioritized for that period of time. Subventions are directed exceptionally to the capital budget. Thus, these transfers are allocated to local governments with specific purposes and can be required back by the central government in case they are spent in a different way. In addition it is worth mentioning that subventions are non-matching transfers, as far as the municipalities who receive the subvention, do not necessarily have to co-finance the programs.

The order of allocation of subventions from the central government to local governments is stipulated by the RA Government by the respective government decree from 2006. According to that in order to receive subventions heads of communities need to send appropriate applications to the regional authorities. Regional authorities send it to the state agency responsible for the specific sector indicated in the application as well as to the RA Ministry of Territorial Administration and Emergency Situations after discussing and summarizing them. For example, if the municipality applies for a subvention in the field of education, the application will be sent to the Ministry of Education. As far as Yerevan is not included in any region, their applications are sent directly to the responsible agency and to the Ministry of Territorial Administration and Emergency Situations. After joint discussions these state bodies either confirm the applications, accordingly including the subvention expenses in their budget of upcoming year and sending them to the Ministry of Finance for final confirmation or reject them.

Thus, it can be concluded that the main decision-making actors here are the respective state agencies, responsible for the field of subvention applied, as far as they are the ones to decide whether the suggested expenditures (subvention) should or should not be included in the draft of their budget and, of course, the Ministry of Finance as state designated agency in the field of finance. Eventually the state budget is approved by the Parliament therefore the Parliament is among the main decision-makers as well. Though the applications for subventions go through regional authorities, they actually do not play a significant role, being responsible mainly for collection and summarizing of all the applications from their regions. However, as the total amount of subventions is not determined, it is very important to note that the chances to receive the subvention is of great extent dependent on the quality of application. Taking into consideration that, as described above the majority of municipalities, especially the rural ones, are often lacking capacities, including appropriate human resources, the bigger and comparably stronger municipalities, have better chances to receive these transfers. Given that conditional non-matching transfers generally aim at encouraging certain policies, another reason behind that phenomenon might also be related with Governments' priorities of encouraging the different policies in different regions of the country.

Thus, it can be concluded that there are no explicit criteria for assessing the applications and thereby accepting or rejecting them with regards of subventions. As a result the decisions made by responsible state agencies can sometimes be subjective due to lack of clear regulations.

The major part of intergovernmental transfers in Armenia comprise financial equalization grants. In contrary with subventions, financial equalization grants are unconditional transfers from the state budget to the administrative part of local budgets. According to the RA Law on "Local Self-government" they are allocated with the purpose of harmonic development of all communities and there can be no restriction on the directions of spending the money. Thus by financial equalization grants the central government aims at increasing financial recourses of the

recipient municipalities, but local governments are free to decide on the directions of spending the money.

Financial equalization grants

The system of allocation of financial equalization grants is clearly regulated. The above-mentioned law on “Local Self-government” stipulates the distributable pool of the equalization grants. First of all, according to this law the total amount for a certain year to be transferred is calculated taking into consideration the consolidated budget of the second preceding budget year, and should be at least 4% of actual consolidated budget revenues. For example, the total amount of equalization grants for 2015 will be minimum 4% of consolidated budget revenues of 2013. This makes the system not only stable, but also predictable for local governments. Moreover, local governments start the local budgets’ planning process right after having preliminary calculations of financial equalization grants for the succeeding year. It is worth mentioning that until 2011 the total amount of these grants has always been set at the minimum level of 4%. However, considering the influence of financial crisis on consolidated budget of 2009, the Government increased this floor to 4.6% for 2011 in order to at least keep the same total amount of equalization grants as in 2010. The same principle was applied for 2012. Given the importance of financial equalization grants for local budgets the Government thus softened the negative influence of crisis on local budgets.

Further details on the distribution of equalization grants are defined by the RA Law on "Financial Equalization". First of all the municipalities are divided into two main groups:

- 1) Municipalities with population of not more than 300 people
- 2) Municipalities with population of more than 300 people.

Besides, the following two criteria lay on the basis of calculation of the amount of financial equalization grant each municipality will receive:

- a) The amount of per capita land tax and property tax (factor "a")
- b) Population of the municipality (factor "b").

All the municipalities with population of less than 300 people receive equal amount of financial equalization grants. This amount is determined in the state budget of each year. Currently, since 2010 it is 3,500,000 AMD. The total amounts of grants allocated by accordingly factor "a" and "b" are also determined in the state budget for each year.

The amount of grants for the municipalities having population of more than 300 people is calculated based on the above mentioned two factors. Particularly, factor "a" considers the level of per capita land tax and property tax of each municipality. This "a" factor grants are for those municipalities whose level of per capita land tax and property tax is below of the average of the country ($I < M$). The municipalities whose per capita level of land tax and property tax exceeds that of capital average ($M < I$), are not entitled to receive equalization grant under factor “a”. Accordingly the following formula is used for calculations:

$$A = (M - I) \times N \times F,$$

Where, A is the amount of equalization grant for a particular municipality, allocated by factor "a".

M is the average per capita level of land tax and property tax (including Yerevan, as the city is entitled to receive financial equalization grants by the same law).

I is the per capita level of land tax and property tax of the particular municipality

N is the number of population of the municipality

F is the average regulatory factor.

The detailed formulas determining the calculations for M and F are also described by the same law.

The grants by factor "b" are allocated to all municipalities (with the exception of those with not more than 300 people) by dividing the total amount of grants by factor "b" to the total number of population of the country and multiplying that with the number of population of the particular municipality.

To sum up, the current system of determining and allocating financial equalization grants is thoroughly regulated, which makes the system predictable enough for local governments. In addition the system is rather straightforward and clear and thus ensures the overall transparency of allocation mechanisms of equalisation grants. However, time has revealed a number of weak sides of the system as well. First of all, this system of allocation of financial equalization grants lacks incentives for municipalities for raising their own revenues, as far as for example when having a higher level of per capita land tax and property tax they will receive less equalization grants. Moreover, there are no any links between the level of delivered public services by local self-governments and the amount of equalization grants received (Movsisyan, 2007). This means that local authorities do not necessarily have financial incentives for providing better level of public services. Besides, the system concentrates on local revenues only. Particularly, while considering financial capacities of the municipalities, their needs are not taken into consideration, as far as the calculation formulas do not include any components addressing the real needs and expenditure specifications of the municipalities (Movsisyan, 2007). Last but not the least, the current system of financial equalization foresees grants to all the municipalities, including the ones that are much richer compared to the others. For example the capital Yerevan, where most of the economic activities of the country and around one-third of all population is concentrated receives a considerable share of all financial equalization grants. As a result the disparities between the capital and other cities are not decreasing and hence the initial objective of horizontal equalization is not being met completely.

To address the above-mentioned drawbacks, the central government initiated a new approach towards financial equalization grants system, drafting a completely new law on "Financial equalization". Currently this draft is in the process of discussion and has passed the first review in the RA National Assembly.

Comparing to the existing system, the proposed one seems to address many of the weaknesses. Particularly it suggests the advantage of consideration of more factors (the distance from Yerevan and the regional center, number of settlements in the municipality, access to infrastructures etc.) instead of focusing on tax revenues and population only. Based on the mentioned factors expenditure needs are calculated per municipality and per capita. Given the issue of small municipalities in the country, another advantage can be considered its particular attention to small municipalities, consideration of the low level of own revenues in the local budgets and income capacity of municipalities.

Administratively the process of allocation of financial equalization grants is in parallel with the State budget document approval. The Ministry of Finance is in charge of calculation and further distribution of these grants. The municipalities receive these allocations on quarterly basis. Together with state budget documents the annexes on financial equalization grants are available in the database of the Ministry of Finance. Additionally the information on both subventions and financial equalization grants is also included in the local revenue reports available in database of the Ministry of Territorial Administration and Emergency Situations mentioned above.

Local borrowing

According to the law on “Local self-government” local authorities, particularly the Head of community when having the approval of the Community Council can receive credits and lending with the purpose of local budget expenditure implementation. However, it is important to note that local authorities can receive credits and lending only in the case of prior approval of the state designated agency in the field i.e. Ministry of Territorial Administration and Emergency Situations. Besides, the annual amount of credit expenditures cannot exceed the 20% of community budget. Each municipality can take a credit only after paying back the previous one and the credits can be allocated to the capital budget only.

In order to be able to take credits the municipality must have guarantees. As such guarantees can be considered only community budget revenues or RA Government guarantees. Practically, majority of municipalities, again as already discussed above, do not have enough financial resources to be considered for credits from commercial banks. Similarly, the Government rarely guarantees communities for taking credits. Moreover, the Ministry of Territorial Administration and Emergency Situations is often not encouraging the municipalities to take the bank credits due to previous unsuccessful experience of some communities. Another legal authorization, opportunity given to municipalities is issuing local bonds. However, likewise the credit system the issuing of local bonds, remains on paper only.

An interesting practice of lending/borrowing exists among the municipalities. Local authorities can borrow from another municipality respectively when agreed with each other and state designated agency. However it should be noted that this lending amounts are directed for funding current expenses and accordingly are reflected in the administrative (current) budget.

Overall the system of local borrowing in Armenia is quite vague and subject to further regulations and development. In practice only a few communities have capabilities for local borrowing.

Local financial management

First and foremost local authorities are responsible for developing and approving the most important documents i.e. community development plan and community budget, thus setting strategic priorities for the development of community.

Community development plan is a 4-year strategic development document for any community. Once elected, the Head of the community develops the draft of this document and presents it for the approval to the Community Council members. The council discusses the draft, can make changes, amendments and approves. Community development plan is the main strategic document which should reflect the community interests and set realistic and feasible goals. Its timeframe of 4 years is based on local self-government bodies' election term. This document should be the guideline not only for annual or shorter-term projects but also for the annual local budget. It is important to mention that apart from the community development plan, the RA legislation does not stipulate any obligations for municipalities to have strategic development plans. Hence, the main strategic development document is the 4-year plan. However, a few municipalities (mostly big cities) have long-term strategic development plans as well.

The community budget is an annual financial plan of local revenues and expenditures aimed at the implementation of above-mentioned community development plan and competences of local authorities. Likewise the development plan, local budgets are also developed by the Head of community and approved by Community Council members. The head of community presents the budget draft to community council's discussion as soon as receiving preliminary amounts of financial equalization grants for the succeeding year from the Ministry of Finance. Community council members can present written suggestions and/or discuss them during the community meeting. In the cases when such suggestions require additional expenditures, the council member should also point out the corresponding funding sources. In the cases when the budget is not approved by the community council by the beginning of the succeeding year, the expenditures are made according to the budget of the previous year. Additionally, the head of the community can suggest his/her resignation when the budget is not approved and in case of community council does not make decision of the resignation of the Head of community within three days, the budget is considered approved.

During the budget preparation process the state designated ministry in the field i.e. RA Ministry of Finance as well as regional authorities provide methodological and consultancy assistance to the communities. In addition, the mentioned authorities hold overall control over the budget procedure. Nonetheless, it is important to note that the control over community budget implementation is the responsibility of community council. The latter is competent to check any budget activity, quality and effectiveness of budget implementation and require reports on budget expenditures. Moreover, to ensure more specialized and effective control, community council members can involve professional auditing companies. These companies will be paid from the local budget.

As described above, local budgets consist of current or administrative and capital parts and the revenues for each part of the budget are stipulated by national legal acts. Apart from budget separation the national legislation also defines other preconditions/standards for community budgets.

Particularly, the community budget must be balanced and the expenditures for each administrative and capital parts cannot exceed the revenues of respective budget sections. In the

cases when the expenditures exceed the revenues, that is to say budget deficit emerges, the legislation suggests the sources of funding. These sources include local borrowing sources, the unused funds from the previous year, funds from selling local real estate etc.

Local budgets also have reserve funds, which can be spent towards unforeseen expenditures or extra funding of planned activities. The amount of the reserve fund of the current budget can be 5-20% of the current budget. The one in the capital budget cannot exceed 30% of capital budget revenues. Here it is important to mention that the unused funds from the reserve fund of the administrative budget can be transferred to the reserve fund of capital budget. However, the funds from capital budget cannot be directed to the administrative budget reserve funds, with the exception of special cases when these funds are transferred to cover the administrative budget deficit and are subject to return to the capital budget within the same budget year. Additionally, the cases of transfers from capital reserve fund to that of current budget must correspond to the regulations of RA government on this issue. All reserve funds can be used exceptionally with community council decisions.

In the context of recent improvements of legislation in the field of local self-government particular attention is paid to citizen participation during the management procedures of both community development plans and local budgets. This is to say that, in order to ensure active public participation in processes of planning and development, public discussion, implementation and control of 4-year community development plans and annual local budgets, local authorities formulate a consultative body (committee). This committee consists of relevant specialists from the staff of local governments and community organizations, independent experts and other interested parties. The further details of committee activities are regulated by community council decisions.

Apart from the committee involvement, the Head of community must organize public hearings and/or discussions on community development plan and community budget, before presenting the draft documents for the discussion with community council members. Head of community also provides the information of received suggestions, recommendations during the public discussions to the community council members.

The citizen participation regulations described above are in force only since mid 2013 and it is very hard to assess their practical implications. However, it must be noted that this is huge step forward not only towards encouraging the citizens to be involved in local level decision-making, but also towards ensuring more transparency and accountability of such important documents as community development plans and local budgets. With this regard it is also worthy to mention that some communities have been organizing public hearings and discussions before 2013 voluntarily. Some cities even organize live broadcasting of local budget discussions through their online portals. Similar practices refer to budget reporting procedures. According to the “Law on Local Self-government” the Head of the community quarterly reports to the Community Council on the budget implementation. Before presenting the annual budget implementation local authorities must organize public hearings and discussions, however, as already mentioned this is not yet always the case in practice. Meanwhile, some local authorities go a step forward regularly reporting to their population about the progress and overall development of implemented projects, respective expenditures and planned activities. In such cases often the factor of Head of the community plays vital role.

Thus, such issues as involvement of citizens in local decision-making, the access to important local documents, accountability and transparency of the local budget, the reporting practices can definitely be considered as potential areas for local benchmarking.

Conflict of interest issues are regulated to certain extent. For example, restrictions exist on community council members for occupying alternative positions. In particular, community council members cannot work in the same staff of local government, in community budgetary organizations moreover act as directors, managers of such institutions the community council member cannot be the Head of community at the same time, neither work in state security and judicial bodies. In the case of starting military service the council member must resign in the upcoming council meeting. However, in practice such cases of conflict of interest may arise as family relationships among heads of communities and council members. This particularly will concern the smallest municipalities, where the population is so small, for example 20-30 people, that the whole population of the community is just one big family.

The above discussed issue is closely interrelated with local management capacity in general and local financial management capacity in particular. As pointed out above several times, almost half of municipalities are very small by population, which results in such a serious issues as the lack of human resources. For that reason, very often local authorities do not have enough professionalism, educational and practical background for proper financial management. It is worth to mention here that the law on “Local self-government” does not stipulate higher education among the criteria and preconditions for being head of a community. Likewise, no regular or mandatory trainings are organized for elected officials and the existing ones are mostly on ad-hoc basis and supported by international donor organizations. In contrary, staff of local administration, particularly community servants (public servants) must participate in mandatory trainings once in every three year. These trainings follow specific training modules developed and approved by the central government in cooperation with academic institutions and are universal for all municipalities.

In general, local financial management can be considered problematic for many municipalities looking at it from different perspectives. However in many cases this is an issue of lack of professional human resources especially in rural communities.

Administrative and professional control can be implemented over the competences of local government units. The administrative control is held on own and delegated responsibilities and is limited exclusively to legal control, i.e. the respective authorities can only check whether the actions of local authorities correspond to legal acts or no. This is also called legal control. Regional authorities (marzpets) are in charge of implementing the administrative control based on the annual action plan approved by highest responsible authority (Ministry of Territorial Administration and Emergency situations in this case). Professional control is implemented over the delegated competences also by the regional authorities. In the case, however, the highest responsible authority is the one responsible for the field, for instance, the Ministry of Environment in case of environmental issues.

Implementation of LFB

Datasets on local budget revenues and expenditures are available both in the Ministry of Territorial Administration and Emergency Situations and in the Ministry of Finance. These

databases are public and can be found on official websites of the mentioned ministries. Additionally some municipalities also publish their budget reports on the websites (the links will be provided in the Annex 5).

The main obstacles that can be faced for the implementation of the LFB are as follows:

- ✓ Upcoming elections. In the majority of municipalities local self-government elections are to be held in fall of 2016. This may act as a hindering factor taking into consideration that local authorities may not be willing to get involved in additional initiatives and moreover might avoid the comparison with other municipalities. Furthermore, succeeding 2017 and 2018 are national election years respectively for the Parliament and the President. This also can obstacle the initiation of LFB implementation, as the ruling government may not start new project in the pre-election period.
- ✓ Lack of incentives for local governments to participate in the future LFB programme. In case if the involvement in LFB is organized on voluntary basis, most of the municipalities may avoid taking the additional burden, considering that they will not have clear incentives for this. Moreover the competition with other communities will also be risky for many municipalities.

The adaptation of the LFB toolkit in Armenia should be considered in the context of local context of local self-government as well as ongoing reforms in the field. As often discussed above majority of Armenian communities, especially the rural ones, are extremely small by population, lack enough infrastructures, financial and human resources and therefore are not capable to provide proper level of public services. Taking into consideration the above-mentioned, the LFB toolkit may be considered for urban communities for the beginning.

On the other hand the country is now undergoing large scale territorial- administrative reforms nowadays. Particularly the consolidation of municipalities is considered as the main option for addressing the above-mentioned challenges and therefore is in the top agenda of respective authorities. From one perspective these reforms may also obstacle the LFB implementation to some extent given that the whole attention of the respective agencies as well as the resources are directed to this particular target area. However, when looking at the issue from another perspective it should be noted that consolidation reforms aim at strengthening the capacities of local governments and fostering local development. The selected pilot communities are set as priority development areas and the initiation of LFB in the newly established, already consolidated areas might be of interest to respective bodies. An option can be the adaptation of the LFB toolkit within the large scale ongoing reforms. Additionally, this may also help to raise public awareness and interest for LFB toolkit.

The main state actor, potentially interested in the LFB implementation will be the Ministry of Territorial Administration and Emergency Situations. However, NGOs active in the field of local self-government and local finance can also be regarded as potential implementers of the project.

Annexes

<i>Annex 1. Summary of the proposed areas of benchmarking: local own source and shared revenues</i>	
National systems, level of decentralization: with references to Rec (2005) No. 1.-36.; 68.-72.	
<i>General principles</i>	
Area No.	Rec (2005). No. x
1. Local governments are entitled to own resources.	3
2. Resources of local authorities are not earmarked.	14
<i>Local taxation</i>	
Area No	Rec (2005). No. y
3. User charges and fees are a considerable part of local own revenues	68
4. Central government sets maximum charges for essential services and minimum charges for convenience services	71
Local governments: with references to Rec (2005) No. 9.-31.	
<i>General principles</i>	
Area No.	Rec (2005). No. x
5. Compensation of financially weak communities	10
<i>Local taxation</i>	
Area No.	Rec (2005). No. y
6. Local governments do not have authority to set the bases for local taxes	17, 19
<i>Fees and charges</i>	
Area No.	Rec (2005). No. y
7. Within the set limits local governments set the rates for fees and charges	18
<i>Other resources</i>	
Area No.	Rec (2005). No. y
8. Tax collection (?)	

<i>Annex 2. Summary of the proposed areas of benchmarking: fiscal equalization and grants</i>	
National systems, level of decentralization: with references to Rec (2005) No.37.-67.	
<i>Financial equalization</i>	

Area No.	Rec (2005). No.
9. The existing equalization system clarifies which local parties are eligible for financial transfers	44
10. Improvements in the system are considered to address the existing drawbacks.	47
<i>Grants to local authorities</i>	
Area No.	Rec (2005). No.
11. Local authorities are provided with appropriate information about the way in which equalisation systems works.	41

<i>Annex 3. Summary of the proposed areas of benchmarking: local borrowing</i>	
National systems, level of decentralization: with references to Rec (2005) No. 73.-76	
<i>Borrowing</i>	
Area No.	Rec (2005). No.
12. Local authorities are not allowed to take out loans to finance current expenditure	74
Local governments: with references to Rec (2005) No. 30.-31.	
<i>Borrowing</i>	
Area No.	Rec (2005). No.
13. Local authority's access to borrowing is restricted, in order to limit the risk of non-repayment and to avoid decisions that would transfer an excessive financial burden to future generations	75

<i>Annex 4. Summary of the proposed areas of benchmarking: financial and budgetary management</i>	
National systems, level of decentralization: with references to Rec (2004) No. 1.-43	
<i>General principles</i>	
Area No.	Rec (2004). No.
14. Local authorities are entitled to their own resources and freely dispose them in the exercise of their powers and responsibilities	1
<i>Limitations on financial autonomy</i>	
Area No.	Rec (2004). No.
15. There are established rules for drawing up, approving and implementing local budgets and for the supervision of their implementation	4

<i>Fiscal estimation methods</i>	
Area No.	Rec (2004). No.
N/A	
<i>Financial risk management</i>	
Area No.	Rec (2004). No.
16. Local authorities have the right to incur debts only for the funding of investment expenditure and not for current expenditure.	24
<i>Local elected representatives and employees</i>	
Area No.	Rec (2004). No.
17. It is not possible to delegate the adoption of the budget and the approval of the accounts to a committee or a body other than the local community council	5
<i>Control</i>	
Area No.	Rec (2004). No.
18. The external control procedure is defined by law and is limited to an examination of the legality of decisions.	28
<i>Recovery of local authorities in financial difficulty</i>	
Area No.	Rec (2004). No.
19. The central authority rarely guarantees the borrowings of local authorities.	34
Local governments: with references to Rec (2004) No. 44.-87.	
<i>General principles</i>	
Area No.	Rec (2004). No.
20. Local authorities develop and approve community development 4-year plan right after being elected	44
<i>Information and openness</i>	
Area No.	Rec (2004). No.
21. Public discussions, hearings on important local documents;	51,52
22. Encouraging citizen participation in local decision making	55, 56
<i>Budget preparation</i>	
Area No.	Rec (2004). No.
23. Local budget is prepared by financial unit of the municipal administration followed by prior discussion with respective field unites	57, 58
<i>Financial risk management</i>	
Area No.	Rec (2004). No.
N/A	
<i>Budget approval</i>	

Area No.	Rec (2004). No.
24. Public discussions, hearing of budget draft are organized, in some cases even public broadcasting is available	73, 74
<i>Budget implementation</i>	
Area No.	Rec (2004). No.
25. Community council receives regular information on the budget implementation	76
<i>Budget accounts</i>	
Area No.	Rec (2004). No.
26. Accounts are submitted to the council within a reasonable time and the approval of the budget is debated	79, 80
<i>Recovery of local authorities in financial difficulty</i>	
Area No.	Rec (2004). No.
N/A	

Annex 5. Availability of information and data on local governments

Ministry of Territorial Administration and Emergency Situations

Local budget Revenues - <http://www.mta.gov.am/hy/budgetary-incomes/>

Local Budget Expenditures - <http://www.mta.gov.am/hy/budgetary-expenditure/>

Local Budget publicity - <http://www.mta.gov.am/hy/budgetary-performance/>

Ministry of Finance

Local budget reports, including revenues, expenditures, deficits or leftovers and deficit funding sources - <http://minfin.am/index.php?cat=206&lang=1>

References, further readings, websites³

General information on local government system, as well as updates on news and recent development can be found in the website of the Ministry of Territorial Administration and Emergency Situations:

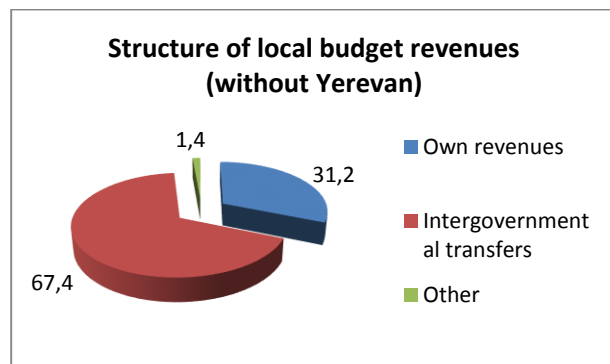
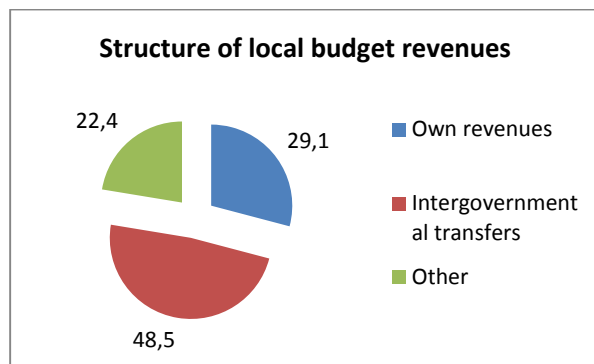
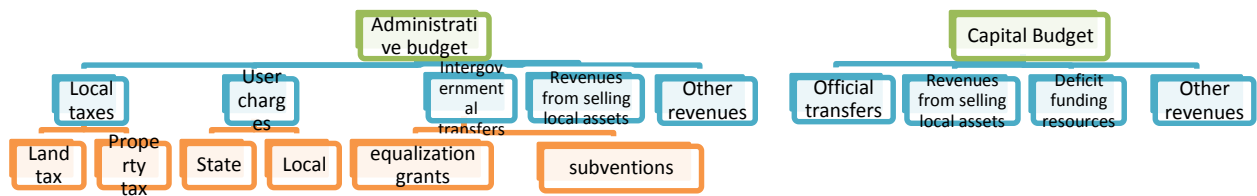
<http://www.mta.gov.am/en/>

³ Many further readings, articles are available in Armenian language only and therefore, are not included here.

A lot of publications, research studies, analytical reports concerning local self-government recent developments can be found in the website of one of the most active local NGOs in the field called Communities Finance Officers Association:

<http://cfoa.am/en/archives/category/publications-en>

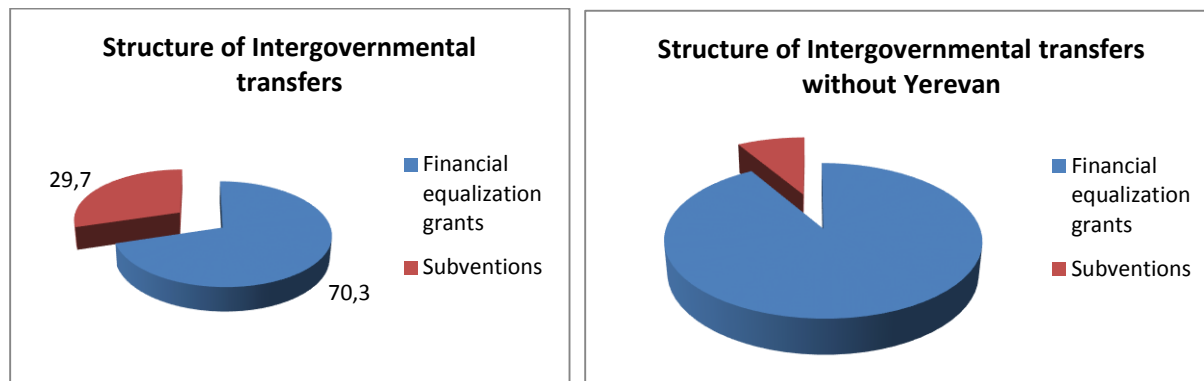
Annex 6: Structure of Local Government Revenues



Structure of local revenues				
	<i>Own and shared revenues</i>	<i>grants, transfers</i>	<i>other</i>	<i>comments</i>
Armenia	29.1%	48.5%	22.4%	Income and profit tax sharing ratio is 0% Separate data on shared revenues is not available. Environmental payments are included in own revenues calculations.

Source: Based on the data of the Ministry of Territorial Administration and Emergency Situations, 2014

Annex 7: Structure of intergovernmental transfers



Source: Based on the data of the Ministry of Territorial Administration and Emergency Situations, 2014

Annex 8: Scope of Decentralization in Armenia

Scope of decentralization			
	<i>Local expenditures in % of GDP</i>	<i>Share of local budget revenues in total budget revenues (%)</i>	<i>Share of local budget expenditure in total public expenditure (%)</i>
Armenia	2.5%	9.8%	8.9%

Source: Calculated based on the data of Ministry of Territorial Administration and Emergency Situations and Ministry of Finance, 2014

References

- Constitution of the Republic of Armenia, 2005
- Law on Local Self-government, 2002
- Law on "Budgetary System of the Republic of Armenia", 1997
- Law on Local Charges and Fees, 1998
- Law on "Financial Equalization Grants", 1998
- Government Decree on "Allocation of Subventions from the State Budget to Local Budgets", 2006
- Ministry of Territorial Administration and Emergency Situations of the Republic of Armenia: Data on Local Budget Revenues, 2014 <http://www.mtaes.am/files/docs/940.pdf>, Information is translated from Armenian by the author (accessed at 18.08.2015)
- Ministry of Finance: Data on GDP and Consolidated budget, 2014 <http://minfin.am/index.php?cat=41&lang=3> , (accessed at 18.08.2015)
- Movsisyan Vahan. *"The Development of Financial Equalization Mechanism in Armenia.* Yerevan, Noyan Tapan", 2007