

# STRENGTHENING LOCAL GOVERNMENTS IN ARMENIA

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## Executive Summary

Decentralization reforms in Armenia have been carried out after the collapse of the Soviet Union. In 1991 Armenia gained independence and as in other post communist countries the reformulation of the whole centralized public administration system was carried out. Former territorial-administrative structure was changed; institution of local government was established with delegation of some tasks and responsibilities to the local levels. However, the decentralization process has been undertaken in highly centralized manner, without taking into consideration the fact that local governments are the first and the closest level of the public administration to the population and that they should be armed with substantial resources to implement their functions properly to meet the needs of the local residents.

The territorial-administrative system was restructured in such a way, which created a big number of small local communities, which even are not able to provide basic public services, assigned to them by the legislation. The revenue provision scheme has been also designed unsuccessfully: local governments do not have any fiscal power over their revenues, in other words they are not able to increase or decrease the amount of the revenues according to the peculiarities of their locality, since everything is decided centrally. As a result local governments are very much dependent on the central transfers. Moreover, the residents do not see any links between taxes they pay and services provided, since central government decides what and how much they should pay, without considering local preferences and features, which leads to the tax evasion. This thesis looks at two problems of high fragmentation and lack of fiscal power of the local governments and tries to propose policy recommendations adjusted to Armenian reality.

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## Introduction

Today Armenia is experiencing the transition process from the highly centralized communist system to a decentralized system of governance. Beginning from 1990s series of public administration reforms have been implemented. As a result of these reforms, the local self-government system has been established, the territorial-administrative division has been formulated, distribution of functions and interrelations among the levels of government have been clarified (Tumanyan 2006, p 73). However, Armenia is still one of the centralized countries among the Former Soviet Union republics (UNDP 2005, p35).

### ***Outline of the problem and objectives of the research***

A substantive criticism of Armenia's decentralization reform is that the degree of decentralization Armenia is pursuing is quite limited, with a limited revenue sources assigned to the local level. Reforms in the territorial-administrative system have also been rather unsuccessful: a large number of territorially fragmented communities is unable to generate enough revenues to provide basic public services to the residents. As a result, the biggest part of the local governments in Armenia, especially those in rural areas are economically underdeveloped and have weak financial viability to perform their functions assigned to them by the legislation. Moreover, the low degree of fiscal decentralization and the high fragmentation of local governments lead to high dependency on the central government transfers and decrease accountability of the local officials towards the residents.

This thesis discusses these two problems of low fiscal autonomy and high fragmentation of local governments together, as the main reasons of the weak financial and economic viability of local governments in Armenia; and tries to propose policy recommendations which can

strengthen the local governments' economic performance in the country. For this purpose, the thesis aims to focus on two important determinants of the economic performance of sub-national governments in Armenia: fiscal decentralization and the size of local governments. Specifically, the paper concentrates on one element of fiscal decentralization: revenue assignment, and on the degree of fragmentation of local governments in Armenia.

The main hypotheses of the paper are the following:

- ❖ The provision of fiscal power to the local governments over their own source revenues increases economic performance in the Republic of Armenia
- ❖ Integration of local governments improves the provision of local services and increases economic performance of the Republic of Armenia.

### ***Methodology and limitations of the research***

The following research methodology is applied:

1. In order to study the relationship between size and fiscal decentralization of local governments and economic performance a cross-country econometric model is constructed.
2. In order to develop appropriate policy recommendations, six open ended interviews<sup>1</sup> and three personal communications<sup>2</sup> are conducted with local government experts, NGO representatives, professors, and public officials in Hungary, Armenia and Spain; and the integration policies of local governments in six countries of Eastern and Western Europe as well as former Soviet Union are analyzed.

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<sup>1</sup> list of interview respondents is provided in Annex 2

<sup>2</sup> List of respondents is provided in Annex 3

The econometric research of the relationships between size, revenue autonomy and economic performance implies the definition of variables. However, due to time constraints and scarcity of data only a limited number of variables are included in the study.

### ***Structure of the thesis***

The first chapter presents an overview of the current territorial-administrative system in Armenia; then it describes the present local government revenue system, after that it analyzes the problem of low revenue autonomy and high fragmentation of local communities. In addition, this section describes the past experience of inter-municipal cooperation in Armenia, which aimed to cope with the problem of fragmentation. The second chapter provides an overview of the literature on the concept of local government size and its implications for the performance of local governments. Different schools supporting and opposing the integration policy are presented in this part. The second part of the literature review is devoted to the definition of fiscal decentralization, the description of four main components of this phenomenon, and emphasizes the implication of local revenues with respect to the fiscal autonomy of local governments. The third chapter looks at the relationships of fiscal decentralization and local government fragmentation with economic performance, using the cross-country econometric analysis. Specifically, the research methodology is described in detail, and then the main findings of the cross-country regression model are presented. The fourth chapter describes the international experience of five countries on the integration policy of local governments. The international practice in Eastern and Western European as well as former Soviet Union countries related to this policy is presented. The fifth chapter analyzes three policy options developed on the research findings, and assessment of these policy options according to the determined criteria



is conducted. Finally recommendations based on the assessment of the policy options are presented in this chapter. The final chapter is devoted to the conclusion part of the thesis.

# Chapter 1: Case of Armenia: Description and Analysis

## 1.1. *Territorial-administrative system*

The Law on Administrative-Territorial Division of the Republic of Armenia (1995) defines the government structure and territorial division of the country. Armenia is divided into 11 regions (marzes), including Yerevan, the capital of the country. Regions are governed by regional governors (marzpets), appointed by the Government of the country. The mayor of Yerevan<sup>3</sup> also has a status of Regional Governor<sup>4</sup> but is appointed by the President upon the Prime Minister's nomination. Governors are responsible for implementation of state policy in the regions of the country. Hence, regional offices are not sub-national tiers of government; they represent the central government in the regions.

Each region is divided into urban and rural communities. Despite the relatively small country size and population of about three million people there are 926<sup>5</sup> local governments in Armenia. According to the Law on Administrative-Territorial Division (1995) the total number of urban communities is 60, including 48 cities and 12 communities (districts) in Yerevan. The remaining 866 are rural. The peculiarity of the local government structure in the country is also the special status of the capital city of Yerevan. Having a regional status it is divided into 12 district communities. The district communities of Yerevan are self-governed and have elected mayors and councils, as any other community. Although it is obvious that the communities vary drastically by population number and their setting (urban versus rural) the Law on Local Self Government (2002) grants equal status to all the communities.

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<sup>3</sup> Capital of Armenia

<sup>4</sup> New Constitution adopted in 2005, stipulates change of the status of appointed Governor of Yerevan to the status of elected Mayor, however the legislation for these change is in the process of review.

<sup>5</sup> Before adoption of amendments in the Law on the Administrative Territorial Division of Armenia in 2006 there were 930 communities.

## 1.2. Local government revenues

Two main types of revenues are available to local governments in Armenia: own source revenues<sup>6</sup> and intergovernmental transfers. Table1 presents the percentage share of the main sources of community budget for five years.

**Table 1: Revenues and Transfers of local government budget in Armenia**

Revenues	2001	2002	2003	2004	2005
	%	%	%	%	%
Revenues of administrative budget, of which					
Tax revenues and Duties	34.2	26.1	29.8	30.6	27.8
Land Tax	10.9	7.4	8.8	8.6	7.1
Property Tax	18.4	15	17.3	15.5	17.6
Non-Tax revenues	10.9	11	12.9	12	12.3
Official Transfers	44.9	56.2	43.4	40.1	43.3
Capital Subventions	0.0	0.3	0.7	2.4	4.5

Source: Modified from Tumanyan (2004, 2005, 2006)

The intergovernmental transfers include formula-based equalization grants (discretionary subsidies) as well as subventions (earmarked expenditures). It is obvious that the official transfers constitute the biggest share of local government revenues for all the five years. Own source revenues include two elements: tax revenue sources and local non-tax revenues (including duties and fees).

The laws on the Budgetary System (1997) and Local Self-government (2002) give an opportunity for the application of tax-sharing model in budgetary system of Armenia. The types of shared taxes, which can be local budget revenues are fixed in these laws. Besides, it is possible to define a share of taxes as local budget revenues every year in Annual State Budget

<sup>6</sup> Here own source revenues also include tax revenues, over which local governments do not have power to set tax rate and base. In the literature own source revenues are defined as revenues over which the local government have the fiscal power to set tax base and/or rate ( Ebel and Taliercio ,2006; Levitas and Peteri ,2005; Martinez-Vazquez and Boex (2004, p 420)

Law (Tumanyan 2002, p 10). In 1997 the land tax and property tax were the only taxes which were collected as tax revenues for the local governments. Later income tax was added (see Table 2), but only 15% of it was allocated to community budgets. However, the amount of income tax was very small in rural communities. That's why it was decided to include income tax in the state budget revenue in 2000. As a consequence, land and property taxes have been left as the only community budget tax revenues and have been paid to the community budget by 100%. In 2002, the legislative framework was reformed to assign the responsibility to collect these taxes by the local governments, although both tax base and rate for these taxes are actually defined by the central government (Tumanyan, 2002).

**Table 2: Share of Centrally Established Taxes Paid to Community Budgets in Armenia, 1997-2000**

<b>Year</b>	<b>Income Tax</b>	<b>Land Tax</b>	<b>Property Tax</b>
1997	-	100	100
1998	15	95	95
1999	15	95	95
2000	-	100	100

Source: Tumanyan (2002)

On 26 December 1997, the Law on Local Duties and Fees was adopted in Armenia, prescribing procedures for the implementation of requirements for nine local duties and three local fees. Under the law, community councils have the right to set rates within a defined range, which is determined by the central government (UNDP 2005, p42).

### **1.3. Problem description**

The problem of weak financial viability of local governments in Armenia is considered as one of the main obstacles for the economic development of the country. Local governments with poor economic and fiscal capacity are not able to provide high quality public goods and services, because the revenues they mobilize are not enough for it. Moreover, there are rural communities

where the residents do not even receive basic services, such as first medical aid, primary education, kindergartens, etc. It has a direct impact on the human factor; people tend to leave the community with low fiscal capacity, which drastically decreases the number of populations in rural communities. As a result the communities with low fiscal position automatically become fully dependent on the intergovernmental transfers allocated by the central government. Yet, in this case they encounter with the problem of irregular allocation of the capital transfers, since in reality intergovernmental capital transfer mechanism is unclear and very much manipulated by the central government (Coxson 2003). The major part of subsidies is transferred at the end of the current year, mainly in the last decade of December. Some communities may receive the subsidies earlier, others later; there is no appropriateness (Tumanyan 2002, p 10). Under such situation, where the local governments are almost completely dependent on the central governments, the accountability mechanism of the local officials is very weak and local residents do not have any trust towards the local officials. The low fiscal autonomy of local governments and high fragmentation of rural communities are two main causes of low economic performance of the local governments.

### **1.3.1. Low fiscal autonomy**

A major weakness of the revenue assignment to the local government level is that local governments do not have any rate-setting discretion over their own revenue sources. This means that at the margin, local governments are unable to either increase or decrease the amount of local revenues collected (UNDP 2005, p. 44-45). Although communities have obtained the power to collect the land and property taxes at their own in 2002, still local governments do not have the fiscal power to set the base and rate of these taxes. In spite of the fact that sub national

jurisdictions have the rate-setting power over the non-tax revenues, these revenues constitute only about 12% of the total local government revenues (See Table 1). Having such a little fiscal power at the local level the local officials lose the accountability toward their electorate, because the link between the willingness of residents to pay taxes and provision of public services becomes less visible and weakens. Furthermore, if the people do not see the link between their payment of taxes and the public goods/services provision by the local governments, they do not see any sense to pay taxes, which leads to the various types of tax evasion and automatically decreases tax revenues of the local governments (UNDP 2005,p.44-45). Consequently, the economic performance of the communities with low fiscal autonomy at the local level dramatically drops.

### 1.3.2. High fragmentation of local communities

Another main cause of low fiscal viability of local government is the large number of extremely small local government jurisdictions; this fragmentation is broadly understood to be detrimental to the ability of local governments to effectively deliver local services (UNDP 2005, p 33-34). As it was mentioned above, there are currently 926 communities in Armenia, each with its own local self-governing body. Two-thirds of the population live in the country's 60 urban communities (twelve of which are in capital itself). The remaining third of the population reside in 871 rural communities. As Table 3 demonstrates there are 481 rural communities where the population is less than 1,000 residents, which constitutes 6.6% of the whole population of the country.

**Table 3: Number of Communities by Population Size**

Population Size by Categories	Number of Communities	[%]	Number of inhabitants	[%]
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Below 1,000	481	51.7	212,009	6.6
1,000-2,000	207	22.3	295,484	9.2
2,000-5,000	162	17.4	470,443	14.6
5,000-10,000	42	4.5	277,438	8.6
10,000-50,000	26	2.8	540,195	16.9
50,000-100,000	3	0.3	237,045	7.4
100,000-1,000,000	9	1.0	1,180,397	36.7
Above 1,000,000	--			
Total	930	100	3,213,011	100.0

Source: (Tumanyan, 2006)

Although the average population size of these communities is approximately 400 residents, there are communities where the population number does not exceed 100 people, especially in the remote mountainous areas. Specifically, there are around 36 rural communities in Armenia having a population of less than 100 people; 163 communities with population of less than 300; 176 communities with population between 301 and 500 people; 185 rural communities with population between 501-1000 people (Tumanyan and others 2003, p9). The communities with such a small number of population can not provide local services at all, which is disastrous for the residents of these communities. Under such circumstances, it is apparent that communities are able to mobilize very tiny revenues, which makes them completely dependent on the central government transfers to survive.

### **1.3.3. Unsuccessful integration policy**

An unsuccessful effort was made to solve the problem of the fragmentation of local governments through establishment of Inter Community Associations in 2001. Thus, starting from 2001, Armenia ratified the European Charter of Self-Government, which together with the

Law on Local Self-Governments (amended in 2002), Law on Administrative and Territorial Division (1995) as well as Civil Code of the Republic of Armenia (1998) constituted the legislative framework<sup>7</sup> of the Inter-Community Associations (ICAs). Although the creation of ICAs was supported by well developed legislative framework and was carried out at the initiative of communities, National Assembly and German Technical Cooperation (GTZ) international donor organization, the formulation of ICAs was not successful. The main reason for the failure of this policy was the lack of the uniform regulatory framework, as well as financial and technical assistance from the central government (Tumanyan and others, 2003). As a result, the ICAs have been successfully established and operated only in two regions of Armenia for a short period of time, in the Syunik Region and Tavush Region, where the GTZ had established its local offices and was cooperating with local ICAs within several projects, directly financing these ICAs. Once GTZ Agency finished its projects in these regions in 2006, the ICAs were dissolved ( Tumanyan and others, 2003).

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<sup>7</sup> See Annex 1



## **Chapter 2: Theoretical Framework**

Considerable literature is devoted to the size and fiscal autonomy as important determinants of the economic performance of sub-national jurisdictions. A review of the relationship between these two variables and economic performance is more relevant if we start from the definition of these determinants.

### ***2.1. Fragmentation of sub-national governments***

The fragmentation degree or more generally, the size of the local government can be determined with two measures: population and surface area of a particular jurisdiction. Although the surface area is more applicable for analysis of such issues as network infrastructure, population number seems to be a more popular indicator in respect to the economic performance of local communities (Swianiewicz 2002, p 5).

#### **2.1.1. Why size matters**

Importance of size as one of the determinants of functioning of local governments has been analyzed by scholars. Population size of sub-national units is very important first of all because it affects the ability of local governments to collect financial resources and to hire local staff to implement their tasks (Davey, 1992, p35). Moreover, size is often cited as a key factor in terms of the efficiency of municipalities, namely efficient provision of public goods and services (Moisio, 2001, p 3). In this context, the balance between economies of scale and various preferences of taxpaying residents is crucial. Thus, large municipalities are more efficient in delivering the services, which exploit the economies of scale. In other words, larger local governments provide public services at a lower marginal cost than small local communities. According to Swianiewicz (2002, p 8) the marginal cost of delivered services is lower when the

total amount of services is larger. On the other hand, the fact that in smaller municipalities public officials are closer to the residents and as a consequence meet their preferences in a more efficient manner supports the argument for small size municipalities (Moisio, 2001, p 4). The optimal size of sub-national governments is the subject of different arguments with respect to the integration and fragmentation of municipalities. The next section provides the background to the academic literature which examines these two approaches.

### **2.1.2. Fragmentation or consolidation – insight into the academic debate**

The academic literature presents two dominant theoretical models related to the degree of local government fragmentation and economic development: a polycentric model and a centrist model.

#### **Polycentric Model or Public Choice School**

The essence of the Polycentric model, which is also called Public Choice model, is that fragmented local units are more efficient in the provision of local services. This theory states that a fragmented government structure gives more choice among services provided by the governments for residents with various preferences. In other words, smaller local governments can include more homogenous social groups with the same preferences, making them easier to be met. This fact provides residents with an opportunity to move between the large number of municipalities according to their preferences for taxation rates and bases and the quality and level of local services, providing good value for money (Berman 2003). As Tiebout (1956) states, in small units citizens can “vote with their feet” i.e. choose their preferred ratio of local taxes versus public goods and services provided by municipalities (Swianiewicz 2002, p 10).

Further, proponents of the Polycentric Model argue that fragmentation constrains government costs and increases the performance of local governments through competition (Tiebout, 1956). Moreover, “fragmentation supports competition between local governments in attracting capital to those places where it will be more productive” (Swianiewicz 2002, p 11). Fragmentation also supports experimentation and innovation. Specifically if there are fragmented local communities in a particular region, it is easier to conduct different policy experiments and to learn from the experiences of the neighboring jurisdictions (Swianiewicz 2002, p 11). Another argument in favor of fragmentation is that in ethnically mixed societies, there can be a strong demand for distinctiveness, and residents of fragmented communities can be reluctant to consolidate with other sub-national governments (Swianiewicz 2007, p 219). Polycentrists believe that all the above mentioned arguments enhance accountability and efficiency of local governments.

#### **Centrist Model or Traditional Reform School**

In contrast, supporters of the Traditional Reform School or Centrist model assert that governmental integration or consolidation support economic growth. They argue that large local governments are more efficient in administration and production. Further they state that consolidated governments have a “larger pool” of recourses and therefore provide a wider variety of desirable services than fragmented communities (Nelson and Foster 1999). There are several arguments in favor of consolidation of local governments, proposed by the proponents of this school.

**Economy of scale.** As was mentioned above in the paper, economy of scale refers to the microeconomic concept of decrease of marginal cost of production with the bigger size of firm or community. In other words, it means that larger local governments are able to provide public services at lower marginal cost than smaller local governments (Swianiewicz 2002, p 11).

However, integration policy does not always exploit the economy of scale. Fox and Gurley (2006) bring an example of water provision, pointing out that on the one hand the treatment of more water may yield scale economies, on the other hand, this must be balanced against the cost of distribution to a greater area, which means the cost of more piping. Moreover, Davey (1992) argues that many municipal services do not require large scale operations and therefore the cost of certain local services does not correlate with the size of municipality.

**Financial capacity and broader revenue base.** It is commonly assumed that large municipalities have a broader revenue base, which positively affects the stability of tax revenues. Moreover, financial resources provide flexibility in deciding about the distribution of these resources (Ignatov, 2004).

**Economic Development.** Large local governments support the promotion of local economic development. Larger scale enables complex planning and makes it possible to finance big infrastructure investment projects, which are important for economic development (Swianiewicz 2002, p 10). Moreover, large communities have stronger economic base combined with lower per unit operational cost, which results in a large part of their revenue base. Another argument suggesting that big local communities are more economically developed is that big municipalities have bigger advantage and capacity to use credit resources to finance investment projects. This is because first of all they are treated as “better clients” for commercial banks and other investors, and secondly due to the more developed skills of the administrative staff (Swianiewicz 2002, p 308-09).

### 2.1.3. Cooperation or amalgamation

The literature mostly discusses two main types of integration of communities: merger or territorial amalgamation and joint cooperation among different communities in the provision of public goods and services. Although the literature does not separate these two policies and the advantages and aims of both of them are actually the same, there are slight differences between the joint cooperation and territorial amalgamation of communities in regard to the effectiveness and feasibility of implementation of these two policies (Swianiewicz, 2007).

One of the important arguments against the merging policy vis-à-vis joint cooperation is the reluctance to amalgamate from the side of residents of fragmented communities aiming to keep their identity. Amalgamation policy in this case can be very rigid and can create tensions in the society. In this case, inter-municipal voluntary cooperation is considered as a more feasible solution to the problem. It is often seen as an alternative to the creation of large local governments through amalgamation process (Swianiewicz 2007, p 221).

Cooperation among municipalities also has its political and economic costs. Cooperation encompasses transaction costs with complicated administrative-managerial setting. There can also be problems related to the lack of transparency and accountability in case the decision makers of “cooperative body” are not directly elected (Swianiewicz 2007, p 223).

However, the "voluntary cooperation of municipalities" is considered as the most commonly accepted policy by most of the scholars (Swianiewicz 2002, p 321; White 2002; Steiner 2003). It is generally accepted that in spite of the above mentioned drawbacks, one of the important benefits of inter municipal cooperation vis-à-vis territorial amalgamation is the benefit of preserving the identity and autonomy of small local governments (Swianiewicz 2007, p 223). Moreover it is worth mentioning that even in countries, where the fragmentation of local

governments is very low<sup>8</sup> inter-municipal cooperation is still available and is very successful (Swianiewicz 2002, p 273, 287). Swianiewicz (2002) also adds that, regardless of the territorial model type of the public administration, there are always functions which can be performed more effectively when a few local governments cooperate with each other.

## **2.2. Fiscal Autonomy**

To define fiscal autonomy Ebel and Yilmaz (2007, p 62) refer to the European Charter of Local-Self Government, which recognizes the autonomy of local governments through four fiscal pillars: expenditures, revenues, intergovernmental transfers and borrowing and debt. Furthermore, Ebel and Yilmaz (2007, p 63) equate fiscal equalization with fiscal decentralization, pointing out that the empirical literature refers to these two terms with the same meaning.

Davey (2002, p 11) defines fiscal decentralization (fiscal autonomy) as a devolution of financial aspects to regional and local government. He adds that alternative descriptions “central-local (or intergovernmental) financial relations” and “fiscal federalism” are often used by European and American writers respectively. According to him (2002, p12) fiscal decentralization covers two interrelated issues. The first is the division of spending responsibilities and revenue sources between levels of government (national, regional, local, etc.). The second is the amount of discretion given to regional and local governments to determine their expenditures and revenues. In other words, fiscal autonomy implies the discretion provided to sub-national governments to define their revenues and expenditures.

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<sup>8</sup> for example Bulgaria, Poland

### **2.2.1. Four building blocks of fiscal decentralization**

Martinez-Vazquez and Boex (2004) provide a broader vision to fiscal decentralization, emphasizing four building blocks: assignment of expenditure responsibilities, sub-national borrowing, revenue assignments and intergovernmental transfers.

The expenditure assignment plays a very important role in the fiscal decentralization system, because expenditure is directly related to the provision of public goods and services, which is the primary economic goal of each sub-national government. The efficient provision of public goods and services is best achieved according to the subsidiarity principle, which means that the provision of goods and services should be made at the lowest level of government, which does it in the most efficient way.

The second dimension of fiscal decentralization system is sub national borrowing. Central governments, especially in transition countries are often reluctant to delegate the borrowing power to sub-national governments. This approach is mostly based on the risk to lose control over fiscal policy as a macroeconomic management tool. However, such countries as Czech Republic, Poland and Hungary have recently established well-developed basis for local government borrowing mechanism. Well-developed capital markets, and institutions such as bankruptcy legislation, disclosure of information and rating agencies are crucial elements for borrowing at sub-national level (Swianiewicz, 2004).

The third component of fiscal decentralization is the intergovernmental transfer system. Because sub-national governments especially in the transition countries are unable generate sufficient financial resources from the own source revenues, intergovernmental transfers play essential role in the framework of fiscal decentralization (Martinez-Vazquez and Boex 2004).

There are two main types of transfers, which should be taken into consideration. The first type is the general purpose (unconditional) block grant. This type of grant is allocated on an annual basis and its use is not restricted. In other words sub-national governments can use these grants for any purpose they find reasonable. Grants allocated for equalization purposes, to equalize horizontal disparities among different jurisdictions, are mostly general purpose unconditional grants (Musgrave and Musgrave 1989: p 486). By contrast, conditional grants are those the use of which is restricted to specific purposes. These types of grants are mostly used in transition countries. Thus, intergovernmental transfers can be classified according to the degree of fiscal autonomy (See Annex 2). However, as Davey (2004, p 9) points out, intergovernmental transfers should not be so dominant to discourage the use of discretion to vary the rates of the taxes and charges which accrue to the budgets of local governments.

**Revenue assignment.** The fourth pillar of fiscal decentralization refers to sub-national revenue assignment. Academic literature pays great attention to this component of fiscal autonomy. Martinez-Vazquez and Boex (2004) claim that sub-national governments that lack independent sources of revenues can never have fiscal autonomy. The same approach is also used by Levitas and Peteri (2005, p 20), according to whom, “the first and most important principle of public finance is that local governments should finance as much of their responsibilities as possible through local own-source revenue (taxes and user charges) the rates, bases, and administration of which are truly under their control”. Ebel (2007, p 110) in regard to local revenue assignment refers to the European Charter of Local Self-Government, which says that “Local authorities shall be entitled ... to adequate resources of their own, of which they may dispose freely within the framework of their powers”. “That principle of granting local governments “own revenue” taxing power is fundamental to a system of local self-government apply to any decentralizing



country” (Ebel and Taliercio, 2005). However, in this regard two important questions are raised: why local revenues matter and which revenues are considered as own source revenues.

**Own source revenues.** The academic literature does not clearly define the issue of sub-national or local revenue (tax). Thus, the Government Finance Statistics (GFS) of the International Monetary Fund (IMF) are reported in a manner that lumps together as a sub-national or local revenue both sub-national receipts from tax sharing of central collections and own taxes and non-tax revenues-fees, charges (Ebel and Taliercio 2006, p 8). On the other hand, Ebel and Taliercio (2006) state that taxes of sub-national government may be divided into categories of decreasing local autonomy (Table 2). If sub-national governments (SNG) have total or significant control over a tax, fee or charge as demonstrated by own political control over tax rate (necessary and sufficient) or base, it is a sub-national (local) tax. If the sub-national government has no control over the rate of a tax then it is not a local tax.

**Table 4. Classification of local taxes by degree of local autonomy**

High Revenue Autonomy	SNG sets tax rate and base	Highest degree of own - source revenues
	SNG sets tax rate only	Necessary and sufficient condition for categorization as “own revenue”
	SNG sets tax rate, but only within centrally permissible ranges	A typical practice is to cap the top rate
	Tax sharing whereby central/local revenue split can be only changed with consent of SNG	Can result when a local authority collects the tax and remits to the center.

No Local Autonomy	Revenue sharing with share determined unilaterally by central authority.	100% control by center; this category is a source of much misspecification of what is a central vs. local revenue
	Central government sets rate and base of “SNG revenue”	May accompany political decentralization

*Source:* Adapted from Leif Jensen, OECD, Report 7, 2002.

Furthermore, Levitas and Peteri (2005, p 11) divide sub-national own revenues into two parts fiscal and non fiscal. Own source fiscal revenues are generated from taxes controlled by local governments, while own source non fiscal revenues comes from either user fees or charges controlled by local governments, or from rental or sale of municipality property. According to them (2005, p12) a “pure” local government own-revenue is a tax, user fee, or charge, the rate, base, and administration (registration, collection, and enforcement) of which is entirely controlled, or determined by democratically elected local officials. Thus, Levitas and Peteri (2005, p14) conclude that the single most important characteristic of an own source revenue is defined as a tax, fee or local government user charge, over which the local governments have the power to set at least the rate.

### **2.2.2. Why fiscal autonomy matters**

What are the major advantages of delivering more fiscal power to sub-national governments? The first argument is that within the framework of a decentralized system the government is moved closer to the people. This is an economic efficiency argument which served as an incentive for most scholars involved in this subject (Oates 1972; Musgrave 1983; Bahl 2007).

The following example described by Bahl (2007, p 256) brightly shows an advantage of delivering more power to local governments, especially the power to formulate their budgets by themselves. Let us assume that people's preferences for services provided by the government are different due to several factors such as religion, language, income, climate, etc. Let's assume also that people have settled in a way that those with similar preferences and tastes live in the same region. If local governments formulate their budgets according to these preferences, then different sub-national jurisdictions will provide various public services according to the preferences of their residents. In this way the welfare of the society will be enhanced since people will get what they want. The centralized system does not provide such an opportunity to the local governments to adjust the local revenues and expenditures to the preferences of the people, because under this system the service provision is more uniform and people in different jurisdiction will get less service mix than they want.

Ebel and Peteri (2007, p110) highlight the importance of local taxes, stating that in order to be able to provide high quality goods and services, sub-national governments must be allowed to exercise their own source taxation and should be in a financial position to do so. That is the essence of decentralization, and this is why fiscal autonomy matters.

### **2.3. Conclusion**

The literature review reveals that academic discussion around the size of local governments does not provide strong arguments in favor of consolidation or fragmentation. Both policies have their advantages and drawbacks in terms of local government efficiency.

Nevertheless, it can be concluded that small local communities gain in terms of better accountability of local governments to the public, in increasing competition between small

communities, which leads to the development of innovation and experimentation as well as improvement of attracting capital.

On the other hand, the best argument in favor of integration relates to the benefits in economic efficiency and development, financial viability and economies of scale of large local communities. The academic literature also discusses the mechanism of integration of communities. Specifically, the literature emphasizes two types of integration: territorial amalgamation of small communities and voluntary inter-municipal cooperation. In this regard, most scholars argue in favor of the inter-municipal cooperation due to its advantages of preserving the autonomy of small local governments and its flexibility.

The second subject of discussion is about the degree of fiscal autonomy of local governments. It is obvious that academia pays considerable attention to this issue. The theoretical framework shows that the importance of fiscal autonomy is supported by a big body of theory. Within the framework of fiscal autonomy the role of local revenues is crucial. High degree of fiscal autonomy in terms of local revenues gives an opportunity to be less dependent on the central transfers and to be more accountable to the local residents by adjusting local revenues to their preferences.

## Chapter 3: Methodology and Econometric Model

This chapter consists of three sections. The first section provides empirical evidence of series of studies on the relationship between fiscal decentralization and economic performance as well as reports about several researches aimed to study the impact of local government size and degree of fragmentation of communities on the efficiency and economic performance of local governments and national governments. The second section describes the detailed methodology of the econometric model of cross country regression analysis. Quantitative measures of dependent and independent variables are defined; data sources as well as econometric model are presented in this section. The third section presents findings of the econometric model.

### ***3.1. Previous Empirical Studies***

Because the methodology of the econometric model mostly relies on the previous empirical studies, in order to define some important variables, the review of previously conducted empirics is essential for the research.

#### **3.1.1. Empirics on revenue autonomy**

There is a large body of literature studying the impact of fiscal decentralization on economic growth, economic stability, public size and economic efficiency (e.g., deMello,2000; Davoodi and Zou,1998). Thus, deMello (2000) analyzes the impact of fiscal decentralization on budget balance, measured as the ratio of the fiscal deficit to GDP, and argues that decentralization promotes fiscal imbalance. He uses several independent variables that explain budget balance, including sub-national tax autonomy (ratio of tax revenue to total sub-national revenue), sub-national fiscal dependency (ratio of intergovernmental transfers to total sub-national revenue),

and sub-national spending share (ratio of sub-national government spending to total government spending). Findings show that sub-national tax autonomy “worsens fiscal position”. Similarly, Davoodi and Zou (1998) look at the relationship between economic growth and fiscal decentralization, measured as the sub-national share of total government spending, and argue that fiscal decentralization is associated with slower economic growth. Further, Oates (1985) conducted the research to test an impact of fiscal decentralization on public sector size and found that fiscal decentralization does not limit public sector size.

However all these studies did not take the factor of revenue autonomy of sub national governments into consideration, while measuring the fiscal decentralization. Thus, in his study deMello does not distinguish whether local governments have the control over tax rate and tax base. Davodi and Zou measure the fiscal decentralization as a sub-national share of total government expenditure. This variable does not represent the multidimensionality of the fiscal decentralization process (Alm and Martinez-Vazquez 2003, p 112). Without taking into consideration the revenue autonomy of sub-national governments the fiscal decentralization variable is very weak.

There is little research that looks at the revenue autonomy of sub national governments as a determinant of economic performance. Ebel and Yilmaz (2002) replicated the models of deMello, Oates and Davoodi and Zou, adding their variables from OECD (2001) data, to find out how the revenue structure of sub-national governments affects estimation results. The dependent variable in this model was the growth rate of real per capita output, and independent variables are:

- sub-national tax autonomy (own tax revenues/total sub-national revenue)
- sub national non tax autonomy (own non tax revenue/total sub-national revenue)
- sub-national fiscal dependency (intergovernmental transfers/ total sub national revenue)
- sub national tax sharing (taxes received from the tax sharing /total sub-national revenue)

The result of this study supports the hypothesis: sub-national tax and non tax revenues, which represent own-source revenue, have positive impact on the economic growth. In addition Meloche, Vaillancourt and Yilmaz, (2004) propose three new measures of fiscal decentralization in respect to own revenue autonomy. The first one, called “revenue autonomy”, is the ratio of sub national governments own source revenue over its total revenue. Own source revenue is defined as the sum of tax autonomy, non-tax autonomy and intergovernmental grants. The second measure is titled as “own revenue ratio”; which is the ratio of sub national governments’ own revenue to aggregate government revenue. Opposed to this, the third proposed measure is “dependent revenue ratio”, which is the ratio of sub-national government revenue controlled by central government, to aggregate government revenue. Estimation results show a positive and significant coefficient for the sub national revenue autonomy variable. To sum up, it is evident that in order to measure the fiscal decentralization it is important to consider the factor of local revenue autonomy, and that own source revenue matters for the economic performance of the country.

### **3.1.2. Empirics on fragmentation**

Although there have been researches devoted to the study of fiscal decentralization impact on economic performance of the country, there are very few researches looking at the relationships of sub-national government size and economic performance at the national level. Most of the researches study the impact of sub-national government size on the economic performance and efficiency at the local or regional level. Thus, Feld, Kirchgassner and Schaltegger (2004) empirically study the impact of different determinants of fiscal federalism on economic performance measured by GDP per capita using panel data for 26 Swiss cantons from 1980 to 1998. Among different instruments of fiscal decentralization they also define the fragmentation

of cantons as independent variable and measure it as the number of communes in a canton divided by population. The findings show that fragmentation of cantons does not affect real GDP per capita.

On the other hand Ignatov (2004) studies the relationships between the local government size and various indicators of performance of local government in Estonia. He comes to the conclusion that larger local governments have significant advantages in carrying out their tasks in an efficient and effective way.

### **3.2. Methodology**

Although both Ebel and Yilmaz (2002) and Meloche, Vaillancourt and Yilmaz, (2004) consider the different combination of sub national revenue structure they do not apply the concept of «pure» own revenues proposed by Levitas and Peteri (2005), namely Levitas and Peteri define «pure» own source revenues as those tax and non tax revenues the rate, base, and administration (registration, collection, and enforcement) for which is entirely controlled by democratically elected local officials. As it was mentioned in the previous section Meloche, Vaillancourt and Yilmaz, (2004 p 12-13) define own source revenue as the sum of tax autonomy, non-tax autonomy and intergovernmental grants together and Ebel and Yilmaz (2002) define this variable separately as tax autonomy, non tax autonomy, tax dependency and tax sharing.

Thus, for my research I measure fiscal decentralization as an independent variable, using approach of Levitas and Peteri (2005) for revenue autonomy variable, which is structured as the sum of those own tax and non tax revenues, over which sub national governments have the right to set either rate or base or both (Annex 5).



The next independent variable is fragmentation of local governments, which is measured based on the method applied by Feld, Kirchgassner and Schaltegger (2004). As mentioned, they measure fragmentation variable as the ratio of local governments in a canton to the population of the canton. Although the dependent variable in their research is the economic performance of different cantons, in my research I use the same independent variable to measure its impact on the economic performance of the different countries in transition (Annex 6).

Because I conduct cross country regression analysis, the dependent variable is the average growth rate of real GDP per capita over the period of 1996-2004. For the regression I also use the set of control variables such as the average growth rate of population, initial human capital, and initial per capita GDP. The measure of human capital is the secondary school enrollment rate. After combining all the above mentioned variables from various data sources, I obtain a cross-country data for 24 countries. The Annexes 5 and 6 present the list of countries included.

Thus, I estimate the regression model of the form:

$$Y_i = \alpha + \beta RA_i + \delta FR_i + \theta X_i + \varepsilon_i$$

where:

$i (= 1 \dots I)$  refer to country  $i$ ;  $Y_i$  is the dependent variable- average economic growth of real GDP per capita;  $\beta$ ,  $\theta$  and  $\delta$  are the vectors of coefficients, and  $\varepsilon_i$  is the error term.

RA is the independent variable of local revenue autonomy

FR is the independent variable of fragmentation rate of local governments

$X_i$  is a vector of all control variables, which includes:

- average growth rate of population
- initial human capital
- initial per capita GDP.

### 3.2.1. Data sources

The data for the analysis is obtained from the various sources. Data of the own revenue variable for the 10 European countries is obtained from the OECD publications (2001, 2002) data set, used by Ebel and Yilmaz (2002) and then later by Meloche, Vaillancourt, and Yilmaz (2003). Whereas the same data for the former Soviet Union and Balkan countries is obtained from the various publications and researches available in the LOGIN (Local Government Information Network) of Local Government and Public Service Initiative Project (LGI/OSI), as well as books published within the framework of LGI Series<sup>9</sup>. The same source of data was used for the fragmentation variable. Other data, including population number, GDP per capita, economic growth, and human capital was obtained from World Bank and IMF data set.

### 3.3. Findings of econometric research

Findings of the regression analysis show no significant effect between fragmentation, fiscal decentralization and economic performance. Table 5 shows that no variable have significant effect on the economic growth.

**Table 5: Regression output**

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	7.675	3.404		2.255	.037
	Revenue Autonomy	-.067	.067	-.347	-.998	.331
	Fragmentation rate	.027	.045	.187	.605	.553
	Initial GDP per capita	4.11E-006	.000	.005	.018	.986
	School enrollment rate	-.029	.042	-.173	-.696	.496
	Population growth rate	-.85.045	68.315	-.278	-1.245	.229

Dependent Variable: Average Growth rate of GDP per capita

<sup>9</sup> LGI series is the series of the books, related to decentralization reforms in Central and Eastern European as well as former Soviet Union countries, published based on the researches made either by the LGI experts in different transition countries or LGI fellows, who do research for LGI in the home countries.

Nevertheless, there are some objective causes of the lack of positive effect, which are worthy to mention. First of all due to the lack of data for the Soviet Union countries, the research does not consider the composition of revenue of local governments, such as own revenue ratio<sup>10</sup> and dependent revenue ratio<sup>11</sup>, as it is done by Miloche, Vaillancourt and Yilmaz (2004). According to their empirical study the statistically significant effect was evidenced between fiscal decentralization and economic performance due to these variables. Secondly, the research does not consider the expenditure part of the sub national governments, which is also essential technique for measuring the fiscal decentralization (Oates, 1985; Davoodi and Zou, 1998) due to the lack of current data as well as the aim of the research<sup>12</sup>. The reason of the absence of the correlation between the fragmentation variable and economic performance of the studied countries may be the problem of the weak linkage between the size of local governments and the economic performance of the whole country. The correlation might be significant in case of the analysis of the same study at the local level (studying the impact of fragmentation on the economic performance of the local communities) rather than at the national level. However, it was not possible to conduct such a study due to the absence of relevant data for all the local governments in Armenia.

Moreover, I acknowledge that the government efficiency<sup>13</sup> could be a better measure of the economic performance of local governments, however in this case the thesis should have been focused on the efficiency of one service provision. Thus, in the future, a natural extension of this work would be to run a regression with government efficiency being the dependent variable.

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<sup>10</sup> ratio of sub national own revenues to the aggregate government revenues, considering tax, non tax as well as “own” intergovernmental grants as sub national own revenues

<sup>11</sup> ratio of sub national government revenues controlled by the central government to the aggregate government revenues

<sup>12</sup> the present research is focused on the revenue autonomy of sub national governments

<sup>13</sup> to measure the efficiency of local government one service provision is analyzed

## Chapter 4: International Experience of Integration Policy

This chapter reviews the international experience of integration policies of local governments in five different countries: Poland, Hungary, Slovakia, Estonia and Spain. The countries are chosen according to three main criteria: geographical area, type and specifications of integration policy. Thus, Hungary and Slovakia have high fragmentation of local government system and represent the group of transition countries in Eastern Europe; Spain has the same highly fragmented local government structure but is considered as developed Western European country; Poland is the country with very big size of local communities and still is an example of successful implementation of inter-municipal cooperation and Estonia is the former Soviet Union country which has undertaken the policy of territorial amalgamation.

### 4.1. Poland

In Poland the present division into basic territorial units (*gminas*) was introduced in 1973 as a result of big consolidation of earlier smaller units, called *gromada*. Later, there was further gradual consolidation in 1978 (Swianiewicz 2002, p 227). At present Polish rural municipalities are relatively large (a typical rural *gmina* has population between 7 and 8 thousand) and consist of several settlement units. Recent empirical studies show that total revenue per capita grows with the size of local government. Moreover, the dependency on the state transfers is higher in smaller local municipalities, and smaller local governments are more costly for the public finance system; they require higher transfers, mostly due to higher per capita current spending. It is important to mention that the level of revenues from own and shared taxes is also increasing in the larger communities (Swianiewicz 2002, p258). Furthermore, municipalities' potential for

economic development increases with the rise of population. Larger units have more resources as well as higher human and economic potential (Swianiewicz 2002, p 258).

In spite of the relatively large size of Polish municipalities, there are a lot of examples of joint cooperation between them to achieve certain goals or to provide public services jointly. The number of such Inter Municipal Associations (IMA) is growing during the last decades (see Table 5).

**Table 6: Number of IMAs in Poland**

1991	1992	1994	1996	2001(January)
50	79	125	150	191

Source: from Swianiewicz 2002)

It is worthy to mention, that IMAs are created not only for joint provision of public services but also for solution of common problems, focusing on more general issues. For example, organizations established for joint promotion of economic development, joint implementation of tourism development projects, programs related to environmental problems, etc. (Swianiewicz 2002, p 272).

Swianiewicz (2002, 272) mentions an interesting example of successful Association of Municipalities of 36 gminas in Jura Region, where cooperation of these local governments was very successful in the tourism development policy. The implementation of this policy was technically supported by the central government. Specifically, central government provided promotional materials, organized participation in international tourist fairs, assisted in production of high quality films. It is worth mentioning, that assistance of central government in the formation of IMAs in Poland is very big (Swianiewicz 2002). In general, Poland shows a successful example of joint cooperation even among large local governments. Capacity of economic development is definitely larger in large local governments. Moreover, ability to

provide more and cheaper local services also works in favor of larger communities (Swianiewicz 2002, 276).

#### **4.2. Hungary**

In Hungary the dramatic increase of population was evidenced in the big cities between 1960 and 1990, whereas the population number was drastically decreased in the smaller localities. Moreover, the splitting of the previously amalgamated communities in 2000s resulted in the increase of too fragmented local communities in Hungary. Under the new local government system (introduced in 1990) there are 3071 local communities in Hungary and an average population is about 1200 people (Swianiewicz 2002, 45).

Even during the communist times Hungary applied the practice of joint cooperation among different municipalities. Although there was some resistance against the model of the joint cooperation, as to the soviet style element, during the first half of the 1990s, later on the process of establishment of joint cooperation of local governments has been accelerated. The issue of joint cooperation or association of local communities is even envisaged in the Hungarian Constitution. The Constitution stipulates that local governments have the right to freely form associations with other local governments. Moreover, in 1997 Hungarian Government adopted the Act on Associations and Cooperation of Local Governments, which specifies the procedure of establishment of associations based on agreement, which represents important guarantee for the unified operation of associations. This Act makes it possible to form associations with autonomic financial rights and liabilities, which grants the right to the associations to be registered in the court as a legal entity. Such an association can establish institutions, and can even impose some taxes (Swianiewicz 2002, 40).

As a consequence of all the above mentioned legal reforms, the willingness of local governments to cooperate is very strong. At present, joint cooperation is more visible between those local communities which previously shared the common council-system<sup>14</sup>. There are objective factors which explain this phenomenon: the common administrative, transport and economic network which existed for about 40 years<sup>15</sup> is easier to revitalize. Furthermore, the survey which was conducted in several counties in 2000 presents, that the fragmented communities have demonstrated strong willingness to cooperate with their neighboring communities (Swianiewicz 2002, 70).

In respect to the model of amalgamation of local communities, it is important to mention that it is almost impossible to implement this policy in Hungary due to increasing local identity. There is a big resistance from the local population towards this policy alternative (Swianiewicz 2002, 85).

It is also worthy to mention that there was an attempt to propose the mandatory formation of associations by the Ministry of Interior in 2001 for the communities with small number of the population. According to the legislative document issued by the Ministry the formation of joint offices would be compulsory first of all for the communities with less than 1000 residents, then for the communities with less than 1500 residents. However, this proposal was not successful and was not approved by the Parliament (Swianiewicz 2002, 85).

It is widely accepted that the problem of fragmentation of local governments in Hungary hinders the provision of public services due to the lack of political, technical and financial capacity. To solve this problem the attention has been turned toward the associations of local governments. In spite of some obstacles at the beginning of 1990s, at present formation of

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<sup>14</sup> Under the communist system the several communities constituted one council-system, with the administrative body located in one of these communities.

<sup>15</sup> This system was formed in 1949

associations is the most realistic and successful type of integration of local municipalities. This policy option is considered as very important and vital for Hungary and at present the central government is elaborating on the modification of the present legislative framework of the associations (Swianiewicz 2002, 86).

### 4.3. Estonia

There is a one-tier local government system in Estonia with 241 municipalities: 39 towns and 202 rural local governments, which operate within 15 counties. Towns and rural municipalities are equal in their legal status. However the size of local governments varies dramatically from one municipality to another with Tallin having 389 000 residents and Ruhnu having only 98 inhabitants (Ignatov 2004, p23). The breakdown of municipalities according to the population size reveals very fragmented nature of the local government system (Table 6).

**Table 7: Breakdown of local governments in Estonia by number of inhabitants**

Number of inhabitants	Number of municipalities
less than 1000	32
1001-2000	97
2001-3000	39
3001-4000	16
4001-10 000	42
More than 10 000	15
<b>Total</b>	<b>241</b>

*Source: from Ignatov 2004*

Thus, Table 7 shows that 129 or 53.3 % of municipalities have less than 2000 inhabitants, and only 57 municipalities or 23, 6% have more than 4000 residents, which is the indicator of high fragmentation of local governments.

The administrative-territorial reform is one of the priority policies of the central government. The need for the reforms is justified by the fact that the current system of the local government in Estonia is designed in the way to adjust to the system of the previous Soviet planned economy,



with large collective farms, called *kolkhozes* and small local units, formed around them. The collapse of the previous system and dissolution of *kolkhozes* led to the severe weakening of revenue base of these small municipalities (Ignatov 2004, p 24).

Since 1994 all major political powers, represented in the Parliament, have shown their support to the idea of territorial consolidation (amalgamation) of municipalities into bigger units. However, only in 1997 working group was established, under the Ministry of Interior, to develop the strategy of administrative-territorial reform. As a result of successful work of this group the intermediate document “Basics for the development of public administration” was prepared in 1999 and the Strategy of the Local Government’s Administrative Reform was adopted in 2001. This strategy proposes administrative-territorial reforms of local government that aims to create favorable conditions for the local governments in order to:

- to guarantee sustainable development on their administrative territory
- fulfill all the tasks delegated to them by the Local Government Organization Act and offer high quality public services to the population
- to be closer to the people and have tight relations with the people

The Strategy points out that in general the minimum rate of the population should be 3500 residents in rural municipalities and 4500 in urban municipalities. Thus, it is expected that the total number of municipalities will be 40-110. The reform has been implemented according to the model of territorial amalgamation based on the voluntary principle.

The financial incentive system has been applied by the Government of Estonia in order to spur the process of amalgamation. Each municipality that decided to amalgamate receives a single grant of 500 EEK<sup>16</sup> per resident from the central government; however the total amount of grant

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<sup>16</sup> 1 US Dollar = 11.42669 EEK-Estonian Kroon ( July 25, 2007)

per municipality is specified within the determined range. Moreover, grant's size is differentiated according to the following scheme

- 100% (500 EEK per resident) for municipalities amalgamated prior to 1 January 2006
- 75% for the municipalities amalgamated prior to January 2007
- 50% for the municipalities amalgamated after 1 January 2007 and prior to 1 January 2010. Municipalities which will amalgamate after this date will not receive financial grant.

As it was already mentioned, the empirical research, which was conducted to find out an impact of the consolidation policy on the economic performance in Estonia, has revealed that territorial amalgamation leads to higher financial viability and enhancement of administrative capacity of local municipalities (Ignatov 2004).

#### **4.4. Slovakia**

The municipal structure of Slovakia features a high fragmentation of local governments. Moreover, Slovakia has undergone several steps of fragmentation of local government at different times (See Table 7).

**Table 8: Number of municipalities at different years in Slovakia**

Year	1950	1989	1991	2000
Number of municipalities	3344	2694	2825	2883

*Source: from Swianiewicz 2002*

As a part of Czechoslovakia, the Slovak Republic was agricultural section of the country with a big number of rural settlements. The fragmented settlement structure was hindering the process of rational development of the society, and it was decided to implement the compulsory merging policy of the communities. Integration via merging meant that the municipalities, which merged

with other municipalities, ceased to exist as such. This mandatory force of consolidation of rural settlements was one of the triggers of fragmentation of local governments which happened after 1989 when Slovakia gained independence (Swianiewicz 2002, 140-41).

As a method of stabilization of settlement structures in Slovakia the Municipal Law no. 369/1990 was adopted, as a basis for legislative framework. The stabilization and optimization of settlements via amalgamation policy was not acceptable for the representatives of the local governments. The experience of forced amalgamation, the identity problem and attachment to the settlement have been important obstacles for the amalgamation policy. The favorable policy alternative has been the formation of inter-municipal cooperation.

Inter-municipal cooperation (IMC) in Slovakia is mostly developed in the areas of: municipal waste management, waste water treatment, tourism, environmental protection, culture, education, and joint project of regional infrastructure such as gas and water supply. It is worthy to mention that one of the main reasons of engagement in IMCs in Slovakia is the scarcity of financial funds, personnel as well as administrative capacity to implement their tasks. Inter-municipal cooperation enables municipalities to accumulate the resources to provide public services efficiently (Swianiewicz 2002, 149).

A survey, conducted by the Ministry of Interior in 2002, revealed that the largest support for inter-municipal cooperation was shown by the fragmented municipalities. This means that the small municipalities did not have enough capacity to perform their tasks on their own; as a result the prevailing part of them has been engaged in the inter-municipal cooperation.

Apart from the voluntary cooperation, the legislation also stipulates mandatory inter municipal cooperation. For the mandatory cooperation the minimal size and service area for a municipal unit is defined in the law. Thus, there are some services, provision of which is mandatory for all

the local governments, however not every municipality has the human and technical capacity to perform them due to their size. Therefore, the inter-municipal cooperation is mandatory for these municipalities to consolidate their resources for effective service provision.

To sum up, in Slovakia the inter-municipal cooperation plays very important role in the service provision mechanism at the local level, and serves as a stabilizing instrument for the historically established highly fragmented local government system. Moreover, central government has been interested in the increase of efficiency of local services in fragmented municipalities, by mandating them to cooperate and by defining the minimum size threshold in the legislation.

#### **4.5. Spain**

The fragmented structure of local government system poses a problem related to the provision of public goods and services in Spain. Although several relationships between size, efficiency and effectiveness are understudied and there is no definite conclusion about the right size of local authority, many small municipalities have to overcome the problem of size in order to be able to provide certain services (Parrado Diez 2006, p 3; Villalba personal communication July, 19, 2007).

In Spain, approximately 86% of all towns have fewer than 5,000 inhabitants, and 72.2% have fewer than 2,000. To solve the problem of fragmentation two basic approaches have been proposed : a) amalgamation of local authorities and b) associations of different government units. Amalgamation attempts have not been successful in the past and are not even considered in the political agenda at present. Inter-municipal co-operation has been promoted through *mancomunidades* (horizontal associations of municipalities) and *consortia* (vertical associations

of municipalities, other levels of government and non-governmental actors). In 1999, a total of 5,857 municipalities joined at least one mancomunidad, and 87.3% of these municipalities were towns in rural areas with fewer than 5,000 inhabitants (Parrado Diez 2006, p 5).

Mancomunidades and consortia flourished in Spain after the transition from dictatorship to democracy. With the advent of democracy, local government gained political autonomy but financial resources, transferred mainly from the centre, did not suffice in providing compulsory services established by law in 1985. Mancomunidades and consortia have a different legal nature, although they both attempt to fulfill the same general purpose, i.e. to deliver services in rural and urban municipalities (Parrado Diez 2006, p 5).

Mancomunidades are either multi-purpose organizations that deliver several services or single-service deliverers. The total list of services delivered by mancomunidades exceeds 60. The most preferred services by mancomunidades are refuse collection, water supply, cultural activities, fire services, social services, tourism and economic promotion (Parrado Diez 2006, p 6).

Unlike the mancomunidades, the consortium is normally a one-purpose organization. This is the case for at least 80 per cent of consortia. The services most preferred by consortia are economic promotion, cultural promotion, fire department and water supply (Villalba personal communication July, 19, 2007).

The mancomunidades and consortia also differ according to the nature of partnership. There are basically two possibilities for rural communities: public partnerships of municipalities or public (-private) partnerships of different levels of government (and/or non-governmental entities, such as NGOs and private businesses). Mancomunidades belong to the first possibility while consortia fit with the second one (Parrado Diez 2006, p 8).

The mancomunidad in Spain is a local body consisting of neighbouring municipalities. There are three restrictions to the mancomunidad in Spain:

- The municipalities should belong to the same political region or state (autonomous community in the Spanish case).
- Higher levels of government (province or county) cannot join a mancomunidad.
- The mancomunidad is not allowed to provide all services of associated municipalities, as this would imply in practice the disappearance of the sense of municipalities.

In contrast, consortia are typical examples of vertical associations, as their members come from any level of government (national, regional, provincial or local). Besides, non-profit organisations are allowed to take part in a consortium. One third of all consortia in Spain have at least one NGO as a partner.

The nature of partnership is very relevant, because depending on this issue decision making in the organizations can be different. In case of horizontal cooperation (mancomunidad) difference in population size have some influence on the decision making process; whereas in case of vertical cooperation, the associate members from higher levels of governments can have informal control power on the decision making process (Parrado Diez 2006, p 9).

The financial resources of both types of municipal cooperation are allocated from the central governments through grants as well as from financial contributions or quotas of the member municipalities. The quotas are determined according to the population size (Villalba; personal communication July, 19, 2007).

To sum up it is important to mention that the number of both types of cooperation is drastically increasing in Spain; judging from the increasing number of these types cooperation, it

can be concluded that it raises the level of services in small municipalities ( Parrado Diez 2006, p 14).

#### **4.6. Summary**

The experience of integration of local governments in five countries with different territorial-administrative structures shows, that there are common features in the implementation of integration policy.

First of all, in all five countries the central government's role in the formation of the inter-municipal cooperation has been substantial. Central government provided material assistance to inter municipal organizations in Poland and financial incentives in Estonia. Moreover Central Government delegated very much discretion to the Inter Municipal Associations in Hungary. The problem of fragmentation was so much prioritized by the central government in Hungary and Slovakia that it was proposed to perform inter-municipal cooperation on the mandatory basis in these countries. In Slovakia the community minimal size threshold for mandatory cooperation was even defined in the legislation. Hungary has gone further; here the formation of inter-municipal cooperation is stipulated in the Constitution. In Spain the central government can even become a member of inter municipal cooperation, as it is in the case of consortium.

Secondly, the experience of all the countries, except Estonia, show that formulation of inter-municipal cooperation is advantageous regardless the size of local governments. Both in Poland, where the size of average municipality is relatively big and in Hungary, with highly fragmented local government structure the inter-municipal cooperation is very effective mechanism to increase the efficiency of provision of local services. Moreover, in all the countries (excepting Estonia) the willingness of local governments to participate in inter-municipal cooperation is increasing.

An important factor is that the territorial amalgamation of the local governments was not accepted by all the countries. Namely, in Hungary, Spain and Slovakia this policy was considered as severe, due to its negative effect on the issue of identity of local residents towards their communities. Although in Estonia this policy has been initiated and central government provided financial incentives to the localities, it is still being implemented very slowly.



## Chapter 5: Policy Analysis, Assessment and Recommendations

Although the econometric analysis did not show any relevant support for the proposed hypotheses, both fiscal autonomy and size of local governments are still very important determinants of decentralization process in transition countries such as Armenia. Moreover, the results of the interviews, personal communications as well as the international experience of five countries also strengthen this concept. This section proposes three policy options, which will be analyzed and assessed based on the results of international experience on the local government integration reforms as well as interviews and personal communications conducted with various experts and public officials and NGO representatives. The assessment of the policies will be made according to the criteria of accountability towards local residents, stability at the local level, efficiency and the feasibility of implementation of the policy. Finally the recommendations will be presented based on the analysis and assessment of the policy options.

### ***5.1. Provision of discretion to set tax rate on land and property taxes***

As it was mentioned above in the paper, this policy implies the provision of the rate-setting power to the local governments on the land and property taxes, which are wholly collected by the local governments.

#### **5.1.1. Analysis**

There are several advantages of this policy option. Firstly, if local governments set tax rates they can increase/decrease their revenues and expenditures according to the preferences of local residents. In spite of the fact that this policy option is not primarily related to the mobilization and increase of revenue capacity of the local governments, it strongly increases the fiscal

autonomy of local governments, which prevents their high dependency on the central government.

The second advantage is that this approach will strengthen the link between residents and local governments since the link between residents' payments and services delivered to them will be more visible. This increases the trust of the residents towards officials and they become more willing to pay taxes. The same argument was mentioned by Mr. D.Tumanyan (interview, June 27, 2007). According to him, since these two taxes have actually been collected by local governments since 2002 but the local governments do not have any fiscal power over these taxes it weakens the link between residents and local government officials. In transition countries such as Armenia this link between people and their local government is a very important element, because if this link is visible then residents are more willing to pay taxes.

Another advantage of this policy was also pointed out by the respondent Mr. A.Grigoryan, (interview, July 5, 2007). Thus, according to him the provision of discretion to the local governments to set the rate over their taxes also increases the accountability of local officials toward residents. These two issues were also mentioned by another respondent Mr. A. Levitas (personal communication, July 6, 2007): If the local government revenue is determined by central governments then citizens and local officials will tend to see all the local problems caused by the national government's "failure" to provide sufficient grants and as a result the link between residents' willingness to pay taxes and public officials' accountability weakens. Thus, nationally set local revenue decreases the accountability of locally elected councilors and mayors toward citizens.

The main drawback of this policy is the possible reluctance from the side of regional governments (RG), which implement the central government (CG) policy at the regional level.

As it was mentioned above in the paper in spite of several successful reforms the public administration system in Armenia is still highly centralized and the political and economic power is concentrated at the CG level. At present, RGs have strong “bargaining power” in allocation of intergovernmental transfers to municipalities, since according to the Presidential Decree on State Administration in the Regions (1997, Article 1/12) they are considered as bodies, responsible for “coordination” of local governments. The provision of discretion to local governments to set the rate for local taxes will, on the one hand, strengthen the local governments’ fiscal autonomy and, on the other hand, decrease the power held by the RGs.

Another drawback is that this policy can lead to the loss of stability caused by over-taxation at the local level. According to Mr. Harutyunyan and Mrs. Khechoyan (interviews, May 4, 2007), this policy may lead to “chaos” and may destabilize the situation, which will be created by the fiscal power delegated to local governments, in other words they can set the rate preferable for them, which may be harmful to society. Respondents claimed that the implementation of this policy at the local level needs time and it is very early to provide fiscal power to local governments at this stage of development of the country.

It is important to stress that almost all the respondents agreed that in order to avoid the threat of losing stability at the local level by the discretion to set the tax rate, the local governments should get the power to determine the tax rate within the range specified by the national government as it is made in case of non tax revenues.

### **5.1.2. Assessment**

First of all it is important to stress that, as it was mentioned above in the paper, the provision of tax base and rate increases the accountability of local officials toward residents, thus the policy perfectly meets the criteria of accountability. On the one hand, this policy is efficient

since, by having the power over local revenues local governments can determine their budgets according to the preferences of their electorate, rather than be highly dependent on central government transfers, which increases the willingness of the local residents to pay taxes. However, on the other hand, the criterion of stability is not well exploited for this policy, since local governments can set the tax rates according to their discretion, which can destabilize the situation at the local level. Regarding the feasibility of implementation this policy is likely to be complex, since big changes concerning the local government legislation framework, state budget system legislation, as well as reorganization and decentralization of tax agencies may be required.

## ***5.2. Territorial amalgamation of small local communities***

This policy means territorial merging of several fragmented local governments into one big unit, which centralizes all the administrative and financial power of the amalgamated communities.

### **5.2.1. Analysis**

The success of territorial amalgamation very much depends on the country it is going to be implemented in, since the implementation of this policy is strongly affected by social and historical factors, particularly by the factor of identity and attachment to the home community (F.Vilalba, pers.com. July 11, 2007). Amalgamation has been relatively successful in Northern European countries, however, amalgamation attempts in several southern and eastern European countries have shown that citizens are very attached to their cities and villages, and policies of amalgamation are therefore doomed to failure. Thus, in Hungary and Slovakia, as it was mentioned, the policy of amalgamation was not accepted due to local residents' high sense of

identity towards their communities. In Spain, taking into consideration the social norms and possible resistance from the local residences towards territorial amalgamation, this policy was not even put on the agenda.

However, there are several advantages of this model. The amalgamation or merging of small rural communities, substantially reducing their number, centralizes financial resources and, consequently, increases financial capacity to implement their mandatory powers. This advantage is experienced in Estonia: the amalgamation of local governments has increased the financial viability and administrative capacity of local municipalities there. Mr. A. Sargsyan (Interview, June 23, 2007) mentions that in Armenia the fragmented communities do not have the capacity to generate enough revenue even for the provision of basic public goods and services. He points out that in some communities the collected revenues are enough only for maintaining a few administrative facilities and the wages of administration. He adds that the implementation of the amalgamation policy of small communities in Armenia will strengthen the capacity of these communities to provide basic public goods and services. According to Mr. A. Sargsyan (Interview, June 23, 2007), the second advantage of amalgamation policy is that big municipalities can more easily concentrate on international projects, which are crucial from the viewpoint of infrastructure development.

The next positive side of this option is that consolidated communities will become less dependent on transfers from the state. It means that neither Central Government nor Regional Government will have a major influence on the decision making process and policy development of the local governments (A. Sargsyan, Interview, June 23, 2007). Furthermore, the amalgamation of communities exploits the economies of scale for the sewerage services and water supply, in those parts of Armenia, where small local communities are located very close to

each other. This situation gives an opportunity not to spend much on the distribution of the water. Hence, the unit cost of the production of water will decrease with the increase of the number of associate municipalities (A. Sargsyan, Interview, June 23, 2007).

Mr. D. Tumanyan (interview, June 27, 2007) pointed out that if territorial amalgamation is accepted as the only policy to solve the problem of the fragmentation of rural communities in Armenia, it should be implemented based on the following principles:

- The merging communities should have shared borders.
- Consolidation of communities may take place only following consultations with the population of the communities involved, in other words it should not be forcefully conducted by the central government.
- The newly created community shall be the legal successor of the uniting communities, and the territory and property thereof shall be correspondent to the territories and properties of such communities.
- The central government should provide material or financial incentives to the local governments within the framework of the amalgamation policy.

However, Mr. D. Tumanyan (interview, June 27, 2007) is very reluctant to the amalgamation of communities in Armenia. According to him Armenia is an ancient country, there are villages and cities which were established more than a thousand years ago and even before, and residents of each community are very proud of their home villages and cities. Thus, even though the policy of amalgamation has substantial advantages, it will simply not be accepted by local residents. It is important to mention that, the same factor of identity of the local settlements was also the reason for the denial of the policy of territorial amalgamation in such countries as Slovakia, Hungary and Spain. In all these countries this policy was rejected because residents were very

much attached to their local communities and did not want to lose the identity of their home villages or cities.

Furthermore, according to Mr. Harutyunyan (interview, May 4, 2007), the policy of amalgamation is a very tough policy and will take a long time to be fully realized, if it is implemented voluntarily. It can be implemented on a mandatory basis in a short period of time; however, it will not be effective and will not be accepted by the international community.

Another important drawback of this policy is that the territorial amalgamation may decrease contacts between residents and councilors. In other words, contacts between councilors and residents are much closer and politicians are more accountable towards their electorate in small rural communities than in the bigger ones. In Armenia this factor is salient, because social ties are very strong in Armenian society. Officials are more responsive towards their neighbors and the people whom they know than to the people whom they do not know, which happen in bigger communities. (A. Sargsyan, Interview, June 23, 2007).

### **5.2.2. Assessment**

In most cases the amalgamation policy leads to the strengthening of the financial and administrative capacity of local governments. For some communal services such as electricity, sewerage, water treatment the amalgamation policy exploits the economies of scale, which improves the provision of these services. In this regard, due to economies of scale the policy of amalgamation perfectly fits the criterion of efficiency of provision of local services. It is important to stress that these services are provided very inefficiently and there are even some fragmented communities which do not deliver this services at all. Thus, the amalgamation of communities strengthens the administrative and financial capacity of the communities, which also relates to the increase of efficiency of service provision.

The policy of territorial amalgamation does not meet the criterion of accountability because it weakens the link between residents and local officials. Taking into consideration the peculiarity of the Armenian society, territorial consolidation leads to the diminishing of accountability towards residents.

For Armenian society the implementation of territorial amalgamation of small communities will not be acceptable. The strong ties of the residents with their communities and local identity are serious obstacles for merging the communities. As a consequence, the territorial administration does not match the criterion of feasibility of implementation.

Regarding the stability criterion it is not possible to clearly define whether this policy will stabilize or destabilize the overall situation at the local level. On the one hand territorial amalgamation can stabilize the territorial structure of the country as it was the case in Slovakia, applying the policy of inter-municipal cooperation; on the other hand the policy of amalgamation may lead to tensions between residents and public officials, which can destabilize the overall situation in the country.

### ***5.3. Inter-Community Associations***

Inter-municipal cooperation is not a new phenomenon in Armenia. Although the legislative framework and administrative structure have been developed in 2001(see Annex 1), reality has shown that the formation of Inter Community Association (ICA) has been hampered by several obstacles. The first reason is that, although according to the legislation the main funding of the ICAs should come from the local tax deductions of the community members as well as state allocations and subsidies (see Annex 1), this funding was not appropriately conducted due to the lack of financial resources of fragmented member communities and weak regulation of the



allocations by the central government. Another problem was the political unwillingness of the central government to properly implement this policy uniformly, namely central government neither provided the necessary administrative and financial assistance, nor allocated necessary incentives to establish ICAs uniformly throughout all the country (D. Tumanyan, interview, June 27, 2007).

### 5.3.1. Analysis

Mr. Tumanyan (interview, June 27, 2007) mentions that the formation of ICAs is very important for the stabilization of the problem of fragmented local communities. This policy has several advantages. Both Mr. Tumanyan (interview, June 27, 2007) and Mr. A. Sargsyan (interview, June 21, 2007) state the ICAs give an opportunity to solve the problems related to bigger infrastructures, which are not possible to resolve by a small community, through the joint cooperation of the communities. An example of “Dilijan” ICA brightly demonstrates an advantage of ICAs. According to Mr. A. Margaryan (interview, June 28, 2007) the associate communities of “Dilijan” ICAs are very small rural communities, which had a big problem of old water supply infrastructure, which caused an enormous amount of water leakage. The project of replacement of the drinking water network was determined as the highest priority<sup>17</sup> project on the General Council meeting in 2003. The joint cooperation of the communities together with financial support of GTZ was very productive, and within one year the old water network was replaced in all the six associate communities, which increased water saving threefold. The same scheme was also very successfully applied in the improvement of the local roads of the associate municipalities. It is worth noting that inter-municipal cooperation creates favorable conditions for the increase of the efficiency of administrative and social service provision as well, such as

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<sup>17</sup> The special procedure of the project prioritization was developed with the assistance of GTZ

for example tourism development in Poland, protection of the environment, joint projects on technical infrastructure as well as garbage collection in Slovakia.

One of the big advantages of this policy in Armenia is that it should be continued rather than designed from scratch; however several changes should be made. Important prerequisites such as both structures of ICAs and legislative framework are established and designed. However the state intervention should be properly regulated both in terms of financing and in terms of provision of incentives (Tumanyan and Sargsyan, interview). It is important to mention that proper state assistance was vital for the formation of inter-municipal cooperation in Slovakia, Hungary, Poland and Spain as well as in Estonia in case of the implementation of territorial consolidation policy.

According to Mr. Harutyunyan (interview, May 4, 2007) the formation and proper development of ICAs is very important and it should be conducted on a mandatory basis since in this case there is no resistance from the side of local residents. Creation of ICAs is a flexible policy since on the one hand, it strengthens the technical capacity of fragmented communities, and on the other hand, does not touch the issue of residents' identity towards their settlements. As it was mentioned, the establishment of inter municipal cooperation on a mandatory basis was also successfully implemented in Slovakia.

### **5.3.2. Assessment**

The integration of communities decreases the accountability of public officials towards the residence, since the closeness of these two parts of society is weakened in integrated communities. This is one of the drawbacks of the territorial amalgamation policy which was described in the previous sub-section. Although the formation of ICAs is considered as the integration policy of communities, it does not affect the ties between residents and local officials.

Hence, the accountability mechanism, which works much better in small communities than in bigger ones, remains the same under the policy of formation of ICAs. This means that accountability towards the residents will be even enhanced taking into consideration the fact that under this policy the provision of such services as water supply and sewerage, garbage collection, tourism development and other services may be improved through the economies of scale. The improvement of these services for fragmented communities in Armenia is vital since the biggest part of them is not provided at all due to the scarcity of the necessary financial, administrative and technical resources in small rural communities. Thus, in Armenia the policy of establishment of ICAs suits the criterion of accountability.

The improvement of provision of administrative services has a direct impact on the efficiency criterion. The formation of ICAs provides an opportunity to join the administrative and technical capacities of small local governments in the provision of public services. Even for those, services which have been provided such as water supply or garbage collection, the efficiency of provision is increased through the improvement of service infrastructure due to the joint cooperation of communities, as was the case in “Dilijan” ICA. Thus the ICAs exploit the criterion of efficiency of service provision.

With respect to the criterion of feasibility of implementation, the formation of ICAs is the policy which should be continued based on the previously established legislative and structural framework; however some administrative and financial changes should be made. This means that the formulation of the policy does not require big legislative amendments and administrative changes. As a consequence the policy can be easily implemented in comparison with the policy of territorial amalgamation.

In spite of the fact that territorial amalgamation can destabilize the situation in society because of the creation of some tensions, this threat does not exist in case of formulation of ICAs. As it was mentioned this policy does not affect the issue of strong identity of localities in Armenian society. Moreover, the formulation of ICAs does provide the stability in the provision of those local services which have been poorly provided due to the lack of proper infrastructure, such as water supply and sewerage system, garbage collection and road reconstruction. As a result of this policy, the formulation of ICAs can be considered as the policy which provides the stability at the local level and within the whole decentralization framework of the country.

#### **5.4. Summary**

The analysis and assessment of the policy options show, that the reformulation of Inter Community Associations in Armenia meets all the defined criteria. It means that this policy is essential for development of Armenian local government system at this stage of development. Although, the policy of territorial amalgamation does not meet three criteria out of four, the most serious drawback of this policy relates to the implementation criterion. The implementation of this policy will create serious tensions in the society and strong resistance from the local population side. The solution of this problem is not possible within short period of time since it is strongly rooted in the society.

The policy of provision of discretion to set local tax rate requires special attention. Although this policy is efficient from the point of view of revenue generation, as well as strengthening the link between residents and local officials, and accountability enhancement, it does not meet the criteria of implementation and stability very well. Regarding the implementation, it is important to find solution of the following issue – how and by which means will be implemented this policy in 930 communities: it is necessary to provide relevant specialists and technical means to

all communities. In this regard the formation of ICAs is vital, since the cooperation among the communities can solve this problem through the exchange of necessary specialists and technical facilities. The solution of the second problem of lack of stability caused by this policy was proposed by all the respondents: the limits, specified by the central government, within which the local governments will have the discretion to set the tax rate is a reasonable remedy of this issue.

### **5.5. Recommendations**

This section presents the recommendations, which are based on the analysis and assessment of policy options discussed above.

**Recommendation 1: The local governments should obtain the power to set tax rate over the land and property taxes within the specified range, which will be set up by the central government.**

Because the land tax and property taxes are the only taxes which are fully collected by local governments the local government should have the marginal fiscal power to set the rates of these taxes. However, to prevent the stability at the local level, the tax rate should be determined within a specified range regulated by the central government. This is important because without proper regulation of this policy the over taxation of the services by the local officials is possible. In other words, having unlimited discretion to set up local tax rates the local officials can increase these rates without consideration the taxpayers' capacity. To prevent this threat the intervention of central government by setting the maximum and minimum limits for the tax rates is crucial. This example is successfully conducted by the local government council in the

determination of rates for the non tax revenues within the range specified by the central government.

This power will first of all increase accountability of local officials to the residents. The local officials, knowing the preferences of residents much better than central government officials, and having the power to change the rate of taxes according to these preferences, will be more accountable towards their residents.

Secondly, if local residents see the link between the taxes they pay and services they are provided, their trust to the local officials will increase and they will be more willing to pay taxes. This issue is very important for Armenian society, because, as a result of the heritage of the highly centralized communist system, local officials, even though elected by the population, do not have much power in their hands. As a consequence the residents rely on the central government in the solution of all their problems.

**Recommendation 2: The Inter Community Associations should be reformulated based on the previous legislative and structural frameworks under the following condition: Central Government should initiate and intervene in the process of reformulation of Inter Community Associations by:**

- **provision of the necessary financial and technical assistance and incentives to the associate local governments of Inter Community Associations**
- **legal determination of the community minimal size threshold for mandatory cooperation**

This recommendation is actually based on the lessons drawn from the past experience of the formation of inter municipal cooperation in Armenia and five studied countries. The main reason

of the unsuccessful implementation of this policy in Armenia was the lack of central government assistance. Thus, it is very important to consider the intervention of the central government in the process of formation of ICAs as a necessary prerequisite for the successful implementation of this policy. Central government should initiate the formulation of ICAs; provide necessary financial assistance and incentives to the local governments, associate members of ICAs. The formation of ICAs is a very important step in the development of local self government system in Armenia.

The formulation of ICAs will help to encounter the problems of service provision for fragmented local governments, which is a serious problem in Armenia nowadays. This policy will strengthen the technical, administrative as well as financial capacity of the fragmented local governments. It will give an opportunity to small local governments to jointly cooperate in big infrastructure projects. The joint cooperation is also beneficial from the viewpoint of exchange of experience, specialists, as well as technical facilities in different areas.

## Conclusion

Highly fragmented system and the low fiscal autonomy are two fundamental problems for the local governments in Armenia, which deep into the country's Soviet past and are the biggest obstacles for the development of decentralization reforms today. Although some attempts were initiated by the local governments in cooperation with GTZ agency to solve the problem of fragmentation of local governments through the formation of inter-community associations, this policy was unsuccessfully implemented due to the passive actions of the central government. With respect to the problem of low fiscal autonomy the local governments were provided the power to collect 100% of all the land and property taxes within their jurisdictions, as well as to determine rates of non-tax charges and fees, within the ranges specified by the central governments. Although implementation of these policies has been important step in the process of decentralization, it does not crucially increase the autonomy of local governments, because the power to determine tax rates is still in the hands of central government, and non tax revenues constitute very small percentage in the total local government revenues, and do not give much autonomy power to the local governments.

In this thesis an attempt was made to analyze these problems as well as to propose feasible recommendations based on the results of constructed econometric model, experience of other countries, which passed the similar problems, and on the professional experience of different specialists. The cross-country regression analysis was conducted to study the impact of fiscal autonomy as well as fragmentation of local governments on the economic performance of 24 countries in transition. Secondly, interviews with the experts on local government, representatives of different NGOs as well as public officials and professors of several universities in Armenia, Hungary and Spain was made to reveal the possible solutions of the



above mentioned problems. Furthermore, the descriptive study of international experience of five countries was done to analyze the reforms of integration of local governments in Western and Eastern European as well as former Soviet Union region.

The results of the cross country empirical analysis did not show any statistically significant effects between the local government size, fiscal autonomy and economic performance. The lack of correlation may be caused by the limitations of some relevant data for some countries. However, the results of qualitative research indicated the importance of the provision of bigger fiscal autonomy and necessity of implementation of proper integration policy of the local governments in Armenia. Based on the results of qualitative research three policy options have been analyzed and assessed according to determined criteria. Finally, based on the assessment of these policy options two main recommendations have been developed: strengthening of fiscal autonomy of local governments through the provision of the power to determine the tax rates of the locally collected taxes, and integration of the fragmented local governments through the reformulation of inter-municipal associations. The important precondition for both policy recommendations is that central government should regulate this processes. Thus, at this stage of development of the decentralization reforms Armenian government should tailor the strategy to increase the fiscal autonomy of local government in line with the creation of favorable conditions for joint cooperation among municipalities.

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## Annexes

### Annex 1. Legislative framework of Inter Community Associations in Armenia

#### *Administrative dimension:*

- Intercommunity associations shall be established following consultations with the populations of the communities involved.
- Cities with a population of above 15000 shall not be included in the intercommunity associations.
- Intercommunity association shall be a legal entity and has a seal bearing the coat-of-arms of the Republic of Armenia or intercommunity association.
- The members of ICAs can be the communities which share the same border or at least are located in the same region
- The residence of an intercommunity association shall be located in the largest, geographically central participating community, which shall be defined by the legislation and the opinion of the Council of the association taken into account

#### *Management dimension*

- The bodies of intercommunity associations shall be the Council and the Executive Officer of intercommunity association.
- The Council of intercommunity association shall consist of Chiefs of Communities involved in the association and one representative from each of the participating Community Councils. The Council of intercommunity association shall elect its chairman; deputy chairman and a secretary, who shall perform their duties on an unpaid basis.

- The Council of the intercommunity association shall appoint, under an open competitive procedure, the chief executive of the intercommunity association. Chief executive of the intercommunity association may not be a member of the Council of intercommunity association. The Council of intercommunity association shall define the rate of remuneration of the chief executive, which shall be no more than 70% of the salary of the Regional Governor.
- The Council of intercommunity association shall make a two-year contract with the chief executive of the intercommunity association, and should such contract be breached, the association may be dissolved at the initiative of 1/3 votes of the Council of the intercommunity association, decision of the Council or under a judicial procedure.

#### *Funding of ICAs*

The financial resources of an intercommunity association shall be construed on the basis of the following deductions from the budget revenues collected onto community budgets:

1. Land tax deductions;
2. Property tax deductions;
3. Income tax deductions;
4. Obligatory payments charged for services rendered by intercommunity associations;
5. Allocations from the state budget earmarked for fulfillment of the powers delegated by the state;
6. Subsidies envisaged under the Law on Financial Adjustment
7. Property tax collections from the property located in the territory of the intercommunity association, which are located outside the administrative borders of the participating communities;



## **Annex 2. List of interview respondents**

### **1. Mr. DAVID TUMANYAN**

Deputy Chairman of Communities Finance Officers Association, Yerevan, Armenia

Telephone interview was conducted on June 27, 2007

Interview via Electronic Mail was conducted on June 29, 2007

### **2. Mr. ABRAHAM GRIGORYAN**

Local Government Expert, Communities Finance Officers Association, Yerevan, Armenia

Interview was conducted on July 5, 2007 in Budapest, Hungary

### **3. Mr. HOVHANNES HARUTYUNYAN**

Rector of Public Administration Academy of the Republic of Armenia; Professor of Public Administration and Local Self Government System in Yerevan State Institute of Economics and in Public Administration Academy

Interview was conducted on May 4, 2007 in Budapest, Hungary

### **4. Mrs. TEREZA KHECHOYAN**

Pro-rector of Public Administration Academy of the Republic of Armenia; Principal Representative of the Public Administration Academy of Armenia in NISPAcee, Professor of Economics in Public Administration Academy and Yerevan State Institute of Economics.

Interview was conducted on May 4, 2007 in Budapest, Hungary

### **5. Mr. ARTHUR SARGSYAN**

Expert on Administrative-Territorial Affairs, Communities Finance Officers Association, Yerevan, Armenia

Interview via E-mail was conducted on June 21, 2007

Telephone Interview was conducted on June 23, 2007

### **6. Mr. ARTYUSHA MARGARYAN**

Executive Director of “Dilijan” Inter Community Association

Interview via E-mail was conducted on June 28, 2007

### **Annex 3. Personal Communications**

**1. Mrs. FRANCISCA VILALBA**

Professor of University of Granada, Spain

Lecturer in Summer School/ Local Government, Management and Public Policy, Madrid Spain

Personal Communication- July 11, Madrid, Spain

**2. Mr. LUIS FAJARDO**

Deputy of Spain Parliament

Professor in Institute of National Institute of Public Administration, Madrid, Spain

Lecturer in Summer School/ Local Government, Management and Public Policy, Madrid Spain

Personal communication- July 16, Madrid, Spain

**3. Mr. ANTHONY LEVITAS**

Lecturer in the Summer School, Course on Inter-Governmental Fiscal Relations and Local Financial Management/Central European University.

Personal Communication on July 6, 2007 in Budapest, Hungary

#### Annex 4. Classification of inter-governmental grants by degree of fiscal autonomy

High autonomy with respect to transfers	Unconditional grant (which may be formula based or in the form of revenue sharing)	Highest degree
	Conditional Non Matching	The central government provides the fund with the stipulation that the sum should be used for a specific purpose
	Conditional, open-ended matching	Autonomy is diminished due to matching requirement
Low or no local autonomy	Conditional, closed-ended matching	This is very specific grant, with cut off on the amount of fund. Lowest degree.

Source: Ebel and Yilmaz (2007)

**Annex 5. Revenue autonomy of local governments in transition countries (tax and non tax revenues): estimated Own-Source Revenues as Percentage of Total Sub national Revenue**

<b>N</b>	<b>Countries</b>	<b>Revenue Autonomy</b>
1	Albania	18
2	Armenia	12.3
3	Azerbaijan	23.8
4	Bosnia & Herzegovina	7
5	Bulgaria	13.4
6	Croatia	27
7	Czech Republic	40.2
8	Estonia	15.4
9	Georgia	15
10	Hungary	33.3
11	Kazakhstan	4.9
12	Kyrgyz Republic	11.7
13	Latvia	20.4
14	Lithuania	4.8
15	Moldova	22.3
16	Macedonia	2.7
17	Poland	35
18	Romania	21
19	Russia	10.4
20	Slovak Republic	46.6
21	Slovenia	28.1
22	Tajikistan	6
23	Ukraine	11.8
24	Uzbekistan	4.6

## Annex 6. Fragmentation rate of local governments in transition countries

<b>N</b>	<b>Countries</b>	<b>Fragmentation rate</b>
1	Albania	10.5
2	Armenia	31.2
3	Azerbaijan	33.4
4	Bosnia & Herzegovina	7.2
5	Bulgaria	3.5
6	Croatia	9.3
7	Czech Republic	60.5
8	Estonia	18.1
9	Georgia	1.4
10	Hungary	31.5
11	Kazakhstan	16.8
12	Kyrgyz Republic	9.6
13	Latvia	25.3
14	Lithuania	16.2
15	Moldova	3.6
16	Macedonia	1.7
17	Poland	6.4
18	Romania	13.4
19	Russian Federation	8.6
20	Slovak Republic	53.1
21	Slovenia	3.1
22	Tajikistan	6.1
23	Ukraine	24.5
24	Uzbekistan	0.9