



## Accountability in State Noncommercial Organizations in Armenia: an Approach

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### Key Messages

- A World Bank-supported project in Armenia was successful in developing a control framework that balances the need to increase the transparency and accountability of the country's state noncommercial organizations (SNCOs), while also recognizing their financial, administrative, and managerial independence.
- An innovative approach involving the use of earlier results to guide later ones was used to address the dire need for SNCOs, which account for 70 percent of the total number of state organizations, to make greater efforts to responsibly administer and safeguard the government's assets.
- The existing legal structure governing the establishment of SNCOs was improved, and the weak control and performance management systems were strengthened in order to address the ineffective monitoring of SNCOs' activities.
- The aim was to reduce the market distortions caused by SNCOs that are engaged in significant commercial activities by addressing SNCOs' heterogeneity and the need for specific fiduciary control requirements for distinct groups.

### Background

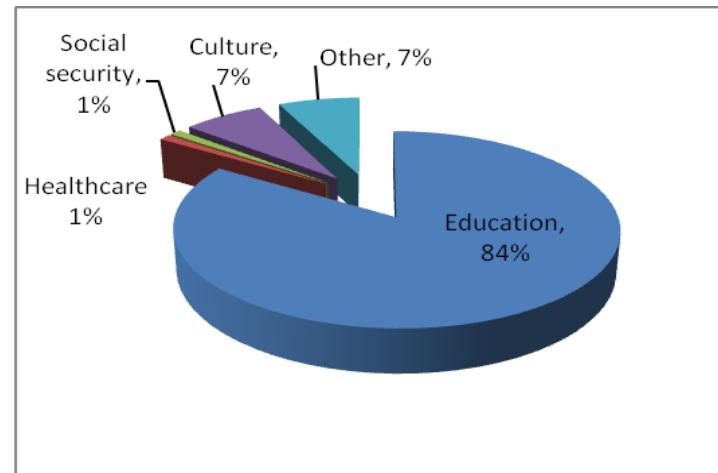
As a result of the privatization and decentralization process launched in Armenia in the 1990s, most budgetary institutions directly involved in the delivery of social services to the population were reorganized into state noncommercial organizations (SNCOs) under a 2001 law. This law led to the creation of over 1,800 SNCOs currently operating in Armenia, which account for a significant proportion of public sector spending.

Operating mainly in the education sector and, to a lesser extent, in the culture, healthcare, and social sectors (see

figure 1), these SNCOs include primary and secondary schools, colleges and universities, museums, libraries, research institutes, and laboratories. The law defined the status and characteristics of SNCO activities, providing them with considerable managerial and financial autonomy compared to former budgetary institutions. As separate legal entities, they exercise significant decision-making autonomy from their authorized public bodies (ABs)<sup>1</sup> in operational, managerial, and financial matters, including the right to conduct income-generating activities.

Since 2001, SNCOs have been able to assume financial commitments and place their funds, previously held in the treasury, in commercial banks. This poses a potential but unquantifiable fiscal risk to the government, since liabilities incurred and unpaid could become the government's.<sup>2</sup> In

**Figure 1. Distribution of SNCOs by Economic Sectors**



Source: Republic of Armenia, Ministry of Finance

<sup>1</sup> Authorized public bodies are the formal institutions that own each SNCO on behalf of the state and are formally responsible for the SNCOs' general management.

<sup>2</sup> Most SNCOs provide public services that should be continuously rendered. Liquidation of SNCOs with unpaid liabilities is politically sensitive, as the SNCOs often provide services that are costly to replace (e.g., theaters, museums, schools, etc.). Recent evidence has confirmed this point.

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general, SNCOS circulate considerable financial resources, and in 2008,<sup>3</sup> their total revenues amounted to dram 129 billion, of which dram 89 billion (69 percent of the total) was received from budgetary sources, and the remaining dram 40 billion (about 31 percent of the total) from nonbudgetary sources. In comparison, the total annual state budget expenditure was roughly dram 810 billion in 2008.

## Challenges

An initial gap analysis of SNCO operations highlighted key challenges inherent in their operation and oversight, including:

- A lack of clarity as to the legal basis for granting SNCO status to an entity, with ramifications for the expediency of establishing and reorganizing SNCOS and the related decision-making process.
- The risks to government caused by the lack of comprehensive fiduciary controls, transparency, and accountability, all of which are specifically linked to the management and effectiveness of financial activities. Contrary to the intent of the SNCO reforms, many SNCOS conduct a substantial number of commercial activities, leading to government concern that SNCO managers may as a result overlook their official role of noncommercial public service provider in the public sector. In addition, the significant commercial projects undertaken by larger SNCOS (for example, projects to construct new building facilities from own/nonbudgetary sources) could expose the state to significant and unknown financial liabilities. Moreover, SNCOS have free access to government assets and receive grants/transfers directly from the government, thereby avoiding the public procurement process and distorting competitive markets.

Overall, weak financial accountability and the lack of control and performance management systems within SNCOS have led, *inter alia*, to unreliable information, fiscal risk from poor commitment controls, and an absence of clarity over these organizations' effective and efficient delivery of public services.

## Developing an SNCO Fiduciary Control Framework

To address these key challenges, from 2006 to 2012 the Armenian government, supported by the World Bank, developed a comprehensive fiduciary control framework for SNCOS. First, a typology identifying the different types and activities of SNCOS was prepared, providing the government with a clearer understanding of the risk these entities posed to the overarching goal of improving public service delivery. Second, the project drew on international

experience from a number of countries of the Organisation for Economic Co-operation and Development (OECD). The government was then provided with a theoretical model, along with a package of required legislative amendments and a draft strategy for their introduction. In the final stage, the World Bank supported the government in applying this framework in 20 pilot entities (12 SNCOS, 7 ABs, and the Ministry of Finance (MoF)), with the goal of improving the model and its practical application. Piloting included the introduction of key elements, including reporting and monitoring mechanisms, in selected SNCOS and ABs.

## Clarification of the Legal Basis

The project indentified a number of criteria to clearly distinguish SNCOS from other public sector bodies:

- SNCOS were restricted from offering commercial services unless they were related to their main activities, with no adverse impact on the outputs from primary services.
- SNCOS should render their services where there is no developed competitive market, and the revenue from their commercial activities should not exceed 40 percent<sup>4</sup> of total revenue.
- To ensure medium-term viability, (i) the SNCO's main services should be sustainable for the foreseeable future, (ii) the organization must be financially viable, (iii) a reliable results system should be established, and (iv) SNCO activities should not result in high political and fiscal risks.<sup>5</sup>

Further, to differentiate SNCOS from other public administrative bodies (PABs), establishing an SNCO must be justified by one of the following criteria:

- Beneficiaries of SNCO services should have a wide geographical distribution that makes it essential to have the service provision as close to the end user as possible (for instance, provision of general education services in schools).
- Units should be autonomous, with management at arm's length and accountability for the delivery of public services outlined according to clear, transparent specifications, so as to avoid the direct involvement of political appointees (e.g., ministers) in the operational

<sup>4</sup> The significant increase in commercial activities on the part of SNCOS may negatively affect the achievement of their objectives and dilute the attention of their management. Studies show that beyond the level of approximately 40 percent commercial services, those management behavior risks may increase significantly.

<sup>5</sup> Usually, fiscal risks are higher when the service provided is linked to the turnover of large funds and management of large assets. Political risks are greater when there is a high probability that decisions made about particular services could lead to a reshuffling of political forces, or could jeopardize the implementation of the main provisions of the given government program. According to international practice, such services are rendered by PABs, rather than other bodies with arm's-length management.

<sup>3</sup> This is the latest official information available, and there has been no major change since then.

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decision-making process, in line with international best practice.

- A narrowly specialized service should be provided that could not be practically or efficiently supplied through the civil service (for example, where salaries are not attractive or civil service eligibility criteria and procedures are not applicable).

## Overcoming Peculiarities of Fiduciary Control for Specific SNCO Groups

Because SNCOs are not homogenous units, the government recognized that they would require a differentiated approach with regard to fiduciary controls. In order to establish the framework, three dimensions or groupings of SNCOs were proposed (table 1):

- 1) By the corporate governance arrangements (degree of management flexibility): (i) *independent* SNCOs, where independent decision making is vital for service delivery (forensic, environmental expertise, etc.), (ii)

SNCOs with *participatory management*, that is, they have large social groups as their beneficiaries, and society is interested in participating in their management and the evaluation of their results (secondary schools, other educational institutions, etc.), and (iii) *autonomous* SNCOs not included in the above groups (theaters, libraries, etc.).

- 2) By level of fiscal risks, based on the amount of an SNCO's financial flows relative to its assets and the size of the state budget: (i) *large* SNCOs that have significant fixed assets and resources, (ii) *medium-size* SNCOs that have fewer resources but with funding that exceeds the predetermined level of state budget spending, and (iii) *small* SNCOs that have a modest turnover of funds not exceeding predetermined levels of state budget spending.
- 3) By depth of commercial activities: SNCOs with a share of commercial activities that exceeds 40 percent of the SNCO's total income.

Table 1. Distribution of SNCOs by Types

		By level of fiscal risks			<u>TOTAL</u>
		Large SNCO	Medium SNCO	Small SNCO	
<u>By level of fiduciary control flexibility</u>	Independent SNCOs	0	9	10	<b>19</b>
	Publically administered SNCOs	7	32	1502	<b>1541</b>
	Autonomous SNCOs	4	34	242	<b>280</b>
<u>TOTAL, out of which</u>		11	75	1754	<b>1840</b>
<u>By depth of commercial activity</u>	SNCOs with significant share of commercial activities	8	17	72	<b>97</b>

Specific fiduciary control mechanisms were established for each group, along with general requirements for planning, reporting, and monitoring, based on the following criteria:

- The existence of output indicators: Where output indicators are missing or appropriate performance reporting and monitoring systems are not present, restrictions and *ex-ante* controls over the SNCO's expenditures on inputs should be included in the relevant purchase agreements.

- Level of SNCO's financial turnover: This involves the establishment of an *ex-ante* control regime by ABs over the significant transactions of SNCOs, including authorization of transactions exceeding predetermined thresholds. For large SNCOs, centralized *ex-ante* control arrangements are foreseen, suggesting that bank accounts of large SNCOs should be transferred to the treasury system, which will implement this *ex-ante* control. A key challenge will be balancing the development of a robust fiduciary control framework

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while retaining the level of flexibility envisaged when the SNCO law was passed in 2001.

- Level of SNCO revenues received from nonbudgetary sources: This means awarding government contracts to SNCOs with a large share of commercial activities only on the basis of open competition so as to promote competition in the market. To ensure equal conditions for competition and increase efficiency in public asset management, rental fees should be levied on the use of government-owned assets, including buildings, facilities, and equipment, where currently they are assigned free of charge to such SNCOs. Fees levied are to be based on the value of the fixed assets provided or assigned to SNCOs, and transferred to the state budget.

## A New Reporting and M&E Framework for SNCOs

Overall, this World Bank-supported project established a modern planning and monitoring and evaluation (M&E) system that addressed the accountability, fiscal discipline, and transparency of SNCO activities. Throughout, the main underlying principle was to differentiate between the functions of the government as “client” (user of services) and “owner” (of public assets). As “client,” the government allocates funds for the procurement of specific services; as “owner,” the government manages the entity, making capital investments to improve the quality of services rendered. This distinction in the budgetary system is crucial because managerial behaviors and M&E systems are different. To account for this, the evolving framework has the following features:

- Each SNCO must develop a three-year Action Plan (AP) outlining medium-term and annual objectives, priorities, and performance indicators for measuring its activities. The AP is the main instrument for the planning and management of the organization’s activities, regulation of relations with the owner, and M&E of organizational performance.
- A process is foreseen whereby SNCOs develop APs, have them approved by their ABs (owners), and submit regular reports based on which ABs will conduct performance monitoring.
- The MoF, in its role as custodian of good governance and financial accountability within government, has an important oversight role in ensuring that ABs effectively monitor SNCOs, beginning with addressing weaknesses in SNCO management, fiduciary control, and M&E systems. Under the new model, the MoF will monitor ABs’ performance as well as submit consolidated reports on the performance of SNCOs to the government.

In summary, the aim of the project was to focus on the nonfinancial performance indicators of SNCOs while concurrently improving the quality of financial reporting. In addition, as the level of new SNCO reporting and monitoring requirements was linked to the relative risks associated with the organization’s activities, more detailed disclosure requirements were envisaged for SNCOs engaged in higher risk activities.

This project has provided the government with an innovative SNCO fiduciary control framework that targets accountability and transparency concerns as well as fiscal risk management. The government has generally demonstrated extensive reform ownership and approved the proposals and concepts. After project completion, the government circulated a draft strategy to introduce the model in all 1,800 SCNOs over the next three years, with the objective of a launch after some fine-tuning in response to testing.

## Conclusion

Lessons learned from the experience of SNCO reforms in Armenia demonstrated that such complex reforms should be well planned and based on a study early in the process of existing challenges, international practice, and local specificities and peculiarities (such as the diversity of SNCOs and the need for specific fiduciary control mechanisms in order to reduce market distortions caused by some categories of SNCOs). Another lesson was the importance of implementing extensive change in a systematic and phased manner, using the results of earlier stages to guide later ones. For example, addressing gaps in the legal system was pivotal in tackling other key areas, including clarification of the legal basis of SNCOs.

Key results of the project include: a new framework for enhanced monitoring and control of SNCOs to provide better transparency and accountability of their activities; improvement of the existing legal system; and a means of reducing overall fiscal risks without significantly impacting the current level of SNCOs’ financial, administrative, and operational independence. The framework and methodology are applicable to other countries with similar conditions like Armenia’s.

### About the Author

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