TECHNICAL ASSISTANCE REPORT

REPUBLIC OF ARMENIA

Updating the Borrowing Framework for Local Governments

MARCH 2024

Prepared By

Natalie Manuilova, Nino Tchelishvili, Imran Aziz, Fernando González

Authoring Departments

Fiscal Affairs Department

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Abbreviations and Acronyms

AMD	Armenian dram
CBA	Central Bank of Armenia
CCAMTAC	Caucasus, Central Asia and Mongolia Technical Assistance Center
CD	Capacity Development
EU	European Union
FAD	Fiscal Affairs Department
FR	Fiscal Risks
GDP	Gross Domestic Product
IMF	International Monetary Fund
LG	Local Government
MOF	Ministry of Finance
MTAI	Ministry of Territorial Administration and Infrastructure
MTEF	Medium-term Expenditure Framework
PFM	Public Finance Management
OECD	Organisation for Economic Co-operation and Development
PIM	Public Investment Management
PIMA	Public Investment Management Assessment
PPP	Public–private partnership
RA	Republic of Armenia
SNG	Sub-national Governments
SOE	State-owned enterprise

Preface

At the request of the Ministry of Finance of the Republic of Armenia (MOF), a team from the IMF's Fiscal Affairs Department (FAD) undertook a virtual technical assistance mission during the period from September 5 to 15, 2023. The mission team was led by Ms. Natalie Manuilova and included Ms. Nino Tchelishvili (both FAD), Mr. Imran Aziz (IMF CCAMTAC), and Mr. Fernando González (FAD short-term expert).

The mission team met with the Deputy Minister of Finance, Mr. Eduard Hakobyan, Mr. Artur Hambardzumyan, Mr. Samvel Khanvelyan, Ms. Anzhelika Stepanyan (all from the Debt Management Department), Ms. Ani Hunanyan, Fiscal Risks Monitoring Department, Mr. Artak Karapetyan, Budget Department, Mr. Narek Karapetyan, Macro Policy Department, Mr. Artur Aleksanyan, Tax Policy Department, Mr. Gor Kocharyan, Accounting and Audit Regulation Department.

From other agencies, the mission met with Mr. Vache Terteryan, Deputy Minister of Territorial Administration and Infrastructure (MTAI), Mr. Artak Albertyan and Mr. Loris Muradyan (both MTAI), Mr. Arman Jhangiryan, Revenue Accounting and Taxation Department of Yerevan Municipality, Mr. Arman Potikyan, Garegin Gevorgyan, Hayk Avetisyan, and Vigen Shahnazaryan (all from the Central Bank of Armenia), and Mr. Zorayr Karapetyan, State Audit Chamber.

The mission met with development partners, including with Ms. Zuzana Sorocinova, the EU Delegation to Armenia; Ms. Lea Hakim and Ms. Armineh Manookian, the World Bank; Mr. Joao Pedro Farinha and Ms. Elena Khachvankyan, Asian Development Bank; Ms. Karine Lalafaryan and Mr. Rudik Tadevosyan, European Bank for Reconstruction and Development.

The mission team would like to thank the Armenian authorities for their cooperation and participation in constructive discussions during the mission, and especially to Mr. Artur Hambardzumyan for coordinating information requests and mission activities. The mission would also like to thank Mr. Vahram Janvelyan, IMF Local Economist, his guidance and support to the mission, and to Ms. Marietta Sahakyan and Mr. Khachatur Adumyan for the interpretation assistance provided.

Executive Summary

Republic of Armenia (RA) is a unitary state with significant financial and decision-making power concentrated at the central government. Following several waves of municipal mergers over the past two decades, Armenia has evolved from a system of many fragmented municipalities, with low capacity and resources, to a more centralized system with 71 communities, plus Yerevan City. Reflecting this centralized system, RA has a highly centralized budget structure with municipalities accounting for a small share of the general government budget—consolidated municipalities' expenditures were 9 percent of the general government expenditure in 2022 (or 2.2 percent of GDP).

Municipalities rely on central budget transfers and grants, between 56 percent of total revenue in Yerevan to 80 percent in other municipalities. Most of the local governments (LG) revenues fund recurrent expenditures, although capital spending has recently picked up reaching almost 20 percent in Yerevan in 2022, supporting the expansion of small-scale municipal investment projects. Based on the current revenue composition, Yerevan Municipality cannot sustainably fund its spending needs with own revenues, which only cover one third of their spending. Presently, there are no clearly defined plans within the government to allow LGs to increase share of local revenues or to expand their spending responsibilities. The decentralization direction is not clear either.

In 2022, Yerevan Municipality announced its plans to raise financing from the local market to help diversify its funding base and invest more into city infrastructure. Presently, LG infrastructure projects are financed by the central budget or by the international finance institutions, loans from which approximate 1 percent of GDP. This loan portfolio is raised and centrally managed by the MOF, with limited cases where loan repayment responsibilities fall on the municipality. Pursuing greater independence in attracting market financing, Yerevan Municipality proposed legislative changes that would allow significant carve outs from the overarching budget legislation and its requirements.

Yerevan City should adhere to the relevant general legislation and controls, while it may request certain special provisions as the largest and capital city of the country. Currently, proposed changes to the legislation focus on allowing Yerevan Municipality significant carve outs from the overarching general legislation and relevant budget processes based on its differentiated status from other municipalities. Such practice should be discouraged. Yerevan Municipality should have the same status with other LGs and abide by a general public finance legislation, and borrowing framework once it is developed, which may contain certain special provisions for Yerevan Municipality as the largest city.

The existing institutional and legal frameworks are not equipped to open borrowing options for LGs, foundations of intergovernmental fiscal relations are lacking. Current legal system and the institutional architecture of intergovernmental fiscal relations in Armenia reflect the leading role of the central government in fiscal affairs, which are sufficient for the existing balance of responsibilities between the center and municipalities. A number of legislative changes and pre-requisite measures should be introduced to ensure that borrowing is only allowed to financially sound municipalities and is raised within clear fiscal and administrative controls. These measures should be accompanied by strengthening the underlying PFM processes and fiscal risks management by the MOF to safeguard the public finances.

Existing administrative controls can be clarified and revised to provide more flexibility for LGs seeking outside financing, within the set parameters. Current administrative controls appear to be overly restrictive and, as a consequence, borrowing is not used by municipalities. The revision of administrative controls' parameters may include several elements, but adhere to the main guiding principles, such as financial soundness of the borrowing LG, defined fiscal space set by the administrative controls, and coordinated approval process with the MOF providing final authorization. The authorities will need to consider and introduce clear parameters for potential borrowing, such as eligibility criteria for municipalities, defined objectives (e.g., for investment purposes only), numerical restrictions on the size of the instrument, pricing thresholds, and stand-alone rating process for bond issues.

Amendments to the legal framework should also be considered to revise the public debt definition to include municipal debt, thus subjecting LGs debt to fiscal rules coverage. In Armenia, fiscal rules currently apply to the central government debt, as the Law on State Debt does not include LG debt into the public debt legal definition. Hence, LGs are not subject to the existing fiscal rules, potentially exposing central government to fiscal risks. Definition of public debt should be aligned to good international practice and include municipal debt in primary legislation and fiscal rules coverage. This work is ongoing.

Should the government advance their decentralization reforms, an in-depth analysis of political, financial, and administrative responsibilities between the center and LGs are warranted. The mission did not focus on the direction or status of the decentralization reforms. If the decentralization process is deepened, the authorities should develop a fiscal responsibility framework to inform any revisions to revenue and spending responsibilities, further strengthen fiscal coordination and identify possible imbalances. Such framework should be based on the long-term decentralization strategy and detailed analysis of the current distribution of municipalities' revenue and spending responsibilities. Depending on the results of the assessments, the borrowing framework for LGs may need to be revised.

Strong public financial management systems, and adequate capacity of local and central governments are pre-requisites that must be in place before considering LGs access to third party funding. Institutional weaknesses, low capacity, and underdeveloped PFM and local taxation systems exacerbate risks and give rise to risk management challenges. Closing the current gaps in the PFM systems will entail actions at the MOF, such as, aligning budget calendars between the central and local budgets, introducing regular monitoring of the municipalities' performance, and strengthening the fiscal risk management function. At the local level, municipalities will need to start regular reporting, including on their balance sheet data.

Capacity development should become a priority to enable an affective PFM system at central government and municipalities. This process should begin as soon as practical to build capacity, processes, and systems at local and central government (MOF, MTAI). To properly and timely assess fiscal risks stemming from LGs, the MOF will need to enhance its fiscal and financial oversight of LGs. Coordination and data exchange between the Ministry of Territorial Administration and Infrastructure (MTAI) and the MOF Fiscal Risks Management Department need to be improved and automated.

This report offers a concept note as a reference for the authorities in developing the LG Borrowing Framework (Annex I). Table below summarizes key recommendations of this report.

Recommendations

Legislative Framework for Borrowing by Local Governments		
	Ensure finalizing the draft legal amendments to:	
2.1	• Revise public debt definition in the Law on State Debt to include municipal debt.	MOF: Q1 2024
2.2	• Include municipal debt into coverage of fiscal rules.	MOF: Q3 2024
LGs Fiscal Risks, Rules, and PFM Readiness		
3.1	**Establish the institutional framework for local governments to borrow.** Consider examples in Chapter III.	MOF: Q3 2024
3.2	**Align the budgeting process between the central and LGs:**	
	• Develop clear entry points for municipalities into the central budget calendar.	MOF, MTAI: Q4 2024
	• Enable the MOF budget challenge function towards LGs budgets.	MOF: Q4 2024
	• Align PIM practices between the central government and LGs for major capital projects[1] (above AMD 1 billion).	MOF, MTAI: Q2 2024
3.3	**Introduce central oversight and monitoring of the municipalities' performance, initiate monitoring of related fiscal risks by the MOF:**	
	• Carry out regular financial performance analysis and fiscal risks monitoring of LGs', including selected balance sheet positions.	MOF: Q2 2024
	• Mandate the MOF to regularly monitor and assess fiscal risks stemming from LGs', starting with Yerevan Municipality.	MOF: Q2 2024
	• Consider introducing external audit requirement for those municipalities looking to borrow outside of central government.	MOF, State Audit Chamber: Q4 2024
3.4	**Build analytical capacity at the MOF, MTAI and LGs, consider engaging development partners.**	MOF, MTAI, Yerevan Municipality: Q1 2024 – onwards
Fiscal Coordination. Other Risks		
4.1	**Clarify and strengthen current institutional coordination between the central and local governments:**	
	• Assign the MOF as the final decision authority as to approving borrowing requests by LGs.	MOF: Q1 2024
	• Establish permanent coordination bodies with municipalities, with periodic meetings in the year, to coordinate any emerging risks.	MOF, MTAI: Q4 2024

[1] Refer to IMF FAD Report on Public Investment (July 2023)

I. Overview of Local Governments' Fiscal Revenues, Expenditures, Borrowing Patterns

1. **Republic of Armenia (RA) is a unitary state, with significant financial and decision-making power concentrated at the central government level.** Division of power, respective roles and responsibilities are enshrined in the Constitution of the RA, and supported by the respective Laws on Self Governance, Self-Governance of Yerevan City, and the Budget System Laws.

2. **Since the start of the decentralization reform in 1995, many local communities were aggregated and merged, and received a greater degree of autonomy.** After legislative updates and community mergers carried out in phases,[2] Armenia has evolved from a system of many fragmented municipalities, with low capacity and resources, to a more aggregated system with 71 communities, plus Yerevan City. As a consequence of the merger process, LGs today are much less fragmented and have more capacity to manage their own resources.

3. **Below analysis presents an overview of the RA's regional and municipal structure, aggregate analysis of local governments' revenues, expenditures and borrowing patterns.** Among all local governments (LG), Yerevan Municipality is the largest and given its size and importance, a deeper analysis of fiscal trends is presented for this municipality.

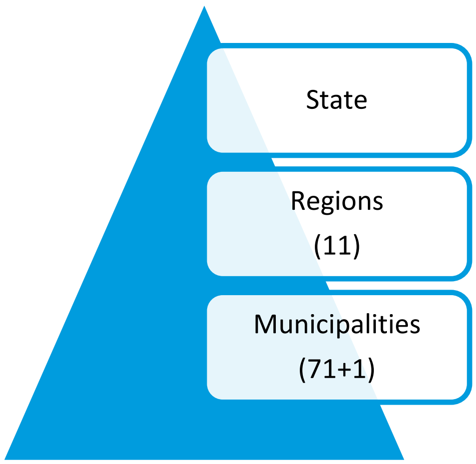
A. Territorial and Municipal Structure in Armenia

4. **The RA territory comprises of 10 regions (marzes) and Yerevan City, which cascade to 70 municipalities (communities).** Regional policy is conducted through municipalities across several sectors, including urban development, housing and utilities, transport and road construction, agriculture and land use, education, healthcare, social security, culture and sports, nature and environmental protection and commerce. Figure 1 provides the RA's territorial structure and Table 1 the breakdown of municipalities per region.

5. **Yerevan is the capital city and the largest municipality in terms of population, contribution to the economy and fiscal flows.** Yerevan houses over a third of Armenia's population (almost 1.1 million people) and is divided into 12 administrative districts, which are dedicated units of the municipality. Yerevan is home to a large number of other entities in its jurisdiction, including schools, kindergartens, music schools, sport schools, libraries, museums, theatres, and cultural centers.

[2] Law on Administrative-Territorial Division of the Republic of Armenia (1995), Law on Local Self-Governance (1996), Territorial and Administrative Reform of Armenia (2014).

Figure 1: Territorial Structure in Armenia



Source: MTAI

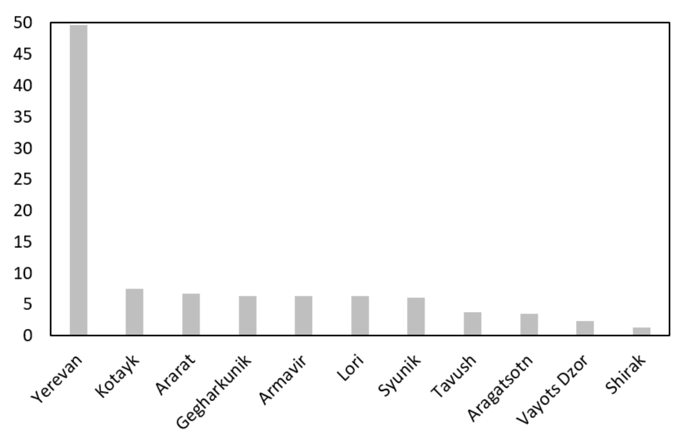
Table 1: Regions and Municipalities

Region	Population (2023)	Municipalities
Aragatsotn	133,960	8
Ararat	260,367	5
Armavir	266,600	8
Gegharkunik	237,027	6
Kotayk	256,509	11
Lori	237,492	11
Shirak	254,033	6
Syunik	142,948	7
Tavush	129,676	4
Vayots Dzor	53,248	5
Yerevan	1,094,813	1
Total	**3,066,673**	**72**

B. Revenues and Expenditures Composition

6. **RA has a highly centralized budget structure with municipalities accounting for a small share of the general government budget, half of which is concentrated in Yerevan.** Consolidated municipalities' budget expenditures reached 9 percent of the general government expenditure in 2022, equivalent to 2.2 percent of GDP. Half of this spending is undertaken by Yerevan Municipality (Figure 2). Subsequent analysis in this section focuses solely on Yerevan Municipality, given its size, importance, and ambitions to borrow outside of general government.

Figure 2: LGs' Expenditures by Region
(percent of total LG expenditures, 2022)



Source: MTAI

7. **Yerevan Municipality's revenues consist largely of transfers from the central government, although their share has been gradually declining from 2020 with own revenues playing an increasing role in local finances.** Significant reliance on central government's transfers is applicable for all LGs in Armenia, with Yerevan leading the way in growing share of their local revenues. In 2017, Yerevan transfers, grants and domestic subsidies accounted for almost three quarters of its revenues (Figure 3), but this dependency has started to change over the past five years.[3] In 2022, transfers from the central budget amounted to 56 percent of the Municipality's revenues. The increases in own source revenues are attributed to growth in property taxes and collection efficiency through digitalization.

8. **State transfers have the lowest collection rate of all revenue sources of Yerevan Municipality (Figure 4).** Except for an increase in 2021 (likely, for COVID-19 community support), the latter has halved from 2017 by approximately 50 percent in 2022. Grants and domestic subsidies for equalization purposes were on a similar downward trend in terms of execution pre COVID-19, but have picked up since, which is likely to be on account of increased social welfare schemes. Collection rates for own source revenues have been strong since 2019 with collections outpacing plans for the last three years.

Figure 3: Yerevan Municipality Revenues by Source (percent of total)

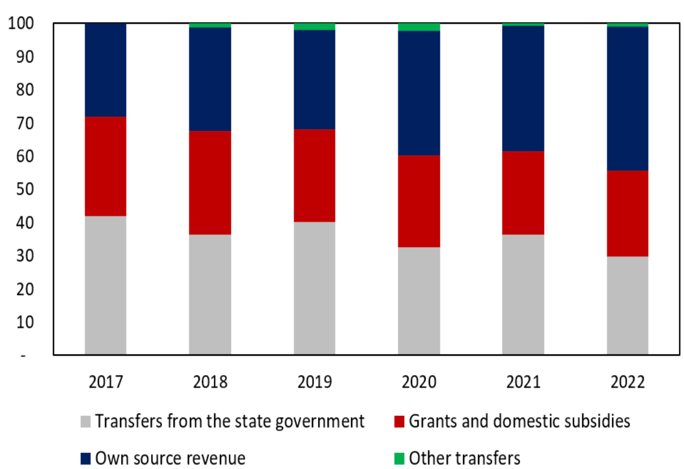
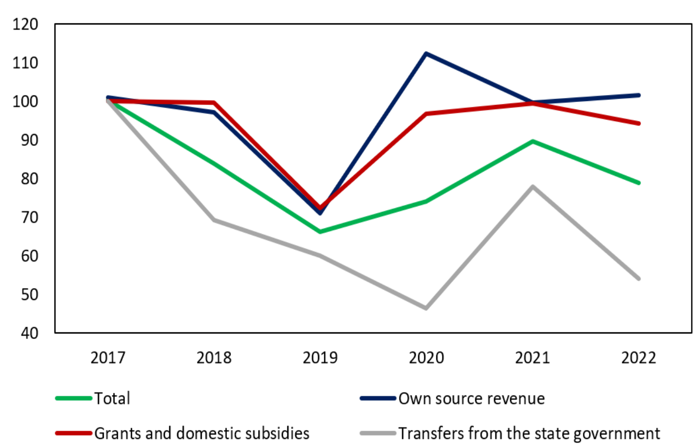


Figure 4: Yerevan Municipality Revenue Collection Rate (percent)



Source: MTAI

9. **Most of Yerevan Municipality spending is recurrent, although capital spending has recently been growing as a share of total spending, which has led to rising budget deficits.** Current expenditure averaged 83 percent of total spending during 2017−23—it is predominantly non-discretionary, consisting of wages and other recurrent commitments, and earmarked transfers to the communities. From 2020, capital spending more than doubled as a share of total expenditure—to almost 20 percent in 2022—-supporting the expansion of small-scale municipal investment projects (Figure 5A).

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[3] State budget transfers include unconditional grants and subsidies for equalization purposes (Figure 3, red bar), as well as block transfers for community's capital investments (Figure 3, grey bar), such as schools, health clinics and kindergartens.

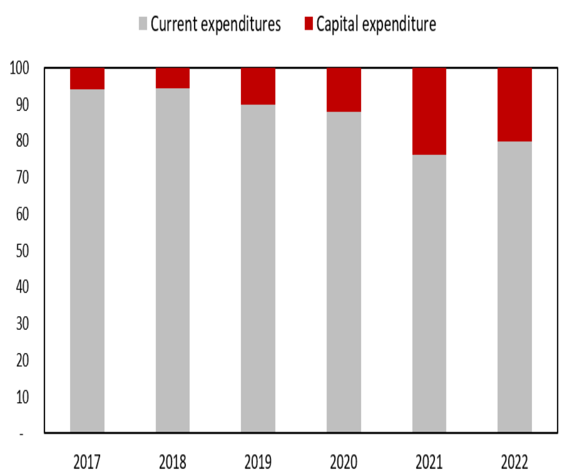
10. **Budget deficits have varied significantly since 2017 but appear to be increasing.** By 2022, the deficit accounted for approximately 18 percent of total spending, or 0.2 percent of GDP (Figure 5B). This could be attributed to the growing spending pressures associated with capital spending but would require further analysis of the municipal expenditure profiles, such as the level of administrative spending versus service delivery functions.

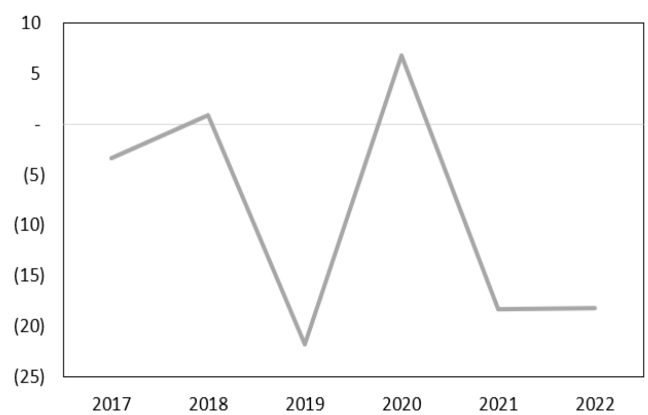
11. **Budget execution rates for capital expenditure have been low due to budget suppressions from the state, which can also indicate limited capacity to execute projects as planned** (Figure 6). Given that state transfers have had the lowest collection rate of all major revenue sources and are earmarked for community investment projects, the low capital budget execution trend can be primarily attributed to in-year resource suppressions. In addition, this trend also indicates challenges in the management of community investments by the municipality.

Figure 5-A: Yerevan Municipality Expenditure Composition

Figure 5-B: Yerevan Municipality Budget Deficit

(percentage of total spending)





Source: MTAI

12. **Based on the current revenue composition, Yerevan Municipality cannot sustainably fund its spending needs with own revenues, which only cover one third of their spending.** In 2022, own source revenue covered approximately 30 percent of total spending (Figure 7), which is lower than advanced economies that have developed systems of devolved sub national borrowing.[4] There are plans to increase the Municipality's core revenues, such as rates for property tax over the next three years and introduce new revenue sources such as hotel tax. There are also plans to introduce fees on certain municipal services, but these changes are likely to have only a minimal impact on the Municipality's fiscal sustainability. A closer assessment of the expenditure profile of Yerevan Municipality would be required to fully assess its sustainability.

[4] 2018 Fiscal Transparency Evaluation (FTE) offered comparisons with selected peer countries. It found that countries with lower self-sufficiency ratios were either newer EU accession states such as Romania and Bulgaria or more advanced economies with developed PFM systems (Austria, Netherlands, Austria, and the UK).

Figure 6: Yerevan Municipality Budget Execution Rates as a Share of Budget Projections (percent)

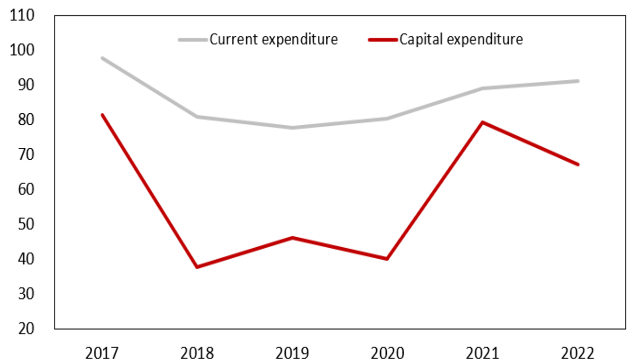
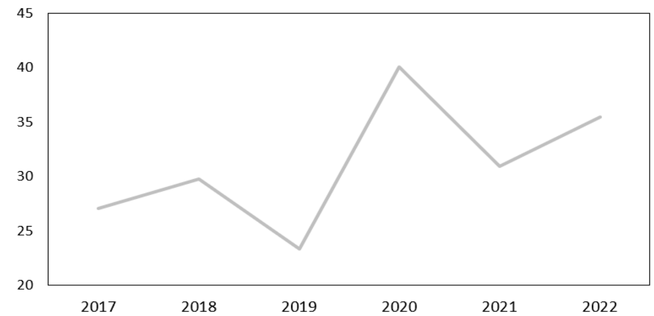


Figure 7: Yerevan Municipality Self-Reliance (own source revenue as a proportion of total spending)



Source: MTAI

C. Yerevan City Borrowing Trends and Plans

13. The majority of external lending for LGs infrastructure projects is financed through the central government, bulk of which is financed by the IFIs and centrally managed by the MOF. A complete list of financing that benefits Yerevan is presented in Table 2. A small proportion of IFI loans is managed through on-lending agreements between the MOF and LGs (highlighted in blue, Table 2). On-lending arrangements often require the municipal state corporation to reimburse the state government as part of principal and interest repayments, whereas other arrangements are for interest only. Total outstanding stock of LGs' loan repayments equates to just over 1 percent of GDP. There is a high degree of heterogeneity within this portfolio, with MOF guaranteeing the loan repayments, where only in some cases (on-lending) repayment responsibilities fall on the municipality. Yerevan Municipality currently has only one direct external loan of Euro 20 million co-financed with other IFI's.[5]

14. In 2022, Yerevan Municipality announced its plans to raise financing from the local market to help diversify its funding base and invest more into city infrastructure. These changes were justified on the grounds that Yerevan has little impact on changing tax rates or the tax base or introducing new tax types, which reduces the municipality's ability to generate new revenue sources and increase revenues. To achieve this funding diversification, Yerevan Municipality proposed changes to the main legislation granting it a differentiated status from the rest of municipalities. Such practice should be discouraged.

15. Proposed legislative changes aim solely at strengthening the differentiated status of Yerevan Municipality's, seeking significant exemptions from the general legislation that bypass the MOF authorization. In 2023, Yerevan Municipality proposed a legislative package, offering to change the Budget System Law, the Law on Self-Governance in the City of Yerevan, and the Law on Self-Governance. The proposed changes offer to carve out Yerevan Municipality of quantitative restrictions

[5] The loan features a highly preferential maturity period of 22 years, and favorable concessional five-year grace period**.** The Euro 20 million project is co-founded between Yerevan Municipality own funds (Euro 2 million), EIB (Euro 7 million), the East European Energy Efficiency and Environment partnership (Euro 10 million), and the Green Climate Fund (Euro 1 million).

applicable to the amount of the borrowing for financing the capital deficit, from the government's procedures for issuing and allocating bonds by local self-government bodies, and from other restrictions, such as the rule of not having two outstanding loans at the same time, the rule of debt service costs capped at 20 percent of the revenues of capital budget, the restrictions on the use of collateral, and the rule that loans and transfers are not granted at the expense of the community's budget. The proposed amendments give authority to the Council of Yerevan to adopt a decision on attracting borrowed funds, and to define the procedure for issuing and allocating bonds. Finally, they change the restrictions on borrowing applicable to Yerevan to take into account not the total capital income, but the own resources, which changes the percentages applicable to debt service.

Table 2: MOF Loan Agreements with IFIs for Yerevan Municipality (2022)

Creditor	Loan / Project	Outstanding Amount (USD)
Japan	Yerevan Combined Cycle Co-Generation Power Plant	147,705,281
France	Yerevan Water Sector and Wastewater Improvement	22,677,109
IDA	Yerevan Water & Wastewater	14,407,055
EBRD	Yerevan Bus	4,482,219
EBRD	Yerevan Water Supply Improvement	3,442,196
EBRD	Yerevan Metro Rehabilitation	889,423
EBRD	Yerevan Metro Rehabilitation II	2,324,161
EBRD	Yerevan Street Lighting	398,744
EBRD	Yerevan Solid Waste (I Tranche)	62,098
EIB	Yerevan Water Supply Improvement (I Tranche)	2,850,000
EIB	Yerevan Metro Rehabilitation (I Tranche)	1,018,793
EIB	Yerevan Metro Rehabilitation (II Tranche)	873,251
EIB	Yerevan Metro Rehabilitation II (I Tranche)	1,667,667
EIB	Yerevan Metro Rehabilitation II (II Tranche)	1,067,307
Total		**203,865,304**

Source: MOF. The table excludes the Kotayk Solid Waste management Project tranches A and B that were not part of the 2022 debt operations table, the agreement was signed in 2017.

16. The proposed amendments may respond to the overall notion of fiscal decentralization, but go against the legislated prudent practices and pose risks to the central budget. The proposed changes to carve out the Yerevan Municipality from the overarching legislation may exaggerate the already special status of Yerevan City and undermine the central government's ability to control the municipality fiscal risks. In this sense, even if some exemptions for Yerevan Municipality can be adopted to reflect its special profile, it is preferable to create a general framework more flexible for all municipalities, without reducing the MOF's role in granting final authorization for issuing debt.

17. This report offers a concept note as a reference for the authorities in developing the LG Borrowing Framework (Annex I). This proposed concept outlines the objectives, limits, and coverage of such potential borrowings by LGs, and proposes the institutional responsibilities to be in place before any such borrowing proposal can be considered by the MOF and the MTAI.

II. Legislative Framework for Borrowing by Local Governments

18. Current legal system and the institutional architecture of intergovernmental fiscal relations in Armenia reflect the leading role of the central government in fiscal affairs. Following several phases of municipalities' mergers over the past two decades, they are much less fragmented and have more capacity to manage their own resources than prior to the reform. In the recent amalgamation process of LGs, the legal and institutional frameworks have not evolved enough to meet to the growing spending powers of Armenia's municipalities.

19. Presently, there is no clear robust framework of fiscal responsibility in place that would support municipalities raising the third-party debt. Main legislation that is applicable to LGs and their ability to borrow includes: (i) Law on the Budgetary System; (ii) Law on Self-Governance; and (iii) Law on Self-Governance of Yerevan City.

- Law on the Budgetary System, Article 28 specified that sources of financing the deficit of municipalities include loans received from the state budget, as well as other sources permitted by law and funds received from the placement of bonds issued by local self-government bodies; Article 30 foresees loans and the issuance of securities can be issued by municipalities with the consent of the state authorized body, provided that the annual amount for the repayment program in each budget year—the sum of the principal amount and interest payments—will not exceed 20 percent of the revenues of the capital part of the municipality's budget for the corresponding year.
- Law on Self-Governance allows the LGs' council to take decisions regarding the attraction of loans and other funds. This Law also establishes the sources of financing the community budget deficit, which include funds raised in the form of loans, or placement of bonds issued by local self-government bodies.

20. While municipalities have authority to borrow under the existing legislative limitations, they do not borrow outside of central government. Number of legislative restrictions and mechanisms are in place to minimize LG borrowing, for example, limit to the annual amount of debt service in loan and securities repayment, principal, and interest payments, which cannot exceed 20 percent of the revenues of the capital part of the municipality's budget for the corresponding year (per Law on the Budget System). The legislation only allows LGs apply for a new loan after paying off the previous loan debt in full. Presently, only the two biggest municipalities (Yerevan and Gyumri) have outstanding third party loans, and those are secured by the guarantee of the central government. Details of the legislative frameworks are available in Annex IV.

21. The Law on State Debt does not include debt of municipalities into the legal definition of public debt. The Law on State Debt foresees purposes for raising public debt that do not include municipal need, these include: (i) financing state budget deficit and ensuring current liquidity; (ii) supporting balance of payments and replenishment of reserves; and (iii) maintaining and developing government domestic debt market. This Law does not include LG debt, or purposes for which LGs seek to borrow, namely, raising long term funds for public investment purposes. There are plans to reform the legal framework relative to public debt, in order to include debt from municipalities, align the public debt definition with international standards and modify the purposes of debt.

22. As municipal debt is not defined as public debt, LGs are not subject to fiscal rules, potentially exposing central government to fiscal risks. The Law on State Debt (Article 5) defines public debt as the aggregate of the Government debt and CBA's debt. It does not include debt of municipalities, which are not considered for the limit of government debt to GDP ratio of 60 percent, as per existing fiscal rule. Moreover, monitoring of LGs fiscal risk by the central government is not systematic, and mechanisms to assess the LGs' authorizations for borrowing are not defined in the legal system.

23. The existing legal framework does not allow municipalities to increase their own resources in case of insufficient funds to finance their increasing spending responsibilities. The Law on Self-Governance establishes the fundamentals of the assumption of spending responsibilities of local governments. On the resources side, the share of own revenues in municipalities fluctuates around 30 percent. Tax rates on local taxes are determined by the tax code, and municipalities cannot modify them. Neither can they modify tax bases or create new taxes. Even though the existing legislation plans an increase of tax rates through 2026, the general view is that LGs will need to increase their own resources if they look to borrow externally and service their debt.

24. It is important to keep the general legal system without exclusions as to the provisions on fiscal transparency. Legislations should protect the right of citizens and the Parliament to understand how money is spent and if fiscal rules are complied with, and in this sense, all legislations contain provisions related to transparency, such as information obligations on debt, on composition of debt or on legal requirements to incur in new debt. Legislative changes proposed by the Yerevan Municipality may give authority to the Council of Yerevan to define procedure for issuing and allocating bonds. This could undermine the general transparency framework for issuing debt and increase the gap of asymmetric information between the issuers of debt and the financial agents.

Recommendations

2.1 Finalize the draft legal amendments to the Law on State Debt, revise public debt definition to include municipal debt.

2.2 Include municipal debt into coverage of fiscal rules in the existing legislation.

III. LGs’ Fiscal Risks, Rules and PFM Readiness

25. **As communities, and Yerevan Municipality in particular, declare their ambition to borrow outside of the central government, sound system of checks and balances must be introduced.** Without a system of clear rules, procedures and regular monitoring of communities’ financial performance, there is greater probability that funds may be mis-used, and the central government will have to intervene if debt becomes unsustainable.

26. **Strong public financial management systems, and capacity of local and central governments are pre-requisites to a functioning system for borrowings by LGs.** Institutional weaknesses, low capacity, and underdeveloped PFM and local taxation systems exacerbate risks and give rise to risk management challenges. This section of the report undertakes a gap analysis of the PFM readiness at both central and local government levels. Whilst it was beyond the scope of the existing mission to undertake a full assessment of PFM systems and processes, the gap analysis draws upon a desk review of budget documents and reports, past PFM diagnostics and responses obtained from meetings with officials at the central and local government level.

A. Fiscal Risks of Local Governments

27. **MOF is rightfully concerned about potential significance of different types of fiscal risks and took steps to strengthen the fiscal risks management function.** FAD CD mission on State-Owned Enterprises (SOEs) Accountability Frameworks reviewed the recent progress in enhancing the fiscal risks management framework and building internal MOF capacity to manage such risks and provided recommendations.[6] A prudent fiscal risks management framework should take a holistic view of public finances and address vulnerabilities in its subcomponents, including risks from LGs.

28. **Allowing LGs to borrow without putting in place the necessary risk management mitigation measures has a potential to create fiscal risks for LG’s.** At present, communities in the RA are heavily dependent on central government transfers, which in combination with fiscal disbalances, pose fiscal risks materialization from borrowing, and/or building up spending arrears.[7] This is especially the case for LGs with a weak own source revenue base and those that lack resources to meet their spending responsibilities. Fiscal risks can be explicit and implicit, and take several forms: (i) bailouts; (ii) call on guarantees extended by the central government; (iii) write offs for central government loans; and (iv) a scaling up of central transfers if LGs do not have enough resources to fulfill their obligations (Box 1). If allowed by the MOF, any new borrowings, and the ongoing service of outstanding borrowings (loans, bonds) from outside the central government will need to be properly pre-assessed and pre-

[6] Please refer to the IMF FAD Report on SOE Accountability Framework (June 2023).

[7] The mission was informed by the authorities that expenditure arrears do not constitute a major issue in LGs, however, the mission was not provided with evidence of this statement (i.e., balance sheet data, or other information).

approved by the MOF, and when allowed duly monitored by MOF to effectively manage the risk exposure.

Box 1: Subnational Fiscal Risk Realizations: Selected Examples

In **Argentina**, estimates of the central government assumption of subnational debt during 2001–04 range from US$9.7 billion to US$12.1 billion.

In **Hungary**, following nearly a decade of buildup, the central government between 2011 and 2014 took over the entire local government debt, which was estimated to have reached about ft 1,344 billion (€4.26 billion). Most of this debt was denominated in foreign currency, which involved exchange rate risks threatening financial stability. The central government also took over the provisioning of education and health care services.

Source: How to Manage Fiscal Risks from Subnational Governments IMF 2022

29. **Monitoring LGs fiscal health by the central government is critical to ensure that essential public services are delivered to citizens, and that communities' budget do not pose a risk for the central budget.** The current legislation envisages a two-level budget system— central and local, whereby the state does not explicitly take on financial liabilities of LGs. At the same time, the central government is viewed as being ultimately responsible for a potential local government failure, as generally believed in many countries, including in RA.[8] Moreover, LGs are legislatively exempt from bankruptcy proceedings, as per Law on Bankruptcy (Article 2). This equates to an implicit guarantee, where the MOF is not legally obliged to bail out a municipality from potential distress, but the public expectation is such that it will have to intervene avoiding a bankruptcy of a LG.

30. **Presently, the MOF does not monitor fiscal risks stemming from LGs', nor performs regular financial analysis on their performance.** MOF's Fiscal Risks (FR) Management Department is charged with collecting SOE and PPP data from communities in a predefined survey form and compile this data for presenting in a fiscal risks report. The FR Management Department does not analyze LGs' performance or their fiscal health, and only analyzes selected municipal SOEs and PPPs.

B. Fiscal Rules and Controls

31. **To protect the public finances and reduce fiscal risks from subnational borrowing, the central government should ensure that LGs financial health is adequate.** This principle entails that a municipality is able to generate sufficient revenues to cover its operating expenditures, manages its fiscal position sustainably, and can support the prospective debt payments, including interest and principal without resorting to central government support (Chapter IV).

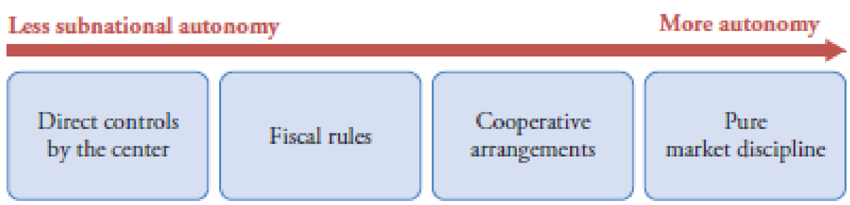
32. **Presently, RA's institutional framework lacks coordination with municipalities and resources for proper monitoring their performance and risks.** LGs present annual reports on budget revenues and expenditure to MTAI which aggregates these reports and sends aggregated information to

[8] As indicated during the mission interviews.

the MOF**.** The MOF analyses the aggregate fiscal and financial position of SNGs. The MOF’s Fiscal Risks (FR) Management Department performs limited analysis given their lack the resources and information to properly monitor fiscal risks originating in LGs.

33. Establishing clear fiscal responsibility frameworks for the LGs is the foundation for sound intergovernmental relationship—first step is to outline the LGs limits within which they can borrow. Subnational finances can be constrained in numerous ways. The various types of constraints can be classified according to the degree of fiscal autonomy left to subnational governments.[9] From the lowest of autonomy to the maximum level of autonomy of LGs, there are generally four main types of fiscal responsibility frameworks that include direct controls by the center, fiscal rules imposed by the center to LGs, cooperative arrangements (based on voluntary participation and negotiation of fiscal objectives), and pure market discipline, where the center does not impose any restrictions and it is the market who imposes discipline on LGs (Figure 8 and 9).

Figure 8: Forms of Control Over Subnational Finances



Source: How to Design Subnational Fiscal Rules: A Primer (IMF 2020).

Figure 9: Forms of Control Over Subnational Finances

Administrative Controls	Fiscal Rules to LGs	Market discipline
More restrictive than FR	Mid to High degree of decentralization: Spain, Italy, Brazil	Federal countries: USA, Canada
Most cases – Government approval: Ireland, Korea, Latvia		
Common to limit borrowing to specific purposes: Spain	Debt limits, balanced budget rules, expenditure rules	
Borrowing abroad or in foreign currency: New Zealand (excl. Auckland)	**Important:** NO BAIL-OUT Fiscal rules with sanctions	**Important:** NO BAIL-OUT Constraints are indirectly imposed by investors
Many countries do not allow SNGs (in particular local governments) to issue bonds: the Netherlands, Denmark		

Source: How to Design Subnational Fiscal Rules: A Primer (IMF 2020).

[9] “*How to Design Subnational Fiscal Rules: A Primer*” (IMF, 2020).

34. One of the effective mechanisms to constrain the discretion of subnational governments to borrow are fiscal rules. Fiscal rules are one type of institutional arrangements that seek to enforce fiscal discipline and set limits to the fiscal autonomy of LGs. The central government may set and revise each year's ceilings on subnational debt depending on the degree of their fiscal autonomy or regulate the type of borrowing allowed (current versus capital investment).[10] Fiscal rules are an intermediate form of constraint, imposing lasting constraints on fiscal policy.

35. In Armenia, fiscal rules currently apply to the central government debt, but eventually it will be important to apply them harmoniously to the entire general government sector. RA's fiscal policy is guided by the fiscal rules, set forth in legislation (see Box 2). The most recent amendments to the central level fiscal rules have been made in 2018, in line with the FAD advice.[11] The authorities are in a process of rolling out MTEF in communities, which can play an important role in setting and implementing fiscal policy objectives, such as debt rules. Strong intergovernmental coordination mechanisms are required to achieve this objective.

Box 2: RA Fiscal Rules (Central Budget)

- **Budget balance rule:** A deficit ceiling of 7.5 percent, set in 2009.
- **Debt rule:** public debt to GDP ratio's threshold is 60 percent. If this ratio exceeds 50 percent, the government is required to present an action plan in its MTEF to gradually bring government debt below 50 percent of GDP. If the debt ratio exceeds 60 percent of GDP, the government shall submit an action plan by the standing Committees on Financial, Credit and Budget and Economic Issues of the National Assembly for consideration to bring the debt path below 60 percent of GDP.
- **Expenditure rule:** (i) Capital expenditures should not be below the level of the budget deficit if the government debt exceeds 40 percent of GDP, and recurrent spending cannot exceed the tax revenues if the government debt exceeds 60 percent of GDP; (ii) the maximum increase in recurrent expenditure (excluding debt service costs) is subject to ceilings defined in the government decree if the government debt exceeds 50 or 60 percent of GDP.
- ***Escape clause***: Escape clause was introduced for large-scale natural disasters, wars, and economic shocks, which could be triggered with the decision of the Government.

36. Many countries chose to establish administrative controls on the borrowing by LGs. The design of fiscal rules for LGs has important challenges and complications, such as the calibration of rules, distribution of fiscal objectives for different levels of government, or certain parameters of the rules, which are not easily translated to the LG level. That is why many countries instead impose administrative controls on the borrowing by LGs (Annex II).

37. For the context of the RA that is only beginning to consider borrowings by LGs, the authorities may consider revising the administrative controls and making them more flexible, as the first measure. Current administrative controls appear to be overly restrictive and, as a consequence, borrowing is not used by municipalities. Before the LGs are given the authority to borrow, the first step to

[10] *How to Manage Fiscal Risks from Subnational Governments (IMF 2022).*

[11] Please refer to the IMF FAD Report *Republic of Armenia: Upgrading Fiscal Rules (June 2017).*

consider is to revise the administrative controls, making them more flexible, but also clear (numerical), so that LGs can start using debt, but at the same time, making it more focused on the purpose of debt.

38. Consider including the LGs in the current national debt rule, as a second measure. This could take place once more flexible administrative controls demonstrate results, and LGs begin to pass through the centralized authorization process. This step has to be based on the pre-requisite of municipal debt being included in the public debt definition. To move to this second step, the authorities will need to decide on the design of the rule, in terms of allocation of objectives and convergence efforts. Some countries (Spain Ecuador, Portugal) have used the size of respective expenditure in the general government's total, or the respective proportion of debt in the consolidated amount in a reference year.

C. PFM Framework for LG Fiscal Risk Management

39. To effectively manage sub national government fiscal risks, central government requires sound institutional mechanisms to systemically monitor the health of subnational finances. A broad framework for central oversight should include: (i) a strong regulatory framework; (ii) accurate and regular fiscal reporting; and (iii) analytical processes to assess potential risks arising from sub national borrowing. Given that Armenia has a highly centralized of sub national transfers, this should emphasize the oversight of public investment (to ensure that borrowing is only undertaken for viable investments and investment related risks are mitigated) and an in-depth analysis of financial performance to service debt using own source revenues. This latter point is particularly important as limited local tax autonomy and an underdeveloped tax administration system, can limit the scope for dealing with fiscal challenges at the local level. [12]

40. Such a framework does not currently exist in Armenia. The mission analyzed the framework based on the roles currently undertaken by the MOF and the MTAI across four dimensions: (i) financial analysis of municipal budgets; (ii) fiscal risk analysis; (iii) entry points in the budget calendar to challenge municipal budget submissions; and (iv) public investment analysis. Presently, budget calendars of central government and LGs are not aligned. Rolling out the MTEF (which is ongoing) and strengthening reporting and transparency at subnational level are critical in empowering LGs to improve their budget function. Major gaps were identified in all four dimensions, which are summarized in Table 3.

41. While limited information on revenues and expenditures is published by the LGs, their balance sheet data is not available. This lack on information on their assets, liabilities, outstanding loans, or arrears, restricts a comprehensive analysis of the ability for Yerevan or other LGs to finance their short-term obligations. This analysis would be required to assess the ability of the municipality to reduce its budget deficit without accumulating arrears.

[12] For more information see the 2023 IMF How to Note on Managing Fiscal Risks at the Sub National Government Level.

Table 3: Assessment Dimensions for Central Oversight of Subnational Risks

Dimension	Ministry of Finance	Ministry of Territorial Administration and Infrastructure
Financial analysis of municipal budgets	No analysis is done. The MoF is only responsible for analysis of the state budget.	Aggregate, regional, and municipal budgets are published on the website with minimal financial analysis – only budget execution of each revenue and expense category.
Fiscal risk analysis	Sub national analysis is not part of the fiscal risk statement.[13] There is currently no department within the MoF undertaking this form of analysis.	Ratios of financial health are not produced to track key parameters such as the ability of own source revenue to cover current spending, liquidity ratios and ability to maintain the asset base.
Entry points in the budget calendar to challenge municipal budgets	The budget calendar includes entry points to challenge submissions by central budget agencies, but this is not done for regional and municipal transfers.	It is unclear how bottom-up spending needs from municipalities are collected and assessed to reconcile needs vs. resource availability of state transfers.
Overview of public investments conducted at the local level	Focus is only on state budget, which includes centrally managed projects with lending from IFIs. Weaknesses were identified in this area in the 2018 PIMA, which can be assumed to transcend to the municipal level.	MTAI is responsible for allocating transfers for lower-level investments (health clinics, kindergartens, schools). No analysis is presented on its website regarding the performance of these projects.

42. **These institutional gaps will require addressing if the central government is to play an effective oversight role and this will require assigning new functions within the MoF.** These functions (listed in Box 3), could either be embedded within existing departments (such as debt or budget) or a new department created. In terms of institutional design, there is no one size fits all and different countries have adopted different approaches based on their legal and administrative arrangements and how the Republic of Armenia plans to roll out its decentralization framework.[14] In its current form, given that municipal spending is relatively small (2.2 percent of GDP), working within existing departmental structures is advisable to avoid additional recruitment and potential parallel structures within government.

[13] Analysis of community owned companies is undertaken, but no specific analysis of the sustainability of finances nor repayment risks associated with on lent loan arrangements.

[14] For example, in Spain where there is a large, decentralized budget, a large unit (of over 100 staff) exist within the Ministry of Economy. Kenya and South Africa have adopted central units in the Ministry of Finance, the former with risk analysis and oversight of fiscal transfers and the latter for screening and vetting public investment proposals that are planned to be financed through sub national borrowing.

Box 3: Oversight Functions and Institutional Considerations for the MOF

The core oversight functions to be embedded in the MOF:

- **Analysis of fiscal deficits:** assess whether deficits are perpetual, material, what the key drivers are and whether these deficits can be sustained without additional transfers from central government.

- **Analysis of investment borrowing plans:** forward looking assessment of whether planned investments have gone through the relevant checks and balances in accordance with the 2023 PIM decree and are based on a clearly defined project pipeline, which has been appraised using a credible methodology. Additionally, whether the resulting debt can be serviced from future recurrent revenue and central government bailouts will not be required.
- **Analysis of the credibility of medium-term forecasts:** assessment of potential forecast biases in revenue collection and underestimations of spending, both based on past trend and forecast error analysis.
- **Analysis of transfers to municipal governments:** this should form an integral part of the budget calendar and consist of target dialogue to reconcile spending needs with available resources. This could involve simplifying the complete budget calendar, which is currently 53 steps, and include specific decision points to hold budget consultations with the municipal governments.

Source: IMF Mission

D. Analytical Tools and Techniques

43. **The MoF will have to develop a suite of analytical tools and techniques to effectively undertake the functions listed in Box 5, drawing on experiences of other countries.** This toolkit will allow the MoF to assess, quantify and analyze potential risks arising from sub national governments and should be built on five key dimensions (Box 4), which will allow the MoF to characterize sub national governments in accordance with their risk characteristics. Given its size, importance to the economy and appetite for borrowing, this framework should be applied to Yerevan first and then gradually rolled out to other significant municipalities.

Box 4: Analytical Dimension for Quantitative Risk Assessment Framework for LGs

- **Fiscal capacity and flexibility:** A subnational government's capacity to manage its fiscal position sustainably and its flexibility to adjust future revenues and expenditures through increased revenues, either by raising taxes or increasing the tax base, and by containing expenditure

- **Operating performance:** a subnational government's ability to generate sufficient revenues to cover operating expenditures
- **Liquidity management:** a subnational government's ability to meet its short-term obligations efficiently
- **Debt capacity:** a subnational government's level of indebtedness and its capacity to take on additional debt
- **Public investment management:** a subnational government's capacity to manage its capital investments, through effective planning, budgeting and monitoring of projects.

Source: How to Manage Fiscal Risks from Subnational Governments (IMF 2023)

44. Adopting and customizing a composite risk score for municipalities that apply the five dimensions above, could be a useful first step for the MoF. This is a common approach that assigns weights to each financial soundness dimension listed in Box 4 to reach an overall risk rating score. Such an approach is used by the Standard and Poor's assessment of non-US sub national government based on seven indicators.[15] The New South Wales Treasury in Australia includes 10 financial performance indicators across four broad risk categories, provides a good model to consider (Table 4)**.**

Table 4: New South Wales Fiscal Sustainability Rating Analytical Framework

Ratio	Benchmark	Weighting (%)	Subtotals (%)
Financial Flexibility			
Operating Ratio	>(4.0%)	17.5	35.0
Own source operating revenue ratio	>60.0%	17.5	
Liquidity			
Cash expense ratio	>3.0 months	10.0	20.0
Unrestricted current ratio	>1.5x	10.0	
Debt Servicing			
Debt service cover ratio (DSCR)	>2.0x	7.5	10.0
Interest cover ratio	>4.0x	2.5	
Asset Renewal and Capital Works			
Infrastructure backlog ratio	<0.02x	10.0	35.0
Asset maintenance ratio	>1.0x	7.5	
Building and infrastructure asset renewal ratio	>1.0x	7.5	
Capital expenditure ratio	>1.1x	10.0	
Total		100.0	

Source: New South Wales Treasury Corporation (2013)

45. Finally, lower capacity of the LGs further exacerbates fiscal risks. The capacity gap in managing budgets and analyzing and managing fiscal risks at the local level may be significant,[16] and will need to be addressed to enable LGs develop their PFM systems and capabilities. The MOF may consider designing a plan for building analytical capacity of the assigned MOF department(s) to undertake LGs' financial and fiscal risk analysis. The same will need to be replicated for the LGs, in coordination with the MTAI and support of development partners, as may be applicable.

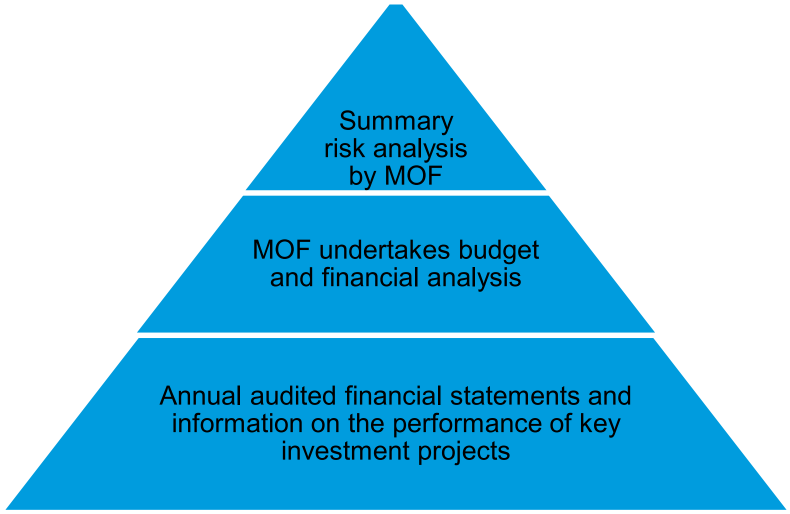
E. Subnational PFM Systems and Processes

46. The oversight functions can only be implemented if the municipalities have sufficient capacity to accurately report on their financial performance. The core oversight functions indicated in Table 6, should be done on a regular basis to inform decision making and be based on internationally accepted accounting and reporting principles. Strengthening PFM capacity starting with financial reporting at the SNG level is therefore the starting point, or the base of the pyramid as depicted in Figure 10.

[15] The seven indicators and their respective weights are: economy (20 percent), financial management (20 percent), budgetary flexibility (10 percent), budgetary performance (10 percent), liquidity (20 percent), debt burden (10 percent) and contingent liabilities (10 percent).

[16] Yerevan Municipality PEFA (2013).

Figure 10: Tiered Structure of Subnational Oversight



47. The core PFM capability at SNG level mirror those of central government and have been mixed for Yerevan municipality. At the core of this process, sub national governments need to have sufficient mechanisms to forecast revenue and expenditure effectively, manage public investment and provide accurate fiscal reports on their financial health to support this process. Table 5 provides a summary of the key elements of a sound subnational PFM system and a provisional assessment of strength in Yerevan municipality mapped against these based on the last PEFA assessment (2013) and observations from the meetings.

48. Given that Yerevan is requesting the ability to borrow independently, it would be prudent to undertake a more recent review of the underlying PFM capabilities. This would help to serve as a guide on readiness of Yerevan for independent municipal borrowing. Any weak spots identified would have to be addressed through capacity, systems or process issues through a targeted reform roadmap that could be supported by development partners.

Table 5: Assessment of PFM Processes and Systems in Yerevan Municipality

Element of the PFM system and importance for risk management	Assessment of Yerevan Municipality
A robust budget formulation process: Should be capable of delivering credible estimates of annual resource requirements for achieving expected policy outcomes. The budget should be comprehensive, covering all public spending, and the process should be guided by transparent and consistent objectives for fiscal aggregates, based on realistic macroeconomic assumptions.	The 2013 PEFA scored this dimension D as no multiyear forecasts are prepared, and the recurrent impact of investment projects were not accounted for. This has been piloted in 2023 based on well-structured methodological guidance to improve medium term planning and budgeting, but this is yet to be fully implemented.
An effective public investment management framework. This ensures only the best projects are selected for funding based on transparent project appraisal and selection techniques and their costs are accurately reflected in medium-term expenditure projections.	The 2018 PIMA scored five institutions low in terms of effectiveness: (i) national and sectoral plans; (ii) multiyear budgeting; (iii) budgeting for investment; (iv) selection, and; (v) project implementation. There is very limited information on Yerevan's website of a pipeline of investment projects and no published appraisal and selection information.
A fiscal risk management function that is capable of identifying, monitoring, and reporting on major fiscal risks and suggesting appropriate risk mitigation measures, as needed. This would include building capacity for the effective oversight of subnational state-owned enterprises, and extrabudgetary entities.	Not assessed at the sub national level but given fiscal risks assessment for subnational government is not practiced in the MOF, it can be assumed it does not exist.
A financial reporting system capable of producing quality information on financial performance and position in a timely manner. Having a system with these capabilities is particularly critical for monitoring by national authorities in accordance with internationally accepted accounting principles and reporting standards.	No financial statements for the municipality are produced or at least are not published. This hinders in depth analysis of financial performance of the municipality.
An independent external audit ensures accountability for the use of resources. Audit reports should be routinely submitted to the legislature and made public. The audit could perform a useful role in monitoring and commenting on subnational financial performance and highlighting vulnerabilities.	No financial nor compliance audit has been undertaken for Yerevan.[1] The audit office has access to the Treasury system of Yerevan, but this is limited only to the state transfers and excludes the liabilities to municipal non-government organizations. This information is not public.

Source: IMF staff based on the dimensions in the 2023 How to Note on sub national fiscal risks
1/ The only audit on Yerevan has been a performance audit on a specific service delivery topic (ambulance services).
Notes: an assessment of the strength of the budget execution system was not undertaken as part of the gap analysis but should be included when a more comprehensive assessment is undertaken. From meeting deliberations this was generally seen as working quite effectively. Similarly, an assessment of the capability of the integrated financial management system would be required. Discussions with Yerevan municipality suggested that multiple IT systems exists, but manual compilation is required in Excel.

Recommendations

3.1 **Establish the institutional framework for local governments to borrow.** Below are some examples of the measures or restrictions to consider:

- Design the administrative controls for the LGs ability to raise third party financing, encompassing: limited objectives to borrow, such as for capital investments only.
- Introduce numerical administrative controls, based on the LGs' financial standing, sufficiency of own revenue stream to service debt.
- Establish a cap on allowed interest rate spread over sovereign pricing, to be authorized in the approval process.[17]
- Subject a borrowing municipality to a stand-alone rating process to accompany specific bond issue.
- Consider introducing a mechanism to provide the central government's / MOF explicit guarantee to a borrowing municipality based on the LGs' financial standing, financial plan to facilitate monitoring by the MOF, and charging respective guarantee fees for the risks undertaken.

3.2 Align the budgeting process between the central and local governments:

- Align budget calendars between LGs and central budget – dates and the inputs should be in sync.
- Develop clear entry points in the central budget calendar to strengthen the MOF budget challenge function for municipal budgets.
- Align PIM requirements and practices between the central government and LGs for major capital projects[18] (above AMD 1 billion).

3.3 Introduce central oversight and regular monitoring of the municipalities' performance and risks, initiate monitoring of related fiscal risks by the MOF:

- Assign the MOF to carry out regular financial performance analysis and fiscal risks monitoring of LGs', including their selected balance sheet positions.
- Mandate the MOF Fiscal Risks Management Department to regularly monitor and assess fiscal risks stemming from LGs', starting with Yerevan Municipality and gradually expanding to other LGs.
- Consider introducing external audit requirement for those municipalities looking to borrow outside of central government (i.e., by the State Audit Chamber).

3.4 Build analytical capacity at the MOF, MTAI and LGs to undertake municipal financial and fiscal analysis, drawing on Box 4.

- Develop capacity building plan, and training calendar. Consider engaging development partners.
- Provide training to municipalities on reporting of their financial position (including balance sheet), and fiscal risks.

[17] Interest rate cap could be established on the basis of which the maximum cost of borrowing operations, including charges and other fees, cannot exceed the financing cost of the MOF at the average maturity of similar operation, increased by the spread established by a public ministerial order of the MoF.

[18] Refer to IMF FAD Report on Public Investment (July 2023)

IV. Fiscal Coordination. Other Risks

49. This chapter discusses the main elements of an institutional framework that can enable effective intergovernmental fiscal relations and proactive risk management that are necessary to undertake borrowings by LGs.

A. Fiscal Coordination and Approval Process

50. The subnational institutional framework should safeguard the state public finances and protect the central government, as the ultimate party to be accountable for macro stability in the country. To ensure this, the MOF should play the final and decisive role as the final authorization body in the process of approving any new borrowings by LGs.

51. Presently, Armenian municipalities coordinate predominantly with the MTAI and have limited accountability towards the MOF. There is no clear framework of fiscal responsibility in place that would support municipalities incurring the debt outside of the central government. Fiscal rules are not applicable to LGs. Fiscal rules consider only government debt, and municipalities' debt is not included (see Chapter III).

52. Authorization process, sequenced mechanism, and eligibility criteria to obtain authorizations for borrowing by LGs are not defined in the current legal system of the RA. Moreover, the institutional framework lacks resources for proper monitoring and coordination with municipalities. The MOF only receives the aggregate fiscal information on LGs revenues and expenditures which is not sufficient to analyze the financial position of LGs. Individual reporting on budgets is submitted to the MTAI.

53. The MOF Fiscal Risks Management Department lacks resources and data to properly monitor fiscal sustainability of LGs. While MOF performs limited analysis on municipal SOEs and PPPs, it has no access to LGs' detailed information, their balance sheet data is not available. There is no systematic, automated reporting of fiscal information by LGs.

54. Possibility of allowing the municipalities to incur debt should be considered in a clear framework for a sequenced approach towards fiscal decentralization. Countries can decide to give borrowing authority to LGs, to give them more spending powers, or to give them more resources to meet the obligations that they need to face. But it is necessary to adopt a sequential approach that would start by clearly defining and attributing revenue and spending responsibilities to different levels of government.

55. As summarized earlier in the report, RA can begin opening up possibilities for LGs to borrow with introducing administrative controls or other types of control measures, anchored in robust approval process. A second step in this process is to analyze and establish an adequate mix of resources to fund the LGs' spending responsibilities from transfers from the central budget, own revenues, and possibly—debt. The last step in this sequence would be to design the institutional framework for coordination and intergovernmental fiscal relations (Annex III).

56. Appropriate institutional arrangements are crucial for effective intergovernmental fiscal relations. According to Singh and Plekhanov (2005), the success of fiscal responsibility frameworks depends on the institutions, existence of vertical imbalances, previous bailouts, and the quality of fiscal reporting. A fiscal responsibility framework may be perceived as imposed from the central government, in which case LGs do not give sufficient institutional support to make the system work. To avoid these problems, some countries have increased the participation of the LGs in the process of managing the system by creating coordination bodies to establish fiscal objectives or discuss aspects related to the implementation of fiscal rules (Box 5).

Box 5: Examples of Intergovernmental Fiscal Coordination

Many countries have put in place institutions dedicated to various fiscal issues, including setting of LGs' fiscal targets, and advising on the vertical and horizontal division of revenue:

- **Spain**: Autonomous Communities' Council of Fiscal and Financial Policy and the National Commission of Local Administration are coordination bodies between the central state and the regional and local governments. They are tasked with setting fiscal objectives and with other financial and fiscal issues, such as tax policy or reform of the financing system.
- **Belgium**: High Council of Finance has two sections, one looking into public sector borrowing requirements, and the other – into taxation and social security contributions.
- **Argentina**: Federal Council of Fiscal Responsibility is an example of fiscal coordination in which participation is voluntary for LGs.
- **Mexico**: there are different bodies to coordinate the central state with LGs on various topics—from tax policy to accounting standards. These bodies include: National System of Fiscal Coordination, National Meeting of Fiscal Officials; Fiscal Coordination Board, National Council of Accounting Harmonization, and Consultative Committee on Accounting Matters.

Source: IMF Mission Team

57. Prudent approval process is critical for instilling fiscal discipline on LGs and safeguarding public finances, with MOF having final authorization. MOF should approve any request from a LG to borrow outside of the central government, as long as the authorization process ensures that the borrowing request is valid, justified, and cannot be fulfilled by other sources of funding, including from the central government.

58. In a more medium term, the authorities may consider designing a fiscal responsibility framework to inform any revisions to spending responsibilities and strengthen fiscal coordination process. Such a framework will need to be based on detailed analysis of distribution of each municipality's spending responsibilities and matching them with their available resources in order to identify possible imbalances. This work will need to be carried out on individual basis for each municipality, prioritizing Yerevan City. Depending on the results of such assessments, the borrowing framework for LGs may be revised, removing duplication or overlaps in spending responsibilities, and ensuring necessary resources are availalble and sufficient at municipality level to deliver its funcitons.

B. Funding Sources and Other Risks

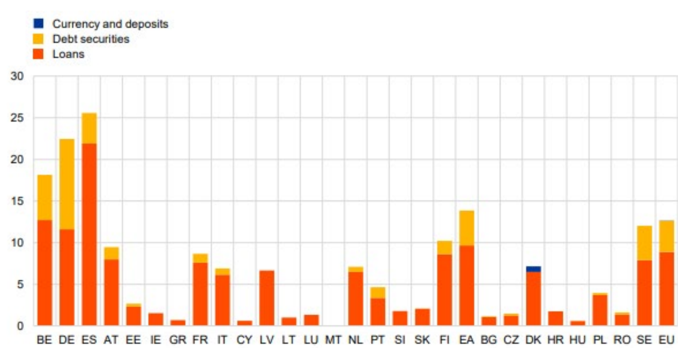
59. There are several sources of funding that can be sourced by LGs from outside of the central government:

- **Concessional loans from international organizations**: Such loans typically feature preferrential interest rates, longer maturity and grace perdiods. This source is actively employed by the RA for central and LGs purposes.
- **Loans from commercial banks**: These loans are primarily obtained from local banks, they tend to be of shorter maturity than would be desirable to finance infrastructures, and may require collateral.
- **Market securities (bonds)**: Typically, explored at environments with more developed capital markets and active investors' base. Access to market financing can constitute a significant challenge for LGs due to multiple reasons, such as shallow domestic financial markets and the lack of access to international markets, lack of investors' interest in subnational bonds, or restrictive pricing. Even when the markets are deep, there are obstacles for LGs' access to market instruments: fiscal imbalances, weaknesses in accounting and reporting, lack of reliable independent credit ratings for local debt instruments, investors' concerns about mechanisms of dispute resolution, or the lack of ex-ante legislation for the orderly resolution of possible municipal financial crises weaknesses, finally, general weaknesses in the legal framework for local government borrowing.

60. As a result of limited funding options, LGs tend to rely on bank financing more than on market instruments. EU wide study[19] identified that in contrast with central government, where debt is mainly composed of debt securities, for subnational governments loans account for the largest part of debt in all EU countries (Figure 11). This is driven by the fact that it is easier for central government to borrow through debt securities than it is for subnational governments, securing larger amounts and better pricing. Debt securities tend to be more restricted, and in many countries, bond financing by LGs is not allowed—or at least not used widespread. It tends to be more developed in federal countries, but in that case, it is often reserved for central governments.

Figure 11: Breakdown of Subnational Government Debt by Financial Instrument

(percent of GDP, 2019)



Source: European Central Bank. Statistics Paper Series No 42

[19] European Central Bank. Statistics Paper Series No 42 (February 2023).

61. **In case of accessing third party financing, the Armenian municipalities may be exposed to significant market and investment-related risks**. These risks should be identified, measured, and mitigated prior to allowing the LGs borrow outside of the central government. The risks may include, but not limited to the risks listed in the Table 6. It is crucial to manage such risks, as pre-requisite to allowing any LG to borrow outside of the central budget.

Table 6: Selected Risks of Borrowing by LGs

Market Risk: the risk of insufficient investors' interest in municipal bonds, or inability of the local securities market to place a type of bond preferred by a municipality.	**Credit Risk:** is the risk that is anticipated by market participants that a bond issuer may experience financial problems that make it difficult or impossible to pay its obligations.	**Interest Rate Risk**: the risk that the interest rate acceptable to the market be restrictive and substantially higher than that planned by a LG for placing a new or rolling over the existing financial instrument.	**Execution Risk**: related to the risk that a borrowing municipality would not be able to execute the declared underlying investment project, and raise the respective revenues, or generate savings, to fund bond repayments.	**Liquidity Risk**: associated with cash and debt management of the borrowing municipality, necessary to accumulate necessary liquidity by a municipality to timely meet coupon and principal repayments.
Potential Mitigant: Conduct preliminary research of investor interest based on the target amount, purpose of the proposed borrowing.	*Potential Mitigant:* Investors tend to trust individual credit ratings to estimate the relative credit risk of a bond as compared with other bonds. Subject a borrowing municipality to a stand-alone rating process to accompany the specific bond issue.	*Potential Mitigant:* Structure the instrument based on multiple scenarios with different features: with and without MOF guarantee, secured by earmarked revenues or underlying assets, maturity scenarios, etc.	*Potential Mitigant:* Instill central government requirements on PIM processes to apply to all major investment projects that are offered for bond financing.	*Potential Mitigant:* Strengthen PFM processes at local level and improve fiscal coordination. Ensure that a borrowing municipality has sufficient coverage and liquidity buffer from own revenue sources.

Source: IMF Mission team elaboration summary based on various risk frameworks

62. **To reduce the probability of fiscal risk materialization from LGs failing on their debt, MOF must also consider the market perception of a sovereign guarantee for a borrowing municipality.** Presently, central government guarantee mechanism, along with many other aspects of fiscal responsibility framework, is not addressed in the Armenian institutional framework. An option of such guarantee being available to municipalities must be clarified, as it is a market perception that the central

government will intervene and bailout a municipality in case it is unable to meet its debt obligations. Presently, LGs are carved out of the bankruptcy norms in the current legislation,[20] indicating that the municipalities cannot go bankrupt. This implies that in case of financial distress, LGs would be bailed out by the central government.

63. To address this inherent market perception that LGs' obligations are guaranteed by the central government, there is a need to institute respective risk management mechanisms. The current perception in Armenia is that the central government will provide the necessary support to municipalities, even in the absence of an explicit sovereign guarantee, as their financial distress can lead to moral hazard. High dependency on transfers from the central budget amplifies this perception of an implicit sovereign guarantee, and in its turn, leads the markets to put less weight on LGs' fiscal fundamentals when pricing their debt. To address this dilemma, the MOF may consider embracing the existing market perception and institute a mechanism for providing an explicit guarantee to a borrowing municipality, while charging respective guarantee fees for the risks undertaken, and attaching certain conditionalities, such as a requirement to submit a borrowing municipality's financial plan.

Recommendations

4.1 Clarify and strengthen current institutional arrangements and coordination between the central and local governments:

- Assign the MOF as the final decision authority as to approving borrowing requests by LGs.
- Establish permanent coordination bodies with municipalities, with periodic meetings in the year, to coordinate any emerging risks.

[20] Law on Bankruptcy, Article 2.

Annex I. Draft Concept Note on Local Governments Borrowings

This document discusses the key features of the legislative and institutional framework in place to enable the borrowing outside of the general government by local governments (municipalities) of the RA. The proposed concept outlines the objectives, limits, and coverage of such potential borrowings, and proposes the institutional responsibilities to be in place before any such borrowing proposal can be considered by the MOF and MTAI.

Presently, all current needs of the local governments are funded by a structured system of budget transfers, grants and by local tax and non-tax revenue. Approximately 60 to 70 percent of local governments' revenues are constituted by transfers, grants from the central government, and only about one third of the local revenues are funded by the local taxes, fees, and levies. For large infrastructure projects, the MOF co-funds public investment projects with international finance organizations, and directly raises debt to finance such projects at sovereign risk.

A coordinated system of clear rules, procedures, and regular monitoring of municipal financial performance must be put in place to safeguard public finances. Absence of such system creates significant risks that the raised financing might be mis-used, and the central government will have to intervene if debt becomes unsustainable. Such risks can be explicit or implicit, and can take several forms including: (i) bailouts; (ii) a call on guarantees provided by the central government; (iii) write offs for central government loans; and (iv) a scaling up of central transfers if the sub national government does not have enough resources to fulfill its obligations.

LGs can only be allowed to borrow from the third parties if proper frameworks for accountability and the MOF oversight are instituted. Several aspects should be considered and institutionalized to enable local governments raise funding beyond the existing financing mechanisms. Such mechanisms must ensure that any such funds are applied in a most cost-effective way, achieving value for money, and minimizing fiscal risks for the central budget.

This concept note provides a set of principles and reform steps to consider before allowing LGs to borrow outside of central government. For each principle, the Note provides both the rationale and the existing arrangements, including those applied to the largest municipality in the country—Yerevan City. The final section suggests targeted reform steps and pre-requisites that will be required to place municipalities on a path to consider borrowing outside of central government.[21]

[21] The proposed Concept Note requires further customization by the MOF through internal departmental consultation, external consultations, including with other ministries (MTAI, MOE), and conversion into the official structure of government documents.

Guiding Principles

The guiding principles should form the foundation for the Government's decision to allow or not municipalities to borrow outside of central government. These steps are necessary to minimize the fiscal risk exposure to the State Government and instill fiscal discipline with the LGs. Main guiding principles of proposed framework include:

Financial Soundness: Assessment of a municipality's ability to sufficiently operate with its core (own source) revenue on a sustainable basis, capacity to manage liquidity.

Fiscal Limits and Control: Analysis and adherence to the set limits (adminsitritaive controls, fiscal rules) to ensure that the outside debt is sustainable and does not pose risks to the central budget.

Clear and transparent approval process: Process to ensure that a proposed borrowing is aimed at viable investment projects, and supported by a complete project documentation, including cost-benefit analysis approved by the MoF.

Reporting, Risk Monitoring and Audit: These three interrelated mechanisms to be put in place for regular monitoring of a borrowing municipality's financial health and liquidity position to service debt.

The Concept Note serves as a check list to guide decisions whether a municipality is capable to borrow independently. If one or more of the principles are not met, the MOF would reject any proposed borrowing plans.

Financial Soundness

MOF shall perform analysis of the LGs' performance and regularly monitor their financial soundness. This principle should be based on objective performance metrics and can divided into two components:

- **Fiscal capacity and flexibility:** Municipality must have capacity to manage its fiscal position sustainably, and possess flexibility to adjust its own funds either by raising taxes or the tax base, or by containing expenditures, or both.
- **Operating performance:** Municipality should have the ability to generate and collect sufficient revenues to cover its operating expenditures.

MOF shall determine and establish parameters to measure whether a municipal government can meet these control components. For the initial stages of the assessment, the Armenian authorities can consider introducing two indicators, as proposed in the Table 7.

Table 7: Key Indicators to Measure Municipal Fiscal Capacity and Flexibility

Indicator	Description	Reference[22]	Application to Yerevan (2022)
Own source revenues/ Total revenues	Measures the degree of reliance on own revenues	Above 50 percent	Currently 43 percent, so still heavily reliant on central government transfers
Own source revenue/ Current expenditure	Measures the ability to cover recurrent expenditures within operating (core) revenues	Above 75 percent	Currently 44 percent, which means there is heavy reliance on state transfers to cover the administrative component of the budget

Fiscal Limits and Control

For the context of the RA that is only beginning to consider borrowings by LGs, the authorities may consider revising the administrative controls and making them more flexible to allow LGs to borrow. Current administrative controls shall be revised introducing a number of flexibilities to allow the LGs to consider obtaining third party financing. Such controls could include some of the examples presented below:

- **(i)** **Objective:** consider introducing specific objective, such as borrowing only for investment (capital) purposes. Do not allow third party funding to fund current or general expenses.
- **(ii)** **Fiscal constraints:** introduce flexible, floating metrics to limit the size of the municipal borrowings from third parties, to manage their fiscal position (see Table 8).
- **(iii)** **Financial Prudence principle.** Define a financial prudence principle that will be assessed in authorizations, on the basis of which the maximum cost of borrowing operations, including charges and other fees, cannot exceed the financing cost of the Central Government at the average maturity of the operation, increased by the spread established by a public ministerial order of the MoF.
- **(iv)** **Government guarantee:** establish a mechanism to evaluate the need in a sovereign guarantee to address the implicit market expectation for the central government's intervention in case of a LG inablilty to pay. If pursued, consider introducing guarantee fees to build buffers for potential bail out, and conditionalities for a borrowing municipality to submit their financial plan.
- **(v)** **Collateral:** allow LGs seeking third party financing (i.e., local banks) to pledge the municipal assets, as may be needed to secure the funding. If this is the case, the asset type and collateral arrangement must be separately presented for the central government approval. This is necessary to avoid ceizure of strategic assets that are critical for public service delivery and ensuring livelihoods of communities.

[22] Based on country examples. As outlined in *How to Manage Fiscal Risks from Subnational Governments* (IMF 2023).

Total amount of third-party funding should respond to the LG's ability to manage debt. To ensure that the outside debt is sustainable and does not pose risks to the central budget, local govenrments should rely on their own capability to generate cash flows and repay their external obligations. Therefore, the size of external borrowing—commercial bank, IFI, or a bond, should be limited by their own ability to generate cash. Based on the good practices around the world, below metrics can be considered by the Armenian authorities:

Table 8: Key Indicators to Measure Municipal Debt Capacity

Indicator	Description	Reference	Application to Yerevan (2022)
Debt / Own source revenue [23]	Measures debt burden to own generated (core) revenues	Below 100 percent	No financial statements available
Debt service / Own source revenue	Measures the ability to cover debt service payments (interest and principal) from own generated (core) revenues	Below 30 percent	No financial statements available

Source: How to Manage Fiscal Risks from Subnational Governments (IMF 2023).

Clear and transparent approval process

All borrowing proposals by municipalities shall be subject to the central government approval, culminating in the final approval by the MOF. MOF should approve any request from a LG to borrow from the third parties. The process should be built to ensure that the borrowing request is valid, justified, and cannot be fulfilled by other sources of funding, including from the central government.

In case, a municipality looking to borrow funds to finance a public investment project, this guiding principle can be divided into two components:

(i) **Adherence to the 2023 PIM Decree and the centralized PIM process**. All investment projects in excess of AMD 1 billion should pass through the centralized public investment prioritization process and quality assurance steps stipulated in the 2023 PIM Decree, and be approved by the Public Investment Committee (Box 6). Non-compliance will result in the borrowing approval being rejected.

(ii) **External borrowing is proposed by the Public Investment Committee as a preferred cost-effective funding source.** A full analysis of the repayment terms should be presented to the MOF and benchmarked against a comparable sovereign loan equivalent in the current loan portfolio.

[23] In Spain, regional governments have to obtain approval from the central government for the placement of domestic or foreign bonds. They can borrow from banks for investment purposes without central government approval, as long as their total borrowing for any year does not exceed 25 percent of revenues for the previous year.

Before approaching the MTAI and MOF for potential borrowing's approval, a municipality must prepare a complete package of the proposed project under the existing PIM legislation. Such package will include but not limited to:

- Proposal for investment project should be assessed for feasibility by a qualified engineering company, and contain complete cost analysis, including maintanance expenses.
- Potential project should have an assessment of time series for investment costs, financing costs, and implementation costs, if separate from the above.
- Conclusion as to potential funding sources, including those from the central government, and an evaluation of the most cost-effective funding mechanism based on all considered sources—to be completed by a qualified financial market participant (i.e., CBA, investment bank, investment advisor).
- Decision on the investment proposal as cleared by the Public Investment Committee as satisfactory and ready for implementation.

The central government may assist LGs (municipalities) in carrying out the above analysis, thus, contributing to their capacity in the long term.

The authorities may consider establishing a joint ministerial committee comprising of the MOF and MTAI representatives, or build a consequent process to ensure inter-ministerial consent. Such committee, or a consequent approval by both ministries, should evaluate the local government's proposal submission to conclude that:

- Purposes and the fiscal limits are respected. Evaluating party – **MOF**.
- Project proposed by LG for a third party lending corresponds to the spending responsibilities of the municipality, accounting for climate and gender considerations. Responsible party – **MTAI**.
- Proposed project documentation covers all projected cost through all financial years until the project is operational. Evaluating party – **MTAI and MOF**.
- Project account for all future operational costs and revenues, including municipal tax and tariff implications. Evaluating party – **MTAI and MOF**.
- Funding sources are analyzed from mutliple perspectives: maturity, currency, interest or coupon rate, security, and reputation of potential lender. Evaluating party – **MOF**.
- Project's value for money is reviewed. Evaluating party – **MOF**.

Box 6: Quality Assurance Stages in the PIM Decree (2023)

1) Identification, development, and preliminary assessment of draft project: Standard format in which project proposals or ideas should be submitted (often referred to as a project concept note) as a first level pre-screening.

2) Pre-selection of draft projects: Provisional decision by the Public Investment Committee on whether the project concept note is approved or rejected.

3) Quality check of preliminary feasibility study and draft projects: Compilation of a checklist by the MOF and respective Line Ministry as to whether the feasibility study sufficiently addresses all key criteria e.g., financial, economic, risk, environmental impact etc.

4) Evaluation of draft projects and prioritization: Final quality check on key project's dimensions, including project readiness and funding sources, before inclusion in the budget.

The central government should consider introducing a bond-linked rating requirement for each transaction offered to the market. Presently, Yerevan Municipality is rated by Fitch in connection with the sovereign ratings. Most recent rating was granted in July 2023 at BB-, "speculative" field. There is no specific municipal rating for Yerevan Municipality, but it is likely to be lower than the sovereign rating, if evaluated separately for the stand-alone borrowing, thus, leading to higher interest rates and more expensive debt servicing. The MOF should consider introducing a mandatory requirement for LGs to rate their financial instruments with dedicated rating for the purpose of attracting market-based financing.

Reporting, Risk Monitoring and Audit

Foundational step to enable the discussion of local government's ability to borrow outside of the central government is initiating the comprehensive reporting and risk monitoring. Presently, MTAI reports on local governments' revenues and expenditures. This detailed information is presented at municipality and aggregate levels.

Municipal reporting, risk monitoring and audit are separate but interrelated processes that must be in place before any external municipal borrowing can be considered. The absence of systems and processes for regular monitoring of LGs financial performance raises the probability that money will be mis-used, and the central government will have to intervene if debt becomes unsustainable due to excessive deficits. Table 9 provides key requirement for this guiding principle.

In addition to their current reporting practices, all LGs shall regularly report on their basic financial statements. MTAI shall collect and present this information to the MOF, and publish on their website. Presently, no information is available on LGs' balance sheets—their assets, liabilities, accounts receivable and payable. Such reporting shall become mandatory, starting with those municipalities that are looking to borrow outside of the central government and/or have intentions for more complex financing arangements. This is necessary to enable an oversight and potential investor disclosure on the amount of outstanding debt, as well as to manage fiscal and reputational risks for the central government, MOF in particular.

Table 9: Key Requirements for Reporting, Risk Monitoring and Audit

Area	Requirements
Municipal reporting	Municipality's financial reporting system is capable of producing quality information on financial performance and position in a timely manner. On an annual basis financial statement should be submitted for audit to assess short term liquidity position and performance of any major investment projects (cost escalation).
Budget, financial and risk analysis	Analysis of fiscal deficits: assess whether deficits are perpetual, material, what the key drivers are and whether these deficits can be sustained without additional transfers from central government. Analysis of the credibility of medium-term forecasts: assessment of potential forecast, biases in revenue collection, and underestimations of spending, all based on past trend and forecast error analysis. Analysis should indicate whether debt can be serviced from future recurrent revenue and central government bailouts will not be required. Analysis of transfers to municipal governments: this should form an integral part of the budget calendar and consist of target dialogue to reconcile spending needs with available resources. Liquidity management and debt capacity: a local government's ability to meet its short-term obligations efficiently. Debt capacity: a local government's level of indebtedness, and its capacity to take on debt. Asset management: a local government's capacity to manage its assets, including infrastructure.
External audit	Monitors and comments on subnational financial performance and highlighting vulnerabilities.

State Audit Chamber will be consulted to introduce regular audits of the municipalities with an outstanding debt. This will ensure that loan proceeds are utilized as planned at the project inception stage, and that no major deviations occur during the implementation.

Capacity Development

MOF shall build their fiscal risks monitoring function to cover the major LGs, prioritizing Yerevan Municipality, and focus on those with larger risk exposure and outstanding third party loans. MOF will require capacity building at the Fiscal Risks Monitoring Department, gradually creating mechanisms for ex-ante approval and ex-post monitoring of local governments' financial health. Such regular monitoring of debt and liabilities stock, quality of accounts receivable, coverage of debt service and revenues' collection rate, will enable the MOF to preempt potential fiscal risks stemming from local governments.

To ensure adherence to these guiding principles, the authorities will commit to the continuous development path to build capacity, processes, and systems at local and central government levels. This will have to be a medium- to long-term plan that will span across all above principles (Table 10) and include the minimum pre-requisites to bring Yerevan and other LGs to a level of readiness to borrow, once these minimum requirements are in place. The authorities should approach the donor organizations to assist them with implementation of the suggested plan.

Table 10: Pre-requisites and Key Reform Steps to Enable Municipal Borrowing

Principle	Specific	Key actions to take (reform steps)
Financial Soundness	Revenue collection and expense reliance	Undertake a study on the ability of Yerevan to raise own source revenues and its spending needs in order to ascertain the medium-term sustainability of its fiscal framework.
Fiscal Limits and Control	Establish flexible administrative controls	Considering good practices, devise the administrative controls that allow LGs to borrow outside of central government – within the set parameters.
Approval Process	Public Investment Management	Strengthen the PIM process in Yerevan consistent with the 2023 PIM Decree by piloting two-three major projects in Yerevan Municipality.
	Develop a pricing structure for external borrowing	Undertake a pricing analysis of municipal borrowing outside of central government vs. existing sovereign arrangements.
Reporting, Risk Monitoring and Audit	Local Government reporting	Enforce the compilation and publication of the financial statements by Yerevan Municipality.
	External audit	Coordinate the external audit of municipalities with the State Audit Chamber, prioritizing those looking to borrow from third parties.
	Central oversight and risk analysis	Assign relevant MOF department (s) to undertake in depth financial analysis of Yerevan Municipality, using standard financial ratios related to own source revenues, liquidity, debt servicing and asset maintenance.

Annex II. Examples of Administrative Controls Applied to Local Governments

Most examples on administrative controls are based on central government's approval:

- **Ireland**: local governments must request ministerial approval for borrowing and they can only borrow from the Central Government.
- **Korea** only requires approval from the Ministry of Public Administration and Security for local goernment borrowing on foreign markets.
- **Latvia** has established a Council to address borrowing and guarantee requests by local governments.
- **South Africa** requires a consensus from all provinces and the national Minister of Finance to allow provincial borrowing.

Another common example is to limit borrowing to specific purposes - generally to finance public investment:

- **Spain**: municipalities and regional government can only borrow to finance public investment if funded by long-term debt.

Borrowing abroad or in foreign currency can also be sometimes forbidden for LGs:

- **New Zealand**: only Auckland is allowed to borrow abroad, as its borrowing needs are too large for the local market.

Many countries do not allow LGs to issue bonds or other financial instruments with higher risk profile. Following some bad experiences during the 2008-09 crisis, several countries have put in place rules to limit speculation and use of derivatives by SNGs (**the Netherlands**).

Other countries establish financial conditions applicable to operations of LGs:

- **Spain**: financial prudence principle means that financial operations of regional and local governments must meet the financial conditions established by the Treasury. They normally contain maximum spreads by reference to the Central State operations and restrictions on the instruments.

Many countries also establish restrictions on the level or growth of debt or on the debt service. Among OECD countries (2021), about two-third of surveyed countries had some type of restriction on the level or growth rate of debt or debt service:

- **the Netherlands**: the average short-term debt cannot exceed 8.5 percent of budgeted spending and long-term debt – 20 percent.
- **Portugal**: 1.5 times the average net current revenues of the previous three years.

There are examples of setting different limits depending on the financial strength of the LG:

- **Mexico**: the MOF has a system that measures the LGs' debt level and classifies LGs into three buckets: sustainable level (green), an observation level (yellow), and a high debt level (red). Sustainable level LGs can borrow up to 15 percent of their non-earmarked revenues, observation level can borrow up to 5 percent of their non-earmarked revenues, and high debt level LGs are not allowed to borrow.

Limitations of the maximum debt stock as a share of revenues vary greatly across countries:

- **Brazil**: 200 percent of net revenues for Brazilian states (120 percent for Brazilian municipalities).
- **Portugal**: 150 percent of average revenues collected in the past three years.
- **Slovakia**: 50 percent of own revenues for previous year.
- **Latvia**: 20 percent of basic budget revenues.

Some countries define the maximum debt stock for LGs annually:

- **Lithuania** defines the maximum debt stock to LG revenue ratio each year in its Law on the Approval of Financial Indicators of the State Budget and Municipal Budgets. This ratio was decreased gradually from 70 percent or projected revenues in 2016, to 60 percent in 2020 (135 percent to 75 percent for Vilnius city).

Debt service limits are also frequently used in countries, as per 2021 OECD survey:

- **Hungary**: 50 percent of annual own revenues.
- **Brazil**: 11.5 percent of net revenues.
- **Spain**: regional governments are subject to a debt service ratio of 25 percent to the current revenues of fiscal year's budget.

Several countries constrain any new borrowing by LGs:

- **Brazil**: new subnational borrowing is limited to 16 percent of net revenues.
- **Portugal**: new borrowing must remain below 20 percent of the available borrowing margin (i.e., to reach the borrowing ceiling).

Other countries set debt ceiling every year for the amount of new borrowing allowed. This practice reduces the predictability of financing and LGs' capacity to plan beyond the budget year. These limits can either be set on aggregate for all LGs (as in **Latvia**, where state budget law annually sets maximum amounts for total increases in LG debt and guarantees), or for each LG (as in **Lithuania**, where the central government sets annual net borrowing limits for LGs, as a share of projected revenues.

Source: Vammalle, C. and I. Bambalaite (2021), "Fiscal rules for subnational governments: the devil's in the details", OECD (2021)

Annex III. Fiscal Decentralization

Decentralization has increased substantially along the last few decades. Regarding the allocation of spending responsibilities, even if countries have decentralized spending powers substantially in the last few decades, the progress stalled after the financial crisis. According to the OECD, countries even are re-thinking their current arrangements with their subnational governments after the Covid-19 crisis, for example in healthcare spending,[24] either to re-centralize it (Colombia, Mexico, Poland) or to decentralize it (Italy, Luxembourg). In any event, there should be a clear delimitation of responsibilities in the legal framework, avoiding overlapping or duplicity of provisions by different levels of government, or when they arise, establishing clear coordination mechanisms in terms of the costing.

Fiscal decentralization process follows three sequenced steps: (i) clearly defining and attributing spending responsibilities to different levels of government; (ii) establishing an adequate mix of resources to fund those spending responsibilities by transfers from the center, own revenues, and possibly debt; and (iii) designing the institutional framework for coordination and intergovernmental fiscal relations.

Allocation of responsibilities among different levels of government is based on principles that allow to identify "spending needs". Some of these principles include: the correspondence between benefits and jurisdiction, the subsidiarity principle (public services and goods supplied by the lowest level, if it can supply it), macroeconomic stabilization in the upper levels (central government), wealth redistribution policies in the upper levels (central government), sufficiency principle, clear distribution of responsibilities, and highest legality principle in the attribution of responsibilities.

Different methodologies exist to quantify spending needs for individual LGs. These are based on different criteria, such as what LGs received in the past, population, direct estimation methods, top-down strategies based on standard budget; bottom-up strategies (accounting supply costs), or the method of the representative expenditure.

For the LGs' own resources, the literature defines principles to guide decisions on what taxes are better for LGs. But also includes consideration for whether LGs should decide and to what extent on: tax bases, tax rates, administration of taxes, collection-sharing, and on LG's ability to create tax breaks and rebates. The main idea is that whereas in principle, tax autonomy is desirable, it should not be absolute and there are features of tax figures that make them more or less suitable for LGs. For example, typical suitable taxes for LGs are:

- Public tariffs and fees,
- Property taxes,
- Taxes on vehicles and transports,
- Taxes on natural resources,
- Taxes on commercial activities,

[24] COVID-19 and fiscal relations across levels of government (OECD 2020).

- Excise taxes,
- Surcharges on income taxes.
- Corporate income tax and VAT are not recommended for LGs due to the high mobility of bases and difficulties for their administration.

Transfers from the central government are always necessary, as LGs' own resources are not sufficient to fund their spending needs, and loan is not always available. Furthermore, different fiscal bases, differences in spending needs (demographics, geography), and possible externalities, may also justify additional transfers from the central budget. There are different types of transfers from the central budget, such as central government revenue sharing, levelling or equalization transfers, conditional transfers, performance transfers and capital transfers. Evidence shows that conditional compensatory transfers are good for fostering spending in specific areas and for expenditure goals. Other defined transfers, on the other hand, can disincentivize using LGs' tax capacity.

Source: Forman, K., S. Dougherty and H. Blöchliger (2020), "Synthesizing good practices in fiscal federalism: key recommendations from 15 years of country surveys", OECD Economic Policy Papers, No. 28, OECD, and IMF mission team.

Annex IV. Armenia’s Legal Framework as it Applies to Local Governments

The Constitution of Armenia foresees mandatory and voluntary tasks of a community, as well as those delegated by the State. A community shall establish local taxes, duties, and fees. The powers delegated to communities by the State shall be subject to mandatory financing from the State Budget. The State shall, to the extent possible, allocate funds aimed at ensuring the development of communities.

The Law on State Debt. Public debt refers exclusively to debt obligations at a point of time in the name of the Republic of Armenia and the CBA, excluding debt obligations of the CBA to residents. According to article 5, Public debt does not include debt of municipalities. It also establishes the purposes of raising public debt: (i) financing state budget deficit and ensuring current liquidity; (ii) supporting balance of payments and replenishment of reserves; 3) maintaining and developing government domestic debt market.

The Law on Budgetary System. Budgetary loans to communities are granted for a period of no more than six months and are subject to repayment in the same budget year. It establishes the concept and procedures for issuance of “budget guarantee letters”, by municipalities. It lists the legal revenues reserved to communities, (tax revenues, duties, official grant, and other income) and the sources that can finance the deficit, including loans received from the state budget and other sources permitted by law and funds received from the placement of bonds issued by local self-government bodies. The community can receive a new loan after paying-off the previous loan debt in full. The municipality, with the consent of the state authorized body, can sign a loan agreement or issue securities, provided that the annual repayment program in each budget year - the sum of the principal amount and interest payments - will not exceed 20 percent of the revenues of the capital part of the municipality's budget for the corresponding year.

The Law Securities Market. Certain provisions give special treatment to municipalities. For example, they are considered “qualified investors”; however, for most articles of this Law, municipalities are excluded from: (i) provisions on public offering of securities; (ii) provisions related to investment services; (iii) periodic disclosure of information by reporting issuer; and (iv) exemption from publishing prospectus.

Decree on Subventions. The Decree 1708 of November 16, 2006, establishes the procedure for providing subsidies to communities from the State Budget Armenia to municipalities. It foresees an interaction between the Ministry of Finance and the Ministry of Territorial Administration after the initial program application by the community.

Law on Financial Equalization establishes the principles and procedures to estimate the transfers from Central Government to municipalities, on the basis of financial equalization (i.e., block transfers, not linked to specific purposes, and intended to fund mandatory and delegated powers of municipalities). It considers factors such as population, scale, transport accessibility, altitude, etc.

Law on Self-Governance establishes the mandatory tasks of the community, the fiscal powers of the community council, that include the approval of the medium-term expenditure plan, the definition of the community's voluntary tasks, the definition of types and rates of local taxes, fees and charges in cases defined by law; the decisions regarding the attraction of loans and other funds in accordance with the law.

Law on Self-Governance of Yerevan City establishes certain specialties for Yerevan in the field of fiscal and financial management. For example, its Council has the powers to establish duties and tax rates within limits, to take decisions on loans and on local fees and charges. The powers of the Mayor in the field of finance include the management of property tax and land tax charge, taxes, duties and fees.