

Fiscal Decentralisation Policies and Financial Autonomy of Local and Regional Authorities in the EaP Countries

Report by Mr Anar Ibrahimov, Chairman of the Committee of Human Rights and International
Relation of the Parliament of the Nakhchivan Autonomous Republic (Azerbaijan)

INTRODUCTION

Fiscal decentralization is an essential element of any decentralized governance system. Decisions over resource allocation and responsibility have widespread consequences: they largely determine what kind of public services are provided by local authorities; how they plan to finance their expenses; what level of justice should or should be in the face of budget imbalance; how stable the national government can be. Local revenues may encompass: budget transfers, taxes and revenue sharing, including public debt.

Budget transfers from the central government is a very important source of income for many local governments, especially in poor and remote regions. Transfers can have different purposes and can be applied in different forms. The transfer scheme does not have a magical formula, but for local governments, they must be adequate to predictable, reliable and assigned tasks.

Decentralization, public administration reform and anti-corruption measures are key pillars of good governance. Members of the Conference of the Local and Regional Authorities for the Eastern Partnership (CORLEAP) point to the poor development of fiscal decentralization and fiscal autonomy as a major obstacle to the development of local and regional governments. Therefore, CORLEAP incorporates fiscal counter-centralization and deepening fiscal autonomy as a key element in the 2018-2020 Action Plan, which focuses on good governance and local democracy. With this in mind, CORLEAP has begun to discuss the concept of democracy consolidation, fighting corruption, improving the judiciary, and implementing regional and regional development strategies, supporting the concept of decentralization.

According to the preamble of the European Charter of Local Self-Government, the member States of the Council of Europe, signatory hereto, are committed to ensuring the existence of local authorities endowed with democratically constituted decision-making bodies and possessing a wide degree of autonomy with regard to their responsibilities, the ways and means by which those responsibilities are exercised and the resources required for their fulfilment. The Charter contains a number of principles regarding fiscal decentralization and financial autonomy. Article 9 of the Charter will establish financial resources of local authorities, under which local authorities shall be entitled to adequate financial resources of their own, of which they may dispose freely within the framework of their powers. Five EaP countries, with the exception of Belarus, have ratified the Charter at different times. Moldova, Ukraine, and Armenia have ratified all the provisions of Article 9, which provide for

fiscal decentralization and fiscal autonomy, while Azerbaijan declared that it is unable to guarantee the application of the provisions of paragraphs 5 and 6, Georgia paragraph 6¹.

The level of fiscal decentralization and financial autonomy in the Eastern Partnership countries is at various stages of development. In Belarus, local budgets are generally perceived as vertical components of the state budget system and are strongly subordinate to the central budget. As a result, the country faces lack of fiscal autonomy, a low level of the tax authorities, and lack of local government revenue. The other 5 countries have a certain legislative framework to strengthen the financial sustainability of local governments and ensure their financial independence. The main problem in these countries is the lack of a unified concept that will ensure fiscal decentralization policies. During the study, it became clear that Georgia is the only one of the six countries to adopt the fiscal focal point, which envisages the implementation of a fiscal policy of a single concept. In Moldova, such a strategy was available in 2012-2015. In Ukraine, decentralization is carried out in two phases, and the second stage envisages an amendment to the Constitution to reform the decentralization system.

Legal Mechanisms for Fiscal Decentralization in the Eastern Partnership Countries

ARMENIA

The budget system in the Republic of Armenia is regulated by the 1997 Law on the Budget System². According to the Law, Armenia's budget system is a set of two-level budgets (the government budget and local authority budgets) governed by law based on economic relations and state structure. State and local authority budgets are based on single financial monetary and tax state policy. Armenia's consolidated budget is a collection of revenues and expenditures of state and municipal budgets.

Municipal budgets revenues include taxes, non-taxes and transfers. Tax revenues include land tax (95%), property tax (95%), income tax (15%), deductions and fees from other types of taxes in the state budget. Non-tax incomes include rent, penalties, local fees, etc. Transfers consist of subsidies and transfers from other sources. According to the legislation³, municipalities receive subsidies, budget loans and loans from the state budget. The subsidy is allocated to the municipality to examine the revenues and expenditures of its budgets. The procedure for grants and subsidies is regulated by the Financial Balance Act⁴. According to the law, the allocation of subsidies is based on population size and the level of budget provision.

The Government lacks any Fiscal Decentralization Strategy. The policy of fiscal decentralization in Armenia is reflected in the Law on State Budget, which is approved annually by taxes and duties to the budget of the communities, and especially the income, profit taxes and environmental payments. The state authorized body responsible for the development and implementation of the fiscal decentralization policy is the relevant Ministry of Territorial Administration, namely the Ministry of Territorial Administration and Infrastructure, which independently develops and implements the policy of the Government of the Republic of Armenia assigned to the Ministry.

1 https://www.coe.int/en/web/conventions/full-list/-/conventions/treaty/122/declarations?p_auth=1jYbxqZE

2 <https://cis-legislation.com/document.fwx?rgn=3052>

3 <https://cis-legislation.com/document.fwx?rgn=3052>

4 <https://cis-legislation.com/document.fwx?rgn=105619>

AZERBAIJAN

Azerbaijan's budget system entails the state budget of the Republic of Azerbaijan, the budget of the Nakhchivan Autonomous Republic and local budgets. The budget system is based on the principles of the functioning of the budgets included in the system and their independence.

Mechanisms for regulating inter-budgetary relations are addressed separately in the current legislation. Thus, according to Article 26 of the Law on the Budget System, mutual relations of the state budget with the budget of Nakhchivan Autonomous Republic and local budgets is realized by distribution of incomes sources and incomes in the form of donations, subventions and budget loans.

There are legal grounds for ensuring fiscal decentralization in Azerbaijan. That is to say, the central budget, which is at the disposal of the government, identifies local budgets in the case of municipalities, as well as the regional budget in the case of Nakhchivan Autonomous Republic, as independent budget links, and individual incomes sources for each level. At the same time, legislation envisages the use of budget allocation (subsidies and subventions) to balance local and regional budgets. Under this mechanism, local and regional self-governing bodies, which do not pay their local revenues, must receive financial support from the central budget.

The analysis of the legislation shows that there is no strategy in Azerbaijan to regulate the policy of fiscal decentralization and to make any commitment to the government. Although significant funds are allocated from the state budget for the development of the regions, these funds are made directly from the state budget but not through the low budget.

BELARUS

The form of local self-government in Belarus differs dramatically from that in other Eastern Partnership countries. Here, local-level governance institutions play a role in the central government as in the Soviet period. If there were grounds for the development of local self-governance institutions in the country during the first years of independence, since 1995 the tendency for centralization began to strengthen. In 1999, the Belarusian state self-government line was established and a model of "local self-governance" was introduced. It also began to support the dominant position of the state's interests over the community's interests⁵.

Under the Constitution of the Republic of Belarus, there are two types of local government: the term "local government" means the local executive bodies accountable to the president and the government. The term "local self-government" means the activities of the Local Council of Deputies, elected by citizens for four years. The constitution provides for vertical subordination of both local executive authorities and councils to higher authorities. In this case, the Council, which is a self-government institution under the Constitution, is subordinate to the country's parliament. The existing model violates the principle of a clear separation of duties, powers and responsibilities between the central and local governments at the local level, and the European Charter of Local Self-Government. According to the European Charter of Local Self-Government⁶, local self-government denotes the right and the ability of local authorities, within the limits of the law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of the local population. This right shall be exercised by councils or assemblies composed of members freely elected by secret ballot on the basis of direct, equal, universal suffrage, and which may possess executive organs responsible to them. This provision shall in no way affect recourse to assemblies of citizens, referendums or any other form of direct citizen participation where it is permitted by statute.

⁵ МЕСТНОЕ САМОУПРАВЛЕНИЕ В БЕЛАРУСИ материалы исследований ПОО «Фонд им. Льва Сапеги» в рамках программного сотрудничества Евросоюза и Совета Европы. www.sapieha.org

⁶ <https://www.coe.int/en/web/conventions/full-list/-/conventions/treaty/122>

The Law on Local Governance and Self-Governance in the Republic of Belarus adopted in 2010, regulates the status, authority of the Councils of local self-government, including relations between the state and local authorities. However, the terms “municipality”, “community”, and “local community” are not commonly used in the world. Whereas, communities are the primary part of local self-government. The law establishes the administrative-territorial unit as the basic level of local self-government.

GEORGIA

Deepening of decentralization reforms in Georgia took place after 2003, and significant steps have been taken to expand the powers and financial capabilities of municipalities. As a result of changes to the Constitution in 2013, the status and authority of municipalities and their role in local governance were clarified. In 2014, Georgia also adopted the Code of Local Self-Government. Under the new legislation, “local government” refers to municipalities. According to Article 2 of the Code, citizens can resolve local problems through the local authorities of their choice. These institutions exist at two levels: 1) self-governing communities (district-level municipalities); and 2) self-governing cities (municipalities established for territorial units defined by law as cities)⁷.

The Government of Georgia adopted decentralization strategy of 2020-2025 on 31th of December, 2019, according to the resolution N678. The principle of decentralization strategy is state engagement in order to support financially weak self-governing unities by the fair allocation of financial funds. The aim of this Strategy is the increase of the powers of the self-governing bodies, fiscal decentralization, and better local governance. Based on the action plan of decentralization strategy, there are planned to look over the local taxes, sharing taxes of utility license to the local self-governments, there are defined the types of delivering properties to the municipalities, rules, terms and conditions of delivering.

Ministry of Regional Development and Infrastructure of Georgia is responsible for decentralization policy.

State ensures the equalization of socio-economic development of Local Self-government bodies with Equalization Transfers allocated from the State Budget. Equalization Transfer is made from the State Budget to provide financial support to Local Self-government bodies in carrying out their duties. Several competences that have been transferred to municipalities (for example, the supply of water) are not full and exclusive. Sectoral legislation is still not in accordance with the decentralization policies of the government and progress on review and harmonization of this legislation is very slow. There is also a need to further elaborate the legal framework, especially concerning sectoral legislation, in order to facilitate and promote intermunicipal co-operation⁸.

MOLDOVA⁹

Local authorities’ financial autonomy is very limited and their finances are extremely poor both in terms of the proportion of own revenues in local budgets and of the share of local spending in total public sector expenditure. Local authorities clearly depend on State transfers and subsidies.

The National Strategy of Decentralisation, and the Roadmap for implementation of Recommendation 322 (2012) co-signed by the Congress of the Council of Europe and the Government

⁷ <https://bakuresearchinstitute.org/one-region-two-models-three-countries-a-comparative-analysis-of-local-self-government-in-the-south-caucasus/>

⁸ Local and regional democracy in Georgia. Congress of Local and Regional Authorities 7 November 2018. https://search.coe.int/congress/pages/result_details.aspx?objectid=09000016808e551a

⁹ Local and regional democracy in the Republic of Moldova. Recommendation 436 (2019) <https://rm.coe.int/CoERMPublicCommonSearchServices/DisplayDCTMContent?documentId=090000168093d89d>

of the Republic of Moldova, has been implemented only to a minor extent and the level of local autonomy seems to be eroded by a trend towards re-centralization.

Unfortunately, after Parliament approved the draft legislation the government reversed itself out of fear of losing political, administrative and financial influence over mayors and local officials postponed the implementation of the law until after the 2014 elections.

In July 2016, a new roadmap for local government and decentralization reform in Moldova was agreed on by the Congress of Local and Regional Authorities (CLRA) of the Council of Europe, the Government of Moldova and the Congress of Local Authorities from Moldova (CALM). The roadmap defines the steps that central authorities have to take to eliminate the enormous policy failings concerning decentralization and local democracy in Moldova.

The decentralization process in Moldova has gone through several stages of development and reforms. In recent years, the national authorities have approved several strategic policy documents identifying priorities and the pathways to accomplish their goals for public administration in general and local government in particular. Specific mention should be made of the National Decentralization Strategy and the Action Plan for 2012-2015 extended till 2018. However, the central government and the national association of local authorities have contradictory views on the degree of completion and achievement of those policy documents.

UKRAINE¹⁰

The state policy of Ukraine in the area of local self-government is based on the interests of residents of territorial communities and provides for drastic changes and systemic reforms, decentralization of power - that is, transfer of a significant part of powers, resources, and responsibility from the executive branch of the government to the bodies of local self-government.

In Ukraine, Decentralization is carried out in two stages.

The first stage encompasses the years 2014-2018. In April 2014, the Government approved the *Concept of Reforming Local Self-Government and Territorial Structure of Power*¹¹. Thereafter, the Action Plan was approved to implement the Concept, thus launching the reform. To implement provisions of the Concept and tasks set out in the Action Plan, it was required to, primarily, amend the Constitution of Ukraine and develop a package of new legislation. Unfortunately, certain political circumstances made it impossible for the Verkhovna Rada (Parliament) of Ukraine to introduce the amendments on decentralization to the Constitution. Therefore, as of 2014, the Government started the reform within the framework of the then effective Constitution.

Meanwhile, the major package of new legislation has been developed and become effective, the priority legislative initiatives of which legislation are currently being implemented.

The second stage of decentralization encompasses the years 2019-2021¹². At this stage, the government has taken on the strengthening of local self-government as a key priority, including the giving of additional powers to local Soviets with small populations. At this stage, it is envisaged to make the necessary amendments to reform the Constitution. Guided by the Constitution, the focus will be a number of legislative acts, including the adoption of new laws regulating the principles of administrative-territorial structure of Ukraine, service and control over their activities in local self-government bodies, and local referendum. Work is underway on a draft amendment to the Constitution within decentralization reforms.

¹⁰ <https://decentralization.gov.ua/en/about>

¹¹ <http://zakon5.rada.gov.ua/laws/show/333-2014-%D1%80>

¹² https://decentralization.gov.ua/uploads/attachment/document/344/decentral_ENG.pdf

The Cabinet of Ministers, in particular the Ministry of Communities and Territories Development of Ukraine are responsible for the policy of fiscal decentralization in Ukraine.

Assessing the Level of Fiscal Decentralization

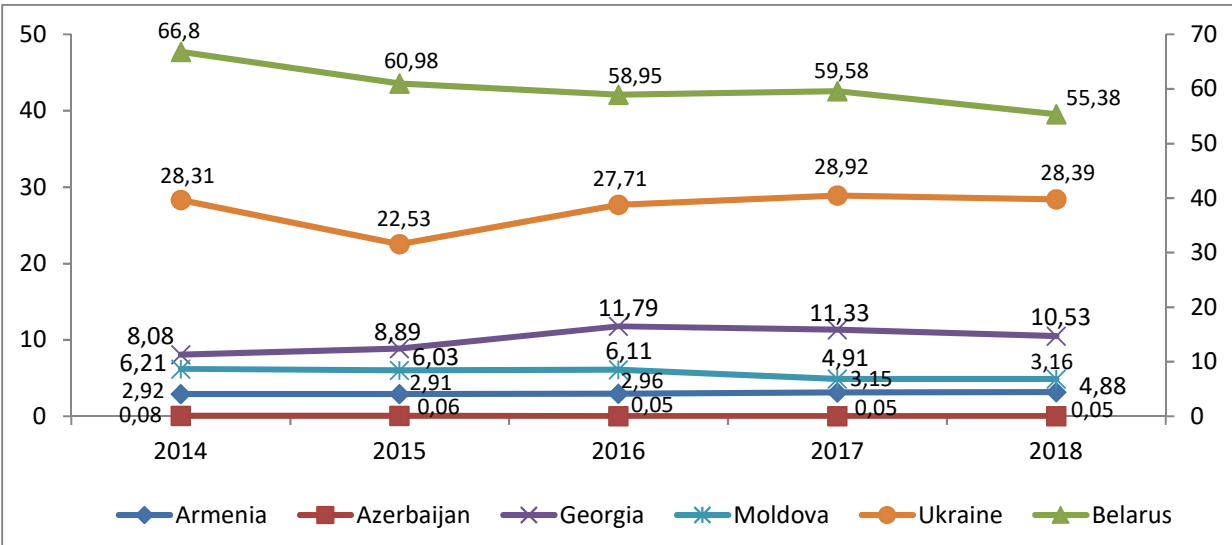
Fiscal decentralization aims to provide a transition from a centralized model of public finance to a decentralized model, to ensure the fiscal capacity of local self-government and to establish an effective system of territorial government, and to fulfill the requirements of the European Charter of Local Self-Government.

According to paragraph 8 Article 9 of the European Charter of Local Self-Government, local authorities shall be consulted, in an appropriate manner, on the way in which redistributed resources are to be allocated to them. In world practice, local governments have access to the debt market in two ways: borrowing by local governments on the securities market through the issuance of their own bonds, and direct borrowing from financial institutions.

The analysis of fiscal data on various indicators of the Eastern Partnership countries shows that the levels of fiscal decentralization vary greatly. *The revenues decentralization indicator*, which is the ratio of local budgets to their revenues to the state budget, shows that the best situation for this indicator is in Ukraine. In Ukraine, the ratio of local budgets to their revenues to state budget revenues varied from 22.5% to 28.9% from 2014 to 2018. The worst indicator is in Azerbaijan. In Azerbaijan, the share of local budgets in their revenues in the state budget does not exceed 0.1%. In Georgia, the level of centralization varies between 8-12%, in Armenia - 3-5%, and in Moldova - 3-6%. In Belarus, which is highly centralized, the share of local budget revenues, which is part of the state budget, varies between 55 and 67%. This level does not reflect the level of the center of income diversification (see Figure 1).

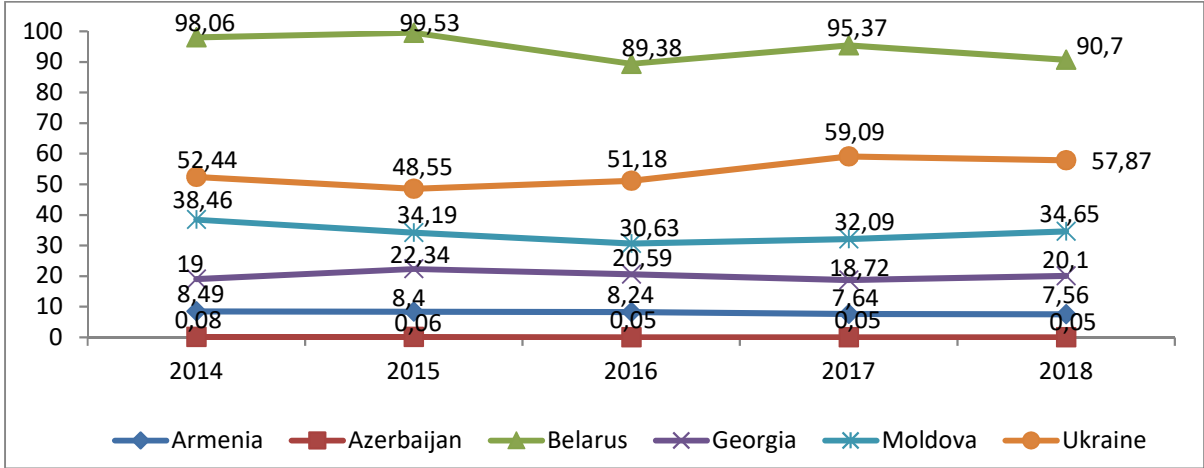
The results of the assessment of the *expenditure decentralization indicator*, which characterizes the ratio of local budgets to expenditures of the state budget, show a similar situation. In Ukraine, which shows the best results on this indicator, the level of centralized spending varies between 49-58%. Unlike revenues, Moldova (31-39%) surpasses Georgia (19-22%) in the cost-sharing ratio. In Armenia, the figure was about 7-8%. In Azerbaijan, the cost-centricity was the lowest (less than 0.1%) (see Figure 2).

Figure 1: Local budget - local budget revenue ratio (%)



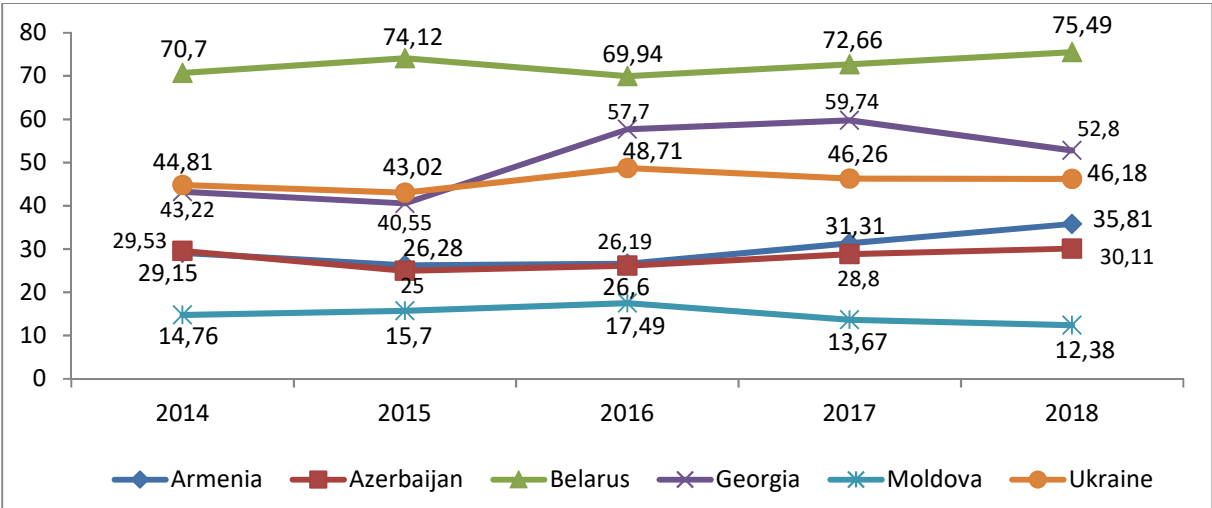
Assessment of vertical fiscal imbalance indicator in the Eastern Partnership countries shows high inequality between budget levels. Vertical fiscal imbalance describes a situation where revenues do not match expenditures for different levels of government. In order to calculate the vertical fiscal imbalance indicator, local (and regional) budgets are calculated based on the ratio of their revenues (excluding state budget transfers) to local (and regional) budgets.

Figure 2: Local budget expenditure-national budget expenses ratio (%)



Assessment of the vertical fiscal imbalance indicator shows the high inequality between budget levels in the countries under study. The highest inequality is in Moldova, where local budgets can meet up to 18% of their revenues. In Moldova, local authorities are among the 6 countries most dependent on central government and other external sources to fulfill their mandates and responsibilities. In 2016-2018, the dependence increased even more and the indicator of the vertical imbalance dropped from 17.5% to 12.4% (see Figure 3).

Figure 3: Vertical fiscal imbalance level (%)



The level of vertical fiscal imbalance in Armenia and Azerbaijan is almost the same, and the level of imbalance in both countries has declined slightly over the last five years. In Armenia, most municipalities are able to meet 36% of their expenses, while in Azerbaijan, local and regional governments can meet up to 30% of their total expenditures. Georgia and Ukraine are able to meet half of their expenses at their own expense. The abolition of balancing transfers in Georgia starting in 2019

and replacing it with VAT at 19% annual interest rate may improve the country's imbalance index. Belarus has the lowest fiscal imbalance. Only one-fourth of the low-budget budgets, which are considered local budgets in this country, are covered by transfers (see Figure 3).

Conclusions and Recommendations

According to the preamble of the European Charter of Local Self-Government, the member States of the Council of Europe, signatory hereto, are committed to ensuring the existence of local authorities endowed with democratically constituted decision-making bodies and possessing a wide degree of autonomy with regard to their responsibilities, the ways and means by which those responsibilities are exercised and the resources required for their fulfilment. The Charter outlines a number of principles for fiscal decentralization and financial autonomy. Article 9 hereto will establish financial resources of local authorities.

As can be seen, the Charter reflects the principles of financial autonomy of local self-government bodies. Five other countries, with the exception of Belarus, have ratified the Charter at different times. Some paragraphs of Article 9, which provide for fiscal decentralization and fiscal autonomy, have not been ratified by some Member States. Azerbaijan did not accept paragraphs 5 and 6 of this article and Georgia paragraph 6. Moldova, Ukraine and Armenia have ratified all the paragraphs¹³.

Paragraph 6, which has not been ratified by Azerbaijan and Georgia, emphasizes the need for consultation with local authorities in an appropriate manner on the way in which redistributed resources are to be allocated to them. Only paragraph 7, which only Azerbaijan has not ratified, does not mean that the right of local governments to undermine their fundamental freedom of choice in policy matters.

Although the level of decentralization in the Eastern Partnership countries differs from each other, the following problems are common to all countries:

- **There is a downward trend in the share of local budget expenditures in GDP.** The lowest share of local budget expenditures in GDP was recorded in Azerbaijan (0.5-0.7%) and the highest in Belarus (15-17%). The reason for the decline is the fact that GDP growth rates in these countries surpass the growth rate of local budget expenditures.
- **The share of local budget expenditures in the state budget is steadily decreasing.** The lowest share of local budget expenditures in the state budget was in Azerbaijan (2-2.5%) and the highest in Belarus (more than 90%). In Ukraine, the increase in foreign trade is between 50-60% and Georgia (19-23%). Growth of local budgets cannot reach the rate of growth of public finances.
- **Despite weak growth, local budgets are becoming less subordinate to the state budget.** Armenia, Azerbaijan, Belarus and Ukraine have seen a tendency for local budgets to increase their revenues in their total revenues over the past 5 years. In the municipalities of Moldova and Georgia, dependence on the state's financial assistance has increased.
- **Transfers from the state budget to local budgets are decreasing.** The country that allocates the least amount of funds to local governments in the state budget is Azerbaijan (less than 2% of the state budget expenditures) and Georgia (3-4%). The lower rate in Georgia is due to the fact that the legislation balances transfers into municipalities. The highest rates were in Moldova and Ukraine. In these countries, one third of the state budget is distributed through local governments.

The policy of fiscal decentralization and the results are different in the Eastern Partnership countries. In addition to common problems, each country has its own problems.

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https://www.coe.int/en/web/conventions/full-list/-/conventions/treaty/122/declarations?p_auth=1jYbxqZE

It is expedient to adopt the following recommendations to ensure fiscal decentralization and financial autonomy in the Eastern Partnership countries.

- **Adopting the concept of a consolidated budget for Eastern Partnership countries.** In some countries (Georgia, Ukraine) local budgets are included in the consolidated budget, but in some countries (Azerbaijan) are not.
- **Unifying the budget system terms in the Eastern Partnership countries.** In Georgia, the state budget and the central government budget are different concepts. In Ukraine, all budgets, except for the state budget, belong to the local budget category. In Belarus, the state budget is replaced by the national budget.
- **Adopting a Fiscal Decentralization Strategy.** This Strategy aims to increase the powers of the self-governing bodies, to achieve fiscal decentralization, and to ensure better local governance.

Georgia is the only economy among the Eastern Partnership countries that has adopted a Centralization Strategy for 2020-2025.

Ensuring the right of local governments to introduce independent taxation and tax rates to enhance financial independence. Although there are local taxes in the EaP countries, they are subject to the central government's decision and are usually regulated through the norms established by the Tax Code. Local governments should have the right to abolish taxes, change their interest rates, and apply tax deductions.

- **Introducing a shared tax system.** Although Ukraine and Moldova apply for their taxes, Armenia has not practically solved it, while Azerbaijan does not have such a funding mechanism. With a change to the Tax Code of the respective countries, a mechanism for allocating a number of taxes (income tax, property and land taxes) to local budgets can be applied.
- **Expanding inter-budgetary transfer mechanisms.** Mechanisms of inter-budgetary transfers should be improved to ensure that the national revenues are fairly distributed among local governments. For this purpose, criteria for allocation of transfers, especially of balanced transfers (subsidies) should be increased, and the provision of targeted financial subsidies should be mainly regulated as part of government programs.
- **Responsible borrowing policies of local governments.** The access of local governments to the capital market should be simplified, the terms and procedures for issuance of securities for municipalities to be financed, and the necessary legislative framework for the state should be established.
- **Increasing local governments' access to financial resources.** One of the mechanisms to facilitate local governments' access to financial resources may be the establishment of financial institutions with the representation of municipalities. Financial institutions such as the Municipal Development Fund in Georgia and the Municipal Investment Development Fund in Poland provide preferential loans to municipalities.