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Subgroup of the WG1 on Local Government and Public Administration Reform

*Proposal for CORLEAP
17th of September 2012*

Rational

The Subgroup of Local Government and Public Administration Reform is working within the Working Group 1 (Democracy and Human Rights) of the Civil Society Forum for Eastern Partnership. It was established in 2010 and since then operated to engage our expert Civil Society Organisations in promoting local governments empowerment in the Eastern Partnership Countries and raise the focus on decentralization and administrative reform, engaging civil society and citizens.

The CSF EaP is a permanent observer of the established CORLEAP and participated in the launch in September 2011, in Poznan. Our members participated actively and the national level to bring proposals and to develop concrete projects to further strengthen the initiated decentralization and to strengthen the capacities of local authorities to implement their own tasks. A particular attention of the Subgroup LGPAR is to make sure the reforms will be engaged fully the citizens and will take in account their participation in decision making and implementation of future policies.

The Subgroup (LGAPR) presented in September 2011 a Position Paper to be addressed to CORLEAP and to the Committee of the Regions and to the local authorities of the EaP countries (and their national associations).

Assessment of the situation after the Position Paper of 2011

The Position Paper of 2011 called

- For the CoR and CORLEAP to bring high in the attention of the Eastern Partnership the Public Administration Reform, Decentralisation and consolidation of Local Governments in implementing the provisions of the European Charter on Local Self Government.
- For the local authorities of the Eastern Partnership (and their Association) to be engaged at the national level to further strengthen the role of decentralisation and functioning of Local governments in the agenda and priorities of the reforms undergoing at the national level.
- For strengthening the presence of civil society and citizens in the policy making, assessment, monitoring and implementation of the processes towards decentralization and public administration reform
- To support local government reform and decentralization in Belarus and Azerbaijan where the issue is particularly problematic.

The outcome of the assessment and monitoring are in the following points annexed.

The main elements are :

- i. Minimum and not coordinated commitment of national policies towards strengthening of local government development and autonomy
- ii. Low level of involvement of civil society in practical terms (even if the legal provisions may exist in some aspects)
- iii. Lack of local government autonomy in Belarus
- iv. Improvements to be consolidated in Moldova, Ukraine and Georgia
- v. Lack of financial decentralization as a common feature shared by all the EaP countries, which prevent any development of autonomy by LGs

Proposal

The Subgroup for Local Government and Public Administration Reform of the Civil Society Forum proposes to CORLEAP to launch a common initiative on a single strong priority, such is **Fiscal Decentralisation**. Aware of the difficulty ahead of us, we propose to identify it as our common priority and strongly lobby for a flagship initiative or programme/project proposal, within the framework of the Eastern Partnership.

Fiscal decentralization remains a difficult and political orientation, which might be perceived as a long term objective. Some the EU members States and EU representatives within the CORLEAP may also think that Fiscal Decentralisation remains not complete within their own country yet. We consider then even an opportunity of common work and reciprocity of joint activities between EU and EaP countries, to further work on a same “uncomplete” objectives.

The Subgroup LGAPR proposes to work jointly with CORLEAP on the definition of this initiative setting up targets (to be discussed within a minim threshold and then country by country, timing and action plan and methods to be adopted).

In particular, Fiscal Decentralisation could be oriented to :

- develop possibilities for local authorities to access the capitals’ market
- strengthen competences to local authorities with consequent budget allocation
- identify possibility of local taxes
- identify possibility of services to be sold and technically provided by local authorities
- improvement of transfer system from the state budget to local budgets.

ANNEXES

**STATE OF FISCAL DECENTRALISATION IN
EASTERN PARTNERSHIP COUNTRIES**

**Drafted by the members of the Subgroup on
Local Government and Public Administration
Reform of the Civil Society Forum for Eastern
Partnership**

At the 10th of September 2012

BELARUS

1. A brief summary of the Fiscal Decentralization evolution in Belarus

As the analyses of belarusian fiscal policy shown, Belarus is far from achieving successful financial decentralisation. Despite the local budget independence proclaimed by the Constitution of Belarus, the budget system remains linked in a position of dependence to the state budget system. Local budgets are perceived by the public as vertical components of the state budget system and local budgets are strongly subordinated to the central budget. The degree of decentralisation, therefore, in local financial management is very low. A low level of taxing power, absence of local budgetary autonomy, chronic shortages of local government own revenues with respect to local expenditures are consequences of the hyper-centralised policy at the local level.

Our researches in field of intergovernmental fiscal relations and local financial management in Belarus two periods in fiscal decentralisation evolution have found. The first period (1995-2003) was connected with a certain "embryos" of liberalization and decentralization in fiscal and budgetary policy has been observed. First of all, it actively started to be developed the tax and budgetary legislation. A certain advance the delegation of fiscal powers to local authorities has got. Since the beginning of 2000 the rights on increase or reduction of tax rates, granting individual privileges, establishment and change of terms of payment on land tax, tax on resources extracted from environment and property taxes were provided to local authorities. Later the rights to define content of local taxes and tax rates on them are provided to regulate tax rates and privileges on separate types of local taxes, to introduce these or those taxes resolved by the central authority were introduced. So this period was characterized by the decentralization period of financial resources at the local level, expansion of local authority rights in taxation.

The second period (2004-present) was marked by stagnation and a gradual withdrawal fiscal decentralization principles and transition to the fiscal centralization based on old Soviet designs. Since 2004 it period began and many laws concerning fiscal decentralization development were revised in favor of strengthening of the centralized beginnings in financial system.

Measurement of centralization and decentralization processes in the Belarus budgetary system during the 2004-2008 periods is showed totally opposite situation in comparison with 1998-2003 periods. The share of centralized financial resources in the budgetary system began considerably increase and decentralized ones - to decrease. Reduction of decentralization level was accompanied by restriction of fiscal capacity and fiscal autonomy.

The main key problems of fiscal decentralization devolution in Belarus are:

- Separating of local budgets from structure of the State budget and elimination of local budgets dependence from the Centre;
- Expansion of the tax power of local authorities and introducing general principles of the distribution of tax power between authorities of different levels (central, regional and local);
- Expansion of local authorities' fiscal capacity and their fiscal autonomy and create financial competition between municipalities
- Improvement of the legislative base of intergovernmental fiscal relations and local finance management, introduction of new special laws regulating the financial activity of local authorities (Law about local finance, Law about local budget and so on), amelioration of the Budget Code

2. A short analysis of the legal framework regulating the FD in Belarus

Legislation pertaining to regulate the fiscal decentralization aspects in Belarus provides for at least three finance regulators. **The first** is the Annual Law about Republican budget. This Law the normative of sharing of State taxes is established. It concerned sharing taxes which divided between Central budget and local budgets (oblast budgets). For example, the sharing taxes normative (VAT and profit tax) are divided on two parts. The Law may also introduce new taxes or exclude ones on a concrete fiscal year both for the Central (Republican) budget and local ones. The Law about Republican budget more concerns the Central budget taxes, as a whole.

The second regulation is the Budget Code and it has been introduce into practice in 2010. This document determines taxes by the governmental tiers. Another words, what tax in what budget should go. The taxes and fees sent to the Central budget, oblast budgets, the Minsk city budget, rayon budgets and the cities with oblast status, rural and urban settlement budgets and budgets of the cities with rayon status are defined by the Budget Code. Besides, the Budget Code classifies groups of budget revenues, content of shared taxes, tax revenues and the non-tax ones.

Finally, **the third** document touched with the fiscal decentralization aspects is the Tax Code. It covers a wide range of the tax relations and contains two parts: the general part and special one. Since January 1, 2004 the general part of the Tax Code is installed. The purpose of this document is establishment of legal bases and base principles of tax system creation unified with modern world categories of taxation. The Tax Code is high level of regulation as it has huge validity in relation to other tax laws. In the general part of the relationships regulated by Code, the main principles of taxation, tax legislation, the order of tax calculation, participants of tax relations, specific modes of the taxation, taxpayers, subject of taxation are concerned. The Code determines what is the tax and fee, who may be taxpayer, their rights, obligations and responsible for tax violation, types of taxes and fees, content of republican (central) taxes and fees and local ones. The special part of the Code an interpretation of main taxes (VAT, PT, PIT, tax on revenues of foreign organizations, real estate tax, land tax, ecological tax and other taxes, duties and fees) used in tax practice contains.

The legal framework of fiscal decentralization in Belarus comprises the following components of revenue assignment: own revenues, shared taxes, equalization grants, municipal borrowing.

The main problems in sphere of own revenues are the absence of taxing power at the local authorities. The Centre almost exclusively retains the rights to define the structure of taxes, to establish tax bases, tax rates and the regulation of taxes. The local authorities can levy taxes, charges and fees prescribe by the Budget Code, only. However, the local authorities, especially of primary and base level may introduce own taxes by the permission of higher local authority (oblast local authority). So in tax practice now the local authority of base level (rayon local authority) can introduce only resort duty without permitting of oblast local authority. In belarusian sub-national budgets it made less than one per cent. Moreover, the local authorities of all levels have no an opportunity to adjust tax base and tax rate of own taxes.

Another problem in own revenue field is the "wash away» of local taxes, fees and duties from the tax system. Under the "flag" of tax pressure to decrease, the Belarus Central authorities almost annually eliminate local taxes and fees from the budgetary legislation. The share of these taxes and fees in local budgets, therefore, makes less than 5 per cent while in 2001-2002 of this share made about 15 per cent. In 2010-2011 from the tax system two important local taxes tax from sales (retail sales tax) and sales services tax (tax from services) were excluded and now only three local taxes and fees remained in the Tax Code (tax for possession of dogs; resort collecting; collecting from suppliers). Such tendency causes a serious alarm concerning provisions of the European Charter of Local Self-Government (art. 9, point3).

There are problems in sphere of sharing taxes. They are belonging to higher level of local authority and no to go to the lower local budgets. So at the higher local budgetary level (oblast budget) huge concentrations of financial recourses are forming. Totally different is the fiscal concentration on lower budgetary levels (rayon budgets and rural settlement budget).

In field of grant transfers the main problem is absence of formula which creates a justice and transparency in financial equalization. So the further evolution of fiscal decentralization in Belarus badly need in fair financial equalization in municipalities based on a formula of horizontal financial equalization. The objective and formalized methods of transfer measurement which any interested persons could apply independently and receive the same result which turned out at local government bodies and the higher authority will allow to use.

The municipal borrowings area is "in embryo" in Belarus. Now municipalities get no techniques of debt management and they have no knowledge and experience how to manage of municipal debt yet. The main weakness of municipal borrowings is the absence of regulations on municipal loans, including established restrictions on borrowing, authorized regulatory bodies, a legislative base for borrowing and special rules by which sub-national governments can access financial markets. It will require a special Municipal credit law to introduce.

3. Policy recommendations

The policy recommendations should be directed to real preparation and implementation of reforms in field of fiscal decentralization. Actually it represents prime base transformations which consist of a number of organizational actions and also preparations and adoptions of the relevant imperious decisions as:

- Modification of the Tax and Budgetary Codes;
- Acceptance by the Belarus Parliament of a number of Laws accompanying reformations in fiscal and budgetary sphere.

The strategic task is to prepare all institutions of the power, civil society to perform the fiscal and budgetary reform successfully. The tactical task consists of a choice of decisions, methods and forms of work which would allow avoiding a situation of chaos, boycott and bureaucratic red tape during reform, not to allow gross blunders, to minimize resource costs of reform implementation.

There are two stages of fiscal decentralization reform are to be realized:

On the first stage the following tasks should be solved:

- Invitation of experts of World Bank, EBRD, IMF for carrying out of analysis and appreciation of the Belarus fiscal and budgetary legislation;
- Preparation of cooperation projects with EU in fiscal and budgetary sphere within programs «The European tool of neighborliness and partnership», «East partnership», Programs of development of the United Nations, etc.;
- Holding the international conferences, seminars, expert visits on relevant issues of the fiscal and budgetary system reformation in Belarus ;
- EU programs, conferences, seminars, training for professional development of experts and studying of foreign experience of reforms, receiving consultations from experts.

On the second stage should be realized:

- Acceptance by the Belarus Parliament the Law «About reform of the fiscal and budgetary system».
- Adoption of law about introduction of additions and changes into the Budget Code and Tax one.
- Adoption of law «About administratively – territorial division. This law should expand the local government jurisdiction by means of assimilation of small local municipalities. The three-level budgetary system instead of existing four-level one should become the result of administrative-territorial transformation.

Expected terms of reform realization will be taken 3-4 years.

It is worth to remember about threats of reform realization in the sphere of financial decentralization. They are resistance of officials (incompleteness of the measures, bureaucracy of procedures; discredit of reform idea among citizens through distortion of its purposes and tasks); mistakes and miscalculations at a stage of adoption of strategic and tactical decisions; conflicts of interests both on a horizontal (between State bodies), and on a vertical (between public administration and local governments); fear of changes and absence of reform supporting by civil society; deficiency of staff for reform implementation.

Finally, it should be noted that fiscal decentralization reform can't be realized nowadays by ruling group because the idea of financial decentralization pulls down all system of existing power.

4. The role of third sector in promoting FD reform

In a situation when the Belarus authorities don't wish to introduce and develop fiscal and budgetary reform very important to form and develop the relevant structures of civil society are working in sphere of fiscal decentralization (public organizations, bodies of territorial public self-government, mass media) . Today in Belarus only 3 – 4 public organizations are working in this direction. For advance of fiscal decentralization reform prime tasks of these organizations are:

- an educational activity directed on citizens of Republic of Belarus;
- development of cooperation with financial and tax authorities;
- analytical and research work;
- informing of the Belarus society and the international organizations on processes of the fiscal and budgetary system development (financial experiments, pilot projects, basic innovations in fiscal and budgetary sphere, etc.);
- monitoring and analysis of fiscal and budgetary legislation;
- preparation and literature edition publications about fiscal and budgetary reforming, the publication of relevant articles in this area in mass media including country cases.

An extremely important is work on improving the qualifications of the experts and specialists, as well as the preparation of options for financial decentralization, mechanisms and implementation stages of reform.

UKRAINE

1. Brief summary of the FD evolution in Ukraine

Since gaining its independence in 1991 Ukraine has started to actively develop own fiscal system and repeatedly tried to conduct fiscal reform. However, the issue of fiscal decentralization remains pressing up to this day.

In 1991 the Law of Ukraine On Fiscal System of Ukraine was endorsed for the first time and in 1995 the law was amended. The Law was the first attempt to tackle the issue of intergovernmental finance relations. But the system was rather centralized due to certain economic problems Ukraine was facing during that time.

In 2001 the Budget Code of Ukraine was adopted. That was a groundbreaking development as the intergovernmental finance relations of the national Government and the local self-government bodies were clearly regulated for the first time ever.

In 2010 a new version of the Budget Code of Ukraine was adopted in the context of economic reforms. It came into force in 2011. The new version of the Code clarifies and elaborates definitions, complements the document with provisions about the state and local budget borrowing and state/sovereign local guarantees. Some changes were introduced to the chapter on the distribution of the state and local budgets' revenue sources (to the benefit of the local self-government budgets), the implementation of certain state obligations was delegated to the local self-government bodies but without proper financial compensation of these additional expenditures.

The current situation with fiscal decentralization in Ukraine demonstrates lack of coordination and overlapping of powers between local self-government bodies and local executive public authorities, in particular, when it comes to development and endorsement of local budgets. Current decentralization is about changing agents that are to carry out duties of the national scale instead of granting autonomy/independence in making budget and taxation decisions to the local authorities. The stable policy of the central Government remains strong, whereas the local executive authorities are expected to implement the strategies developed by the "headquarters". Another shortcoming of the Ukrainian fiscal decentralization is the percentage of transfers and transferred income despite the proclaimed tax and budget decentralization. At present, the revenue structure of local budgets shows an increase of intergovernmental transfers' share in the local budgets' earnings.

This state of affairs is not acceptable because the local budgets are financing sources of the greater part of the state expenditures, social expenditures first and foremost. Therefore, the negative consequences of the centralized fiscal system lead to underfunded social benefits such as education, health care and housing and municipal services provided at the local level. The inexpedient system of budgetary relations between various budget levels weakens the capacity of local public authorities to implement effective budget policy that would forge and promote a favorable investment climate.

2. Short analysis of the framework of fiscal decentralization in Ukraine

The Laws of Ukraine On Local Self-government in Ukraine (1997), On Local Public Administrations (1999), the Budget Code of Ukraine (2010) and the Resolutions of the Cabinet of Ministers of Ukraine about the intergovernmental transfers distribution formula regulate the decentralization in the budgetary and taxation areas. In particular, the mandate of local public authorities to prepare and implement local budgets is defined and regulated by the legislation.

In compliance with the Budget Code the local budgets include revenues and expenditures to implement the powers that the public authorities of the Autonomous Republic of Crimea, local public administrations and local self-government bodies have. The Budget Code includes a separate line on income of the local self-government bodies' budgets (village, town, city) and the income of the budgets of the AR of Crimea, oblasts and districts.

Personal income tax makes the basis of the local budgets' income. However, only insignificant share of this tax stays in the local budgets. Besides, the local budgets receive a percentage of various **fees for use of natural and mineral resources and payments for different licenses**. These earnings made by the local budgets are taken into consideration to calculate the amount of intergovernmental transfers.

The income of the local budgets also includes the municipal enterprises income tax, local taxes and fees. This income is not used to calculate the intergovernmental transfers.

Effective January 01, 2011 according to the Tax Code of Ukraine the local taxes and fees include:

- Property tax, which is different from the land plot tax (the introduction of the tax is postponed until 2013)
- Single/fixed/self-employment tax paid by natural persons registered as entrepreneurs
- Fee for some business and entrepreneurial activities
- Fee for parking space available to vehicles
- Tourist tax.

The Budget Code defines several types of intergovernmental transfers. They are:

- Equalization grant. This is an intergovernmental transfer to equalize the revenue capacity of the budget/spending unit that receives it
- Subvention. This is an intergovernmental transfer to be used for a particular purpose, in accordance with the procedures defined by the authority that has made a decision to grant a subvention
- Funds transferred to the local budget from other local budgets
- Additional grants.

The Budget Code and the Law of Ukraine On Local Self-government differentiate types of expenditures between various budgets. The state can grant a right to the local self-

government bodies to make expenditures provided that relevant financial resources are made available to the local authorities. These financial resources shall be locked in/allocated in the respective budgets and include the national taxes and fees (obligatory payments) or percentage of them as well as the transfers from the State Budget of Ukraine. The uncomfortable truth is that various programs are adopted at national level and the local budgets are expected to provide respective funding to carry them out. Or local self-government bodies receive new powers that are not accompanied by proper financial support. Therefore the Government resorts to transfers and grants that in fact make the system of expenditures and revenues distribution centralized. Today the Ukrainian local self-government bodies receive very little financial resources to implement the powers delegated to them by the state. The introduction of a full-fledged property tax as a local tax is hindered due to political tensions and speculations around the issue as well as the lack of a consolidated concept of the tax as regards its administration and rate calculation. To sum up: today the local budgets in Ukraine have a very low share of income sources, which are not considered when calculating transfers. The local public authorities are not in position to manage revenues on their own and in line with the development priorities of their administrative-territorial unit.

3. Policy recommendations

- In order to make fiscal decentralization a success it has to be complemented by other vital reforms such as administrative-territorial reform, social safety net reform, reform of housing and municipal economy and other reforms.
- It is necessary to regulate relations between the local budgets and “the headquarters” by optimizing the distribution of powers to make expenditures and improving the procedure for transfers’ distribution.
- To have a clear division of powers between the state and the local self-government bodies when it comes to delivery of social services such as education, health care, social safety net etc. It is important to ensure that these services are provided as close as possible to the recipients. It is necessary to bridge the gap between the responsibilities the local self-government bodies have and financial resources they have at their disposal to implement these responsibilities by providing a clear definition of what local budget income is and increasing it.
- It is important to develop and introduce a system to offset losses local budgets incur as a result of the state tax remissions.
- It is necessary to raise the standards of fiscal capacity to enable appropriations for secured expenditures but also to ensure the development of physical infrastructure of the budgetary institutions.
- To adopt laws to create mechanisms to combine resources of the local budgets within the framework of the financial-organizational cooperation at the local level.

- To introduce performance-based budgeting to the local budgets that would stipulate for a switch from rendering support to budgetary institutions to rendering high quality services to people and ensuring effective use of public finance and achieving noticeable economic and social effects.

4. The role of the third sector in promoting FD reform

Today the Ukrainian CSOs play the important role in fiscal decentralization issues. The important actors of the public policy-making process in this area are the following organizations: Institute for Budgeting and Socio-Economics Research (IBSER), The Association of Ukrainian Cities, The International Centre for Policy Studies (ICPS), the Civil Society Institute (CSI) and etc. These organizations have made a great contribution to the development and implementation of the FD reform.

We see the role of CSOs in the following:

- To conduct public discussions on trends and mechanisms of FD reform
- To develop policy proposals, a draft law and conduct advocacy campaign (be advocates of the reform)
- To conduct public evaluation and to provide public expertise and to ensure the independent monitoring of the FD policy implementation.

Moldova

1. Fiscal decentralisation evolution, the major trends and key points of the steps

The institutional framework and legal principles of local communities functioning have been created in Moldova during four local administration reform periods (1994, 1998, 2003, and 2006 years). Principles and legal status of territorial units have been established in accordance with various laws and regulatory provisions subordinated to the legislative framework. Implementation of reforms hasn't contributed, however, to deliver the expected results. Today in local public administration system there are unsolved issues that hamper the development of local communities and make the administrative and fiscal decentralization process less efficient than it could be.

During the first stage of reform (1991-1994), the old soviet approach of drafting local budgets and shaping the fiscal base was still in force. There was a strict subordination to central government. Local governments were, in effect, an extension of the central government, charged with supervising municipal enterprises.

The second stage of local reform (1994 -1997) started with adoption of four laws, the Law on Territorial-Administrative Structure, the Law on Local Public Administration and the Law on Local Elections and Law on Local Taxes and Fees, which introduced new taxes, although their contribution was insignificant for local budgets. Local authorities had the right to select from a list of 14 local taxes/fees established by Parliament, as well as establish the method of tax levy. But the maximum threshold of the tax/fee rates was the prerogative of Parliament.

This third stage of the reform (1998-2001) that introduced the judet system did not represent much of an advance with regard to the local budget process. A positive element was the balanced budget requirement, which did not allow recourse to deficit financing. However, local governments had little financial autonomy as more than half of their planned budget expenditures were committed upon normative directions issued by the Ministry of Finance.

The fourth stage of reform (2002-2005) started on 27-28 December 2001 when the Moldovan Parliament passed legislation that fuelled controversial debates in and outside the country. The legislation adopted by the communist government undermined the local autonomy and reversing decentralization reform toward centralization. The new Law on Local Public Administration passed in 2003 removed the authority to "establish local taxes and fees" from the list of the local council's authorities, this had been the prerogative of the Parliament and the 2nd tier level.

Since 2006 was initiated a new stage of the local public administration system reform, which has stalled more than progressed until 2009. The new democratic government established by the government program five priorities, including Strengthening local autonomy and decentralization. Concrete actions of reform implementation presently occurring are based on the National Strategy for decentralization which was approved by Parliament in April 2012.

2. Analysis of the legal framework, actual situation : problems and gaps

The legal framework governing fiscal relations consists of Law on Local Public Finance no. 397-XV from 16.10.2003, Law on Budget System and Budget Process no. 847-XIII of 24.05.1996, Law on local public administration no. 436-XVI of 28.12.2006, Law on accounting no. 113-XVI from 27.04.2007 and Tax Code of the Republic of Moldova, Title VII, Local taxes. According to the results of legal expertises realized by experts of the Council of Europe, national and international experts the legal framework of financial autonomy in Moldova abound in provisions diminishing the financial autonomy of local government and ensure the existence of an unfavourable context for an appropriate fiscal decentralization tax. As is noted in the National Strategy for decentralization the main gaps in this respect are:

Inability of local economies to generate sufficient tax revenue to meet public needs. Most taxes with an increased rate of collection are taken in the state budget. And for LPA are set taxes with reduced tax yields.

Limited fiscal autonomy regarding the local taxes and fees, insufficient fiscal potential, the lack of stimuli of extension for the fiscal base. ATUs in the Republic of Moldova have an insufficient fiscal base, where the local economies get confronted with the incapacity to generate incomes in the necessary quantity. These are limited and do not allow the responsabilization of the LPA's authorities in front of the local collectivity of contributors. The LPA has no in-house important income sources, and thus cannot decide and solve independently many of the emerging problems. The current local taxes and fees bring small amounts, constituting a reduced percentage from the local budgets – less than 15% from the local budget. Moreover, the LPA authorities have a limited capacity of: (i) modifying the levels or the base of local taxes and fees provided for in the Tax Code; (ii) reassessing periodically the immovable property; (iii) establishing in-house fiscal facilities for the local taxes and fees.

Budgetary dependence of each level of the public administration towards the immediately upper one, a dependence coming from: (i) the insufficiency of its own local incomes; (ii) the vertical disequilibrium caused by the discrepancy between the distribution of responsibilities and income sources amongst administration's levels (section 1 –Decentralization of services and competences); and (iii) some inherited practices of including the first-level LPAs' budgets into the second-level LPAs' ones. This results in the excessive intervention of the central authorities and, more often, of the

district level, in the management of the in-house local financial resources. As a result, between the LPAs' levels unofficial subordination relations are created, which are stipulated in the legislation in force, but persists in practice.

Erosion of the fiscal base by legislative granting of numerous facilities and easements. These lead to the restraint of the fiscal base, the diminishment of the in-house local incomes and the reduction of the fiscal equity by favouring some economic agents or social categories. The local authorities have no real rights and leverages to influence the taxpayers aiming at assuring the opportunity and plenitude while paying local taxes and fees.

Inefficiency of the existing transfers system between the CPA and the LPA of different levels results in discouraging the in-house fiscal effort of municipalities. Transfers formula is simplistic and does not take into account objective factors which need compensation of local needs with adequate financial resources. Also, all transfers are non-transparent, and are based on subjective and political interests. According to the current practices, the LPA's budgets are completed through transfers according to the equity principle. Thus, the LPAs that increase the budgetary incomes by their own local initiatives may find themselves in the situation of being indirectly fined by the reduction of transfer amounts to the local budget. Another deficiency of the system consists in the unjustified fulfilment of the transfer in two steps – first towards the district budgets and then to the first-level LPAs' budgets.

Volatility of the whole system of local finances (incomes, expenditures, budgetary procedures) every year. This doesn't only mean that it has modified during the past decades, but that these modifications have been rather unpredictable, which affected the low capacity of the local authorities to plan its resources. As a whole, the parameters of the financial policies locally (income sources, expenditures, procedures), though provided for by the law, may change to easy every year through the Law of the State Budget. This makes the multiannual budgetary planning as well as the whole financial management at the level of LPAs difficult.

Using at the reduced scale of public borrowing. Existing legal system allows only bank borrowing limit of 20% of their income size of APL. Regulations in force do not allow to develop mechanism debentures as it contains a small number of normative provisions.

3. Policy recommendations

The main policy recommendations are:

- Evaluation of the fiscal capacities of particular territory through evaluation of the economic potential of each territory based on of certain realistic fiscal forecasts and as a result identification of the amount of the transfers for budgetary levelling , which can be assured for the medium-term.

- Reconsideration of the concept of local budgeting transforming local budgets in independent budgets of local authorities at both levels.
- Gradual transition to direct and stable inter-budgetary relations between state budget and LPA budgets at level I.
- Use of the modern budgeting methods and technologies including program-based budgeting and performance-based budgeting.
- Extension of the practice of elaboration of MTEF at least to the level of ATU at rayonal centers.
- Introduction of multi-annual budgeting.
- Reduction of vertical fiscal disequilibrium through attributing on permanent basis to each level of the budgetary system of the corresponding sources of revenues.
- Prohibition of competencies' allocation to LPAs without financial coverage.
- Growth of local fiscal tax outturn including through increase of efficient administration of local taxation.
- Redesigning the system of fiscal incentives, elaboration and implementation of certain concrete mechanisms for economic agents' stimulation to timely pay local taxes.
- Growth of fiscal outturn of tax from residents or from property or from commercial activities on the territory of relevant local authority. Results of relevant studies recommend that for Moldova is rational to use the principal of taxation in accordance with the place of residence of the taxpayers.
- Elaboration of the methodology of impartial evaluation of ATU fiscal base and optimization of the tax rates and taxes collected by LPA aiming at increasing public revenues in local budgets
- Designing of stimulating mechanisms to extend local fiscal base.
- Increasing the financial autonomy of the local governments, giving them the right of establishment, for a long term, the tax base and local taxes.
- Improving normative framework for local borrowing.

4. The role of third sector in promoting FD reform

The NGO sector in Moldova is probably the most dynamic and active sector from all six countries of the Eastern Partnership. The approximately 8000 registered NGOs, is a huge intellectual potential and an important partner for local and central public authorities to promote reforms. NGO sector's importance is fully appreciated by the central authorities. In 2010 at the initiative of the Government of Moldova and NGOs was created the National Participation Council which consists of 30 members, representatives of organized civil society groups. NPC intends to facilitate involvement of all interested stakeholders in designing, implementing, monitoring, evaluation and updating of strategic planning documents. The NPC mission is to contribute to the adoption of public policy decisions which would correspond to the interests of society.

In the process of drafting the National Strategy for decentralization were involved lot of NGOs that have assisted the Government in drafting background studies, organizing public debates, elaboration of policy papers etc. NGO participation demonstrated that, there is a significant demand for further assistance in the decentralization area, especially taking into account little progress registered so far by the central authorities in promoting this reform. Further assistance may be structure in three priority areas:

Elaboration of Policy documents (sectoral strategies) in the following areas:

- Decentralization in various areas such as education, health, social services, etc.
- Intergovernmental transfers and equalization principles
- Asset management and municipal property, public goods and public services
- Local fiscal policy and economic development
- Capital budgeting and financing through municipal obligations
- Implications on human rights of fiscal decentralization process.

Capacity building:

- Training for key staff involved in local social issues and economic development from the central governmental institutions, members of the Parity Commission (such as Ministry of Finance, Ministry of Economy, Ministry of Education, Ministry of Health, etc.) on basic concepts and principles of policy issues set up above.
- Training of Trainers (ToT) on the policy subjects mentioned above in order to ensure the basis for offering further continuous education to the local public officials.
- Implementation of the local e-government projects by empowering their information flow and transparency and improving their IT capacity.

Legal and regulatory impact assessment

- Provide assistance to the Ministry of Finance and other central authorities on the assessment of potential impact of various responsibilities' redistribution, de-concentration of services and decentralization of authorities.
- Carry out pilot projects in an area with greatest potential for decentralization on the matter of regulatory impact assessment of the proposed changes.

AZERBAIJAN

1. Brief summary : The Problems of Fiscal Decentralization in Azerbaijan

Municipalities were established in the Republic of Azerbaijan since 1999. Azerbaijan joined the European Charter on Local Self-Governance in December of 2001. However, the status and competencies of the municipalities are still not in compliance with requirements of the European Charter on Local Self-Governance, which means that the municipalities do not have the status of local governance.

The government of Azerbaijan has not also joined the 4.3 article of the Charter considering the principle of subsidiarity. This article requiring the delegation of state competencies to the governmental body close to citizens is very important in terms of fiscal decentralization reforms, thus realizing this point the government refuses to join it.

Azerbaijan has also not signed the articles 9.5 and 9.6 of the European charter.

The ongoing process show that the government has not only taken any steps towards fiscal decentralization but also restricted financial opportunities of the municipalities. In 2006 property tax on car transportation, one of the tax revenues of local budget, is deprived of municipalities and given to the state budget. Sale and rent mechanism of the lands under municipality property has been changed and the role of municipalities has respectively been minimized in this process. Currently these lands under municipality property are sold through state body. This means that the revenue of local budget has been decreased 2 times as a result of new sale mechanism. The municipalities has not received any compensation consequently.

During 13 years activity of local self governance insitutions even a few competencies granted to municipaliites (maintenance of cemeteries, mosques) were not provided with any financial resources.

Lacks and contradictions of legislation on revenues of local budgets, restriction of the tax base and imperfect mechanism of tax collection do not allow to formulate stable and high income base for the municipalities.

Despite the fact that state programs and investing projects that cost billions of dollars are implemented, the municipalities are not involved in these works. Only 0.02 percent of the state budget resources are given to the local self governance bodies in the form of subsidies. The main competents of the budget resources are state bodies.

Reforms in fiscal decentralization area are not expected in the country in the soonest period. Thus the government has not prepared any concept on decentralization reforms. Even in the currently discussed draft of the “Azerbaijan 2020: development concept” prepared by the decree of the head of state there is no any political intent about determination of the status of municipalities, extension of their competencies and financial resources and decentralization reforms in the country.

Fiscal decentralization problems

Weak financial capacity of the municipalities in Azerbaijan is mainly due to lack of decentralization reforms in the country. However Article 9 of the European Charter on Local Self Governance states in its first paragraph that local self-governance organization shall have sufficient private financial resources under the framework of national economic policy for spending it freely during fulfilling their functions.

Though special taxes and payments for municipalities are defined by the legislation of Azerbaijan those income sources are not sufficient for self-governance bodies even for fullfilling their current restricted functions.

The volume of budgets of the municipalities does not allow them to work normally. During their 13 years existence the maximum record of budget revenues of the municipalities was in 2007. Budget revenues were 62.5 million USD by that time¹. Decrease was observed in the subsequent periods. In 2011 total budget revenues of all municipalities was equal to 43 million USD². Last year income per person of the local budgets was approximately 4.6 USD. The average annual budget of municipality was about 25 thousand USD. In rural municipalities, constituting approximately 85% of all municipalities, this record equals to 5-6 thousand USD. Currently the share of total revenues of the municipalities in the consolidated budget is less than 0.02 percent.

The legislation in force- Tax Code, the laws on “Local (municipality) taxes and payments”, “Budget System” defined a range of revenue sources for self governance bodies in Azerbaijan. These are 4 taxes and about 7 non-tax revenues. However, in reality major part of those sources do not formulate stable and high income base for the municipalities.

Analysis of statistical data shows that although the legislation considers more than 10 sources of income for municipalities only two of them can play significant role in formulation of local budgets. In 2011 9.6 million USD or 21.8 % of municipality revenues

¹ Statistical newsletter on execution of the budget of municipality bodies. January-December 2007. SSC, Baku, 2008

² Statistical newsletter on execution of the budget of municipality bodies. January-December 2011. SSC, Baki, 2012

was formulated by the land taxes income. In comparison with the amount of the land involved in municipality tax the amount of income is very low. The average tax cost of the land per ha of land is 5 USD. The rate of this tax has remained unchanged for the last 10 years.

The second major income source of the local budgets is revenue that municipalities get from land renting and sale. In 2011 21 million USD or 47.6% of budget revenues were formulated by this source.

Analysis³ show that low level of incomes from most financial sources defined for municipalities and their absence as a source of sustainable funding for the payment of budgets is the result of non-working tax collection mechanism rather than restricted tax base. Even mechanisms for some tax (for example property tax for individuals) and payment collections are not defined in the legislation.

The system of transferring to the local budgets exists in Azerbaijan only symbolically. The share of financial aid that municipalities get from the state is very small in the consolidated budget and it is equal only to 0.2 per cent. Current legislation does not create any legal impediment for the state to demonstrate necessary financial support to the municipalities. According to the law on “Budget system” and “Basis of municipality finances” unconditional (dotations) and conditional transfers (subsidies and subventions) can be given to the local budgets from the state budget. Since the establishment of municipalities only unconditional transfers –dotations were made to them.

According to Azerbaijani legislation dotations are given to the local budgets with the purpose to regulate their income and costs. This financial aid has been started since 2000 and 4.5 million USD dotation was allocated from the state budget in the same year. Although dotation for 2002 reached its maximum level (6,3 million USD) in 2003 this number was decreased for 5 times. Annual amount of dotations remained 4.4 million USD during 2007-2011. In 2012 the government increased the level of dotation to 6,3 million USD again. Since their establishment the municipalities received 52 million USD (41 million AZN) of financial aid from the state budget. Whereas in this period revenues of the state budget have increased 28 times and reached 22.4 billion USD (2012) from 0.8 billion USD (1999)⁴. The share of the dotations in these costs decreased against the background of increased costs from state budget. In 2000 the volume of the share of dotations in the costs from state budget was 0.47%. In 2002 the share of dotations reached their maximum level- 0.54% while in 2012 this figure was 0.03%.

³ Strengthening Financial Capacity of Azerbaijan’s Municipalities: Improving the taxable base of physical entity property tax. Support For Economic Initiatives. Baku, 2011 http://sei.az/upload/files/properitytax-paper_english_SEI.pdf

⁴ www.budget.az information database. SEI

Success of financial decentralization depends not only on the volume of interbudget transfers, but also on the distribution methods and what kinds of methods are applied to. The following lacks are observed in the current implementation methodology of the distribution of dotation:

1) The principle of distribution of dotations is unclear. The results of researches show that during distribution of dotations the criteria considered in the legislation are not used.

2) Vertical separation from the existing criteria for dotations do not include the financial balancing. According to the legislation dotations are distributed based on the specific share of the municipality in formulation of financial resources of the country and number of population. Whereas there are municipalities located in mountainous or lowland areas, with bad or good infrastructure, with big or small territories. These or other factors should be taken into consideration during distribution of dotations.

3) Dotations are not sufficient for paying costs of the local budget, they are mainly of symbolic character. The principle of “A little bit, but in everybody’s reach” is the major consideration during distribution of dotations. Because the researches show that in the best case municipalities can get half of required dotation. On the other hand, the amount of dotations allocated for 90 % of municipalities is either the same or differs slightly

Although it is considered in the legislation, a practice of distribution of direct transfers is not observed. The article 11.14 of the law on “Budget System” states that the municipalities intended to receive financial support (as well as direct transfers) from state budget should justify the volume of financial support and present it to the respective executive committee until May 1 of the ongoing year. But precise principles and criteria of receiving direct transfer is not stated by the legislation, the use direction and assignment are not concrete. If lately the municipalities would apply to the government for receiving direct transfers, now the number of applications is very few. Municipalities are also involved in execution of state programs implemented by the state. But during 13 years of their existence the municipalities were not subject for allocation of direct transfers.

Shared tax system, which is one of the popular types of the interbudget transfers in the world practice, is not implemented in Azerbaijan.

Despite the real need of municipalities, working mechanisms ensuring providing local self governance bodies with access to the credit market do not exist. This is one of the main reasons of weak financial potential of the municipalities in Azerbaijan.

The lack of payment capability of municipalities and budget constraints to pay current expenses of almost all of them not only deprive them from debts, but also becomes a reason for the financial institutions not to be interested in giving credits to institutions with such a weak potential. On the other hand, municipalities are not commercial organizations and it is impossible for them to receive credit under commercial conditions. Nevertheless, such credits have the purpose to establish social services and for this reason mechanisms for municipalities to receive loans under favorable conditions should exist.

Recommendations

Complex reforms is necessary in the direction of financial decentralization and improvement of related legislation base in order to adhere development of local self governance in Azerbaijan to the principles and requirements of the European Charter. For this purpose the following is recommended on the major directions of the local self governance:

- The standards reflecting the status of municipalities as local government body should be set forth in the legislation;
- Local governance bodies should be given exclusive powers, the exact division of powers should be carried out between municipalities and local government bodies
- Municipalities should be given sustainable funding sources to carry out their responsibilities, and the possibilities of application of the shared tax system should be considered by a change in tax legislation;
- Legal basis of the application of “minimum budget provision” mechanism should be established in order to achieve formulation of financial resources appropriate to the competencies of municipalities;
- Tax arrangement mechanisms should be improved for using current tax resources more efficiently;
- Current mechanisms of allocation of transfer to municipalities should be improved, along with unconditional transfers, distribution of conditional transfers to the municipalities should also be ensured and the volume of transfers should be significantly increased;
- Mechanisms should be worked out for municipalities to receive loans under favorable conditions, establishment of financial foundations supporting development of municipalities should be facilitated.
- Flexible and efficient mechanisms for local self-government bodies should be established in order to obtain the property within the limits prescribed by law
- Legal barriers for establishment of a united municipality for Baky should be lifted up, special law on “Status of Baku” regulating complex of issues in regard with the status of Baku city should be adopted;

- ❑ In order to increase efficiency of local governance in Azerbaijan transformation to the regional governance and compliance of the current local governance system to regionalization should be carried out.

The role of third sector in promoting FD reform

The role of the third sector in promoting fiscal decentralization is undeniable. The municipality authorities are afraid of claiming their rights in Azerbaijan. The municipality does not express the will of voters being appointed by the central government, as well as local executive power offices. Therefore, municipality members feel guilty before the central government and consequently, do not leave any comments. Local executive power bodies have more authority than municipalities allowing them to make municipalities dependant on them. In this case, the load falls on civil society.

There are NGOs that operate in Azerbaijan working in the direction of strengthening local self-governance. They create coalitions by mobilizing their powers. One of these coalitions is a NGO Alliance for Municipality Development (BINA). One of the purposes of BINA is to achieve the reforms favoring fiscal decentralization. The Alliance organizes public debates, media campaigns, does researches, presents recommendations to the government. The Alliance does annual evaluation of the situation of local self-governance in Azerbaijan and the level of fulfillment of the requirements of European Charter. This report plays a role of alternative source allowing to assess compliance of the local and regional self-governance in Azerbaijan with the requirements of the Charter that has been developed by the Council of Europe's Congress of Local and Regional Authorities.

Activity of the Alliance also includes organization of seminars, trainings aimed at increasing knowledge and skills of the municipalities, publishing and distribution of guidelines. Another part of the Alliance activity is to learn and disseminate successful foreign practices among municipalities.

As a result of the advocacy work done by BINA the question of giving additional competencies to the municipalities is already on the agenda. Parliament members, ombudsman, political parties express the importance of increasing competencies/responsibilities of the municipalities and respective reforms in the governance area.

BINA and its inclusive structures have presented the government more than 10 policy papers, research and recommendation documents on fiscal decentralization.

GEORGIA

1. Brief summary of the FD evolution in Georgia

It can be said that the first serious step Georgia made towards decentralization of government system was ratification of European Charter on Local Self-Government by the Georgian Parliament in 2004. By that time, it was obvious that local self-government - a fictitious unit of public administration system that did not possess any political, administrative, or fiscal independence and was incapable of implementing the legally assigned responsibilities - need a reform.

Politicians and experts were largely unanimous in defining the major reasons causing this problem. Namely, existence of a district governments as an extension of central government hindered development of local self-government units within the given area; the majority of self-government units, due to their small scale, could not mobilize human, financial and other resources, which resulted in low quality or high cost of public services they provided; there was no legal mechanisms providing for fair distribution of financial resources among the self-government units, etc.

However there has been no common vision of such conceptual issues as administrative-territorial organization of local self-government units, principle of their agglomeration and optimal scale.

In 2005-2006 Parliament of Georgia adopted a range of laws which should serve as a foundation for financial-economic, administrative-territorial and institutional development of local self-government. These are: Georgian organic law on "Local Self-Government", Georgian laws on "Municipal Property", "Municipal Budget," and "Governmental Supervision over the Activities of Local Self-Government Units". Besides, amendments and additions were applied to the Law on "Capital of Georgia – Tbilisi", Law on "Georgian Budget System" and Law on "Budgetary Distribution of Tax, Non-Tax, and Capital Revenues".

Consequently, the above legal changes provided some ground for optimism. The legislative vacuum connected with municipal budgeting got gradually filled up; the mechanisms of authority delegation and funding got defined; equalization transfer calculation rules and formula were specified, and though they were far from being perfect, at that stage their very existence was a crucially important step toward fiscal decentralization. According to reform authors, self-government units should start to strengthen financially and economically, as a result of which business environment and social situation in the country would improve tangibly.

In autumn 2006, municipal elections in Georgia were arranged in accordance with updated legislation. Legislation regulating municipal finances and budgeting underwent numerous changes since then. New “Budget Code” was introduced in 2010, several crucial laws were cancelled.

2. Short analysis of the legal framework of fiscal decentralization in Georgia

Amendments, applied to the Georgian Tax Law on January 1 2008, cancelled social tax, and increased the income tax levied on physical persons from 12% to 25%. Parallel to this, an amendment was applied to the Georgian Law “On Distribution of Receipts between the Budgets”, and starting with January 1 2008 income tax no longer represent a municipal budget receipt. This tax has been fully directed into the national budget. According to the government, this shortfall would be compensated to self-government units by means of equalization transfers. The updated, second version of equalization transfer formula was also introduced on January 1 2008. However, the reality proved to be quite different: this change caused considerable damage to local self-government units⁵. The idea to make income tax a local tax, which was periodically discussed by experts in 2005-2007 and realization of which would be an unambiguously positive step toward fiscal independence of local governments, became even more unviable in 2008. At the same time, reassigning of income tax to the national budget put an end to the practice of filling municipal budgets with national taxes.

Property tax is the only local tax and the only kind of tax receipt for the municipal budgets. In 2005-2010 property of different categories was gradually exempted from this tax. Changes also affected tax rates. Differentiated approach to calculation of industrial property (except land) was introduced on June 7 2009. The rate of property tax payable by physical persons also increased in 2009; definition of income, received by physical persons’ families was clarified. Due to these changes, accumulated value of property tax flowing into the municipal budgets increased stably⁶. However, in spite of the growth dynamics, property tax payments, as own tax receipts, constitute a small part of local budgets.

Changes applied to the legislation in 2006, 2008 and 2010 gradually expanded the opportunities of self-government units to use special purpose transfers received from the State budget. In the initial version of the law, such transfers could fund measures directed at eliminating the impact of environmental catastrophes, natural disasters, capital costs and other pressing payments. At present, it become possible to allocate special purpose transfers from the national budget to self-government bodies for any

⁵ In 2008, self-government units lost more than 179 million GEL (this estimate does not include municipal structures of autonomous republics). Source: “Fiscal Decentralization Reform in Georgia”, year 2008. www.csrddg.ge

⁶ In 2007 - 107,9 mln GEL; in 2008 - 131,9 mln GEL; in 2009 - 160,4 mln GEL; in 2010 - 191,7 mln GEL; in 2011 - 220,4 mln GEL. Source: consolidated budget of the Ministry of Finance (www.mof.ge)

purpose, including funding of municipal programs or LSG's own competencies. Bearing in mind unpredictability of special purpose transfers and lack of legal regulations defining their allocation or amount, the above changes should be considered as a restriction on financial independence of local self-government bodies. These changes contradict the principles laid out in article 9.7 of the Charter, which states that application of grants for the financing of specific projects is unreasonable. At the same time, the provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction.

In the current Georgian "Budget Code" the term "special purpose transfer" defined as transferring of funds in the form of financial support from one budget to another. I.e., if, before 2010, Georgian Law "On Municipal Budget" implied that special purpose transfers had to be paid to municipal budgets from the state budget or budgets of autonomous republics, now this amendment enabled allocation and reception of special purpose transfers by budgets of any level. This seemingly flexible system might have an adverse impact on fiscal independence of local self-government units with the assumption that allocation procedures of special purpose transfer are not regulated by law and consequently are not transparent.

The issue of target purpose transfer definition still remains problematic. Namely, Georgian "Budget Code" defines it as resources transferred from the national budget or the budget of an autonomous republic to municipal budget as "financial support" aiming at implementation of delegating competencies by the self-government unit. It is not logical to label the funds transferred for implementation of delegating competencies as "support", this diminishes the idea of self-government unit's self-sufficiency and autonomy. Allocation of financial resources to local self-government bodies on the part of an entity delegating competencies is an obligation, not free will.

Definition of equalizing transfer is also unclear. According to article 71.1 of Georgian "Budget Code", the government ensures balancing of social-economic development of local self-government units by means of equalization transfers allocated from the state budget. Sub-article 3 of the same article reads that the goal of equalization transfer is to equalize the amount of financial resources available for implementation of exclusive competencies on the part of different local self-government units. It is however obvious that balancing of social-economic development and equalization of financial means available for implementation of exclusive competencies are objectives of totally different categories

Equalizing transfer calculation procedures and formula changed several times after the local elections of 2006. It can be said that every subsequent procedure and formula represented an attempt at improving its preceding versions. Formulas applied in 2007, 2008, 2009 and 2010 and their drawbacks were analysed by Centre for Strategic

Research and Development of Georgia (CSR DG) in its empirical researches⁷. On a general note, it can be said that parallel to changing of calculation procedure and formula, there increased the amount of required information, which to a certain extent reduced transparency of the formula. We imply the availability of information necessary for calculating the amount of transfer. Apart from this, restricted legal regulation of equalization transfer calculation remains the main problem in terms of its equal distribution. In the meantime, the Minister of Finance has a nearly unlimited power to expand these legislative rules. This means that the Ministry of Finance has a realistic opportunity to manipulate with equalization transfer amounts by adding different factors to the formula and adjusting their scope.

Starting with January 1 2009, an amendment applied to the Georgian Organic Law on “Local Self-Government” simplified the procedures required for self-government units to receive grants (not governmental grants). Namely, this amendment lifted a restriction, which implied that the self-government units could only receive grants from government of Georgia or with its permission. This can be evaluated as a positive change.

On the contrary, legal procedures set out for local self-government units wishing to obtain a loan remain as strict and inflexible as ever. Self-government units can only take loans from the government of Georgia or with its permission, which practically denies them real access to the national capital market, required for attracting capital investments, as set out in article 9.8 of the European Charter.

An amendment applied to Georgian Organic Law on “Local Self-Government” on March 27 2009 defined voluntary material-technical assistance to state-run public authorities in special circumstances as temporary competencies of local self-government units. The deadline for application of the above “temporary competencies” was first set at year 2011, but a subsequent legal amendment postponed it till 2013. This means that the “temporary competencies” actually became regular competencies, which contradicts the European standards of self-government. Besides, the law does not provide any details on the meaning of “material-technical” assistance or the applicable decision-making procedures. It is also unclear what could be the motivation of a local self-government unit in providing voluntary “material-technical” assistance to state-run public authorities. All this obscures the possibility of voluntariness in exerting of authorities and should be considered as the restriction on the right of local self-government units to independently plan their budget total outlays.

⁷ “Fiscal Decentralization Reform in Georgia”, 2008. Available at http://www.csr dg.ge/upload/editor/file/biuletenebi/lifet_decentralizacia.pdf

“Fiscal Decentralization in Georgia”, 2011. Available at <http://www.csr dg.ge/upload/editor/file/EU%20gia%202011/FD%20study-eng.pdf>

3. Policy recommendations

- In order to ensure social-economic development and equalization of the standard of life it is necessary to change the situation with regards to distribution of public funds across various budgets, because a major part of the resources remain located in the State budget.
- Dependence of the self-governed entities on the transfers received from the centre should be decreased. Currently, most part of the funds spent from the budgets of self-governed units are provided as grants from the State budget, deepening the vertical misbalance and limiting fiscal independence of the local governments.
- Current principals of distribution of tax and non-tax revenues between the State and the local self-governed budgets need to be revised in order to ensure effective decentralization. Currently, only an insignificant part of the revenues mobilized in the country is transferred to the budgets of self-governed units, which decreases their interest to promote economic activities on their territories. It is desirable that a part of income tax be transferred to the local budget. This measure will raise the level of fiscal decentralization and increase motivation of the self-governed entities.
- Evaluation of the transfer policy with objective indicators needs to be introduced, which will reduce subjective decisions in distribution of the funds by transfers.
- The transfer policy should provide elements of incentives for self-governed entities. The existing transfer policy ignores stimulation of the self-governed entities for increasing the mobilized revenues, which, in the long run, carries a risk of resulting in higher dependence on the Central government.
- Equalization of the self-governed entities should be based on the minimal standards of the services under their competencies and respective financial norms.
- The equalization transfer formulae needs to be further improved, because, regardless of the yet another implemented change, there are still remaining problems in terms of validity of the calculation transparency, adequacy of the components used in the formulae and their weights.
- A legislative procedure for obtaining a loan needs to be developed, enabling the self-governed entities to effectively use credit resources. The existing regulations about the issue remain stiff and inflexible for the local bodies, which

practically rules out the self-governments real accessibility to the capital market for getting capital investments.

4. The role of third sector in promoting FD reform

Georgia's third sector organizations hold important expertise in fiscal decentralization issues. Their activity forms are: organization of training courses; implementation of studies; development of policy recommendations; organization of workshops and conferences to initiate public discussions. It should be said that so far the Central government is less interested in cooperation with non-governmental organizations on these issues. For example, studies carried out by CSRDG in 2008 and 2011, which, based on specific calculations, were aimed at evaluating fiscal independence of the self-governments, identifying the main problems existing in this area, and offering alternative ways for their solving, were not met with adequate interest expressed from the government.

Despite this, we believe that non-governmental organizations need to be more active in this field. We see their role in the following:

- Within the self-governance reform, evaluation of the level of self-governments' fiscal independence should be conducted with a certain regularity and policy recommendations developed, by performing respective legislation analysis and conducting empiric studies;
- Consolidation of non-governmental organizations (countrywide, as well as regionally) interested in fiscal decentralization issues, and development of their coordination and cooperation is necessary. This will help bring closer their positions and increase lobbying possibilities;
- Periodically, various formats of public discussions of the issue need to be organized that will ensure keeping the issue on the political agenda;
- Any possibility to participate in the fiscal decentralization reform needs to be utilized.

ARMENIA

1. Brief summary of the FD evolution, the major trends and key points of these steps

Republic of Armenia regained sovereignty in 1991 embarked on implementation of large-scale reforms and establishment of new political and economic systems. As a result of decentralization local self-government system has been formed. In the overall context of reforms the decentralization process per se was launched fairly late, i.e. in the aftermath of promulgation of the Constitution in 1995.

Legislative bases of decentralization, including FD, were founded in 1995-1998. After that period FD process has been stopped and there wasn't any development till 2005 when amendments in the Constitution of Armenia were made. But legislation bringing into compliance with the new provisions of the Constitution started from 2009 and continues nowadays.

There are 2 main measurable indicators for the evaluation of the degree of FD, such as:

- Share of local budgets expenditures in total public spending (indicator A);
- Share of local budgets expenditures in GDP (indicator B).

According to the data (indicator A was 8.8% and indicator B was 2.4% in 2011) the degree of FD in Armenia is fairly low. Armenia is way behind the EU countries in terms of both decentralization and financing of powers. Armenia is ahead from EU countries by indicator A from Greece, Cyprus and Malta and by indicator B only from Malta. These 2 indicators of Armenia very low in comparison with EU average ones. Indicator A in Armenia is small from EU average 3.8 times and indicator B is small 7.3 times. Trends of these 2 indicators are the following:

- Indicator A was 4.7%-7.9% from 1997 to 2009 without any clear trends and in 2010 and 2011 were 8.5% and 8.8%.
- Indicator B was 1.2%-1.7% from 1997 to 2009 with clear raising trend and in 2010 and 2011 were 2.4%⁸.

Development of local self-government without further FD is not possible in Armenia and further steps should be taken.

2. Short analysis of the legal framework regulating FD and actual situation: problems and gaps presented in the local taxes and charges, shared taxes, intergovernmental transfers, credits, loans and bonds, pending responsibilities of local authorities, local budget revenues, etc.

⁸ Significantly increasing of this indicator is a consequence of statute of municipality to Yerevan and incorporating unified budget of Yerevan municipality in the total structure of municipality budgets.

The Constitution of the Republic of Armenia, adopted by referendum on 5 July 1995, directly addresses issues of regional and local self-government in chapter 7, articles 104–110⁹. These articles became the legal foundation for decentralization reforms. Further legislation rapidly followed, paving the way for the creation of new system of local self-government in a short space of time.

The Law on Local Self-government (22 July 1996) established general principles (FD also) of local self-government as well as the specific division of powers within local governments.

The financial basis of local self-government was addressed by the Law on the Budgetary System (21 July 1997), which stipulates procedures for the creation, implementation and supervision of municipal budgets; intergovernmental fiscal relations; and types of revenues and expenditures. The Law on Local Duties and Fees (9 January 1998), which defines the types and permitted rates of local duties and fees, further enhanced local initiative and economic and political autonomy. Financial equalization grants from the central to local budgets are regulated by the Law on Financial Equalization (23 December 1998), which establishes the form of financial equalization grants, the main factors and formulas for their calculation.

Each of the above-mentioned laws has been repeatedly amended since adoption. Even the new Law on Local Self-government was adopted on 7 May 2002, which gave new responsibilities to the local governments.

Local budget revenues

By the Laws on Local Self-government and Budgetary System municipal budget revenues are:

- local taxes
- shared taxes
- state duties
- local charges (duties and fees)
- intergovernmental transfers
- other revenues (land and property rent, etc.)

Local taxes

On November 29, 2005 amendments in the Constitution of Armenia were made and some provisions related to the FD. Before the amendments in the Constitution there was not the term “local tax” in the legislation of Armenia and the following

⁹ On November 29, 2005 amendments in the Constitution of Armenia were made, including FD related issues.

provision has been included in the Constitution: “Municipal Council shall establish local taxes in accordance with the legal procedure” (Constitution, Article 107).

The additions and amendments introduced in the law on Taxes (April 27 2010) marked the outset of the process of introducing local taxes in the country. This law establishes property, land and hotel taxes as local types of tax assessment. Application of the first two types has been mandatory in all the municipalities, while the third shall be defined and established by the municipal council of the individual municipalities if so initiated by the head of the municipality.

One of the main characteristics of local taxes is the establishment of applicable rates of taxation by the LSGs within the scope defined by the legislation (European Charter of Local Self-government, Article 9:3). But the rates of property and land taxes shall continue to be defined by law; as it currently stands (the municipal council shall define exclusively the rate of the hotel tax). In this particular case it should be mentioned that the above mentioned provision contradicts the European Charter of Local Self-government insofar as the LSGs are not entitled to define the rates of taxation in case of the taxes that have been established as local by the national legislation.

Already at the end of 2009 the Ministry of Territorial Administration submitted to the Government of Armenia the draft Law on Hotel Tax¹⁰ stemming from the package of legal acts on local taxes but it hasn't been adoption yet.

Shared taxes

Tax sharing principle was used only in 1998-1999 years. Local budget tax revenues at that time were: property tax-95%, land tax-95% and PIT-15%. Nowadays there isn't tax-sharing in practice but the law on Budgetary System gives possibility to use principle of shared taxes on income tax, profit tax and environmental fees, fixing rates in the annual state budget law. But it is not applied in practice yet.

State duties

Two kinds of State duties are municipality budget revenues:

- duties for registration of the Acts of Civil Status, issue of the duplicates of the certificates for citizens on respective Acts, making alterations, additions in the records of the Acts of Civil Status and issue of certificates regarding the restoration;
- duties for render of notary services by the Notary Offices, issue of the copies of documents certified by notary, drafting of contracts and applications by notary agencies, issue of the copies of official documents and making extracts from them.

¹⁰ The draft law has been developed by the Communities Finance officers Association (CFOA).

Why these duties are state duties isn't clear. Both are municipal budget revenues and it is necessary to define these duties as local ones. There is one problem also. These state duties are budget revenues in those municipalities where exists appropriate offices. So, more than 800 municipalities haven't such offices and these 2 state duties aren't considered as their budgets revenues.

Local charges

In different countries and local government systems, the distinction between taxes, user charges and other miscellaneous revenues are blurred. Armenia is among these countries related to the distinction of local charges.

There are three types of local charges in Armenia: local duties, fees and fees for public services delivery (user charges). Types of local duties and fees¹¹ are defined by the Law on Local duties and fees and the types of user charges are not clarified by any law. Taking into account this situation, the Ministry of Territorial Administration of Armenia initiated development of the Concept on Local Duties and Fees for the purpose of their unification, clarification and updating. The draft law on Local Duties and Fees will be developed according to this concept.

Intergovernmental transfers

Grants apportioned to municipality budgets from the state budget are classified into following groups distinct in the purposes of allocation:

- *Financial equalization grants,*
- *Other grants,*
- *Subventions.*

If financial equalization grants distribution is regulated by the law, other two types of grants allocation haven't regulated by the law. It is necessary to mention that existing financial equalization mechanism only partially considers fiscal capacities of municipalities and hasn't take into account financial needs of municipalities. That's why was developed a new draft law on Financial Equalization, which was adopted by the Parliament in 2009 at first reading and final adoption of it is delayed.

¹¹ There are 12 types of local duties: duty for a license to start construction, strengthening, reconstruction of buildings and other civil engineering facilities (including temporary) or to change the exterior of a building in the territory of the community; duty for a license to start taking down a building or other civil engineering entity in the territory of the community; duty for a license, which meets community trade requirements to sell alcohol drinks and (or) tobacco products in the territory of the community; duty for a license for open-air trade activities; etc.

There are five local fees: fee for setting up and confirmation of technical and economic conditions and executive documents on construction of a new building or changing of the exterior of an existing one – against services provided by the local self-government body; fee for participation in auctions and tenders organized by local self-government – for the coverage of expenditures of the latter; etc.

Credits, loans and bonds

By the Law on Budgetary System among the sources covering of the municipal budget deficit are: loans, credits and financial means received from the allocation of municipal bonds. Budgetary loans and credits, from the national budget, receiving procedures are regulated by the Government Decrees. Receiving of loans from the commercial banks is regulated partially by the law. Allocation of municipal bonds aren't regulated by any legal act.

It should be mentioned that municipalities have not yet become subjects of capital market. There are only two-three cases from 1996 to 2012 when municipalities received loans, while no bonds were issued in any municipality whatsoever. One of the reasons this happening is the shortcoming of the legislation, lack of relevant mechanisms, lack of the Government interest, passive position of municipalities and so on.

Pending responsibilities of local authorities

Fiscal decentralization directly connected with decentralization of responsibilities. Local self-government bodies are responsible for delivery the following municipal services:

- water supply, sewerage, irrigation and central heating systems;
- construction, reconstruction and operation of municipality's irrigation systems;
- landscaping and municipality improvement;
- use and maintenance of municipality building stock, including residential and non-residential buildings, dormitories, administrative buildings and other municipality-owned structures;
- ensuring the proper maintenance of cemeteries;
- construction, maintenance and operation of roads, bridges and other engineering structures within the municipality's jurisdiction;
- operation of municipality public transport;
- sanitary cleaning, waste collection and disposal;
- streets lighten;
- kindergartens;
- specialized education;
- clubs, libraries and museums.

At first sight it seems that above-mentioned responsibilities are not few and now the main problem is their financing and proper fulfillment by local governments. In any case, it is very difficult to reach the ideal version, especially in transition countries. The functions implemented by the central government and local governments are nearly on the same level and there aren't any essential differences concerning their valuable functioning. That's why the powers correct distribution between various levels of government is very important and must be accompanied with administrative-territorial reforms at first.

Assignment of new mandatory powers to local self-governments is considered necessary and possible in the following areas:

- Secondary education,
- Public ordinance,
- Social security,
- Health care,
- Accounting and registration of population.

Transferring above mentioned responsibilities to local governments must be parallel accompanied with transferring of appropriate financial means, so FD.

3. Policy recommendations

In order to provide local governments with the necessary finances to carry out their responsibilities effectively and fully and for the further FD, the following steps should be taken:

- to transfer local authorities the right of definition of all local taxes rates within the limits of the law;
- to define a share of centrally established taxes (PIT and CIT) by law as a new municipality budget revenues;
- to define state duties for registration of the acts of civil status and for render of notary services as local duties and make appropriate amendments in the legislation;
- to develop the Concept on Local Duties and Fees for the purpose of their unification, clarification and updating and develop the draft law on Local Duties and Fees according to this concept;
- to adopt a new law on Financial Equalization, in which is taken into account fiscal capacities and financial needs of municipalities;
- to develop and invest a model on subventions (targeted transfers from the state budget to the municipalities budgets), which will be based on priorities defined by the central government, definition of winning applicants by the tender and transparency principle;
- to develop and invest a model on other grants:
- to establish all necessary conditions for involving municipalities in capital market (development of draft law on Municipal Bonds, additions in the laws on Local Self-government and Budgetary System related to the municipalities receiving loans from commercial banks).
- To transfer new responsibilities (secondary education, public ordinance, social security, health care, accounting and registration of population) to local authorities and to implement appropriate financial decentralization.

4. The role of third sector in promoting FD reform

The third sector may have important role in promoting FD reform. First of all, organizations of this sector can monitor implementation of the reform. They can establish networks in all regions in Armenia, to develop monitoring methodology jointly. Many organizations can be included in this process. It is not less important involvement of third sector organizations into the implementation of it. The number of such organizations is few. There is good experience in Armenia in this respect. Communities Finance Officers Association (CFOA) is a partner of the Ministry of Territorial Administration of Armenia, which is responsible for local self-government reforms. CFOA has developed many concepts and draft laws on local self-government; part of which have been adopted and some part are in the Government and Parliament in the process of adoption. Adopted concept on Local Taxes and Law on Additions in the Law on Taxes (new chapter on local taxes), concept on Consolidation of Municipalities and Inter-municipal Cooperation, the Law on Financial Equalization (adopted by 1st reading) has been developed by CFOA. In the process of adoption are the following concepts and draft laws: concept on Local Duties and Fees, draft law on Additions in the Law on Local Self-government (related to the citizen participation in local authorities), draft law on Hotel Tax, draft law on Implementation of Municipality Head`s Responsibilities.

CFOA is a partner of municipalities too. CFOA implements many projects with the partnership of municipalities directed to the adopted laws performance and local self-government development.