

Impact of Fiscal Decentralization Reforms in Albania

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Abstract

Decentralization and fiscal decentralization constitute one of the most followed trends for political and economic reform in recent years around the world. Albania, in the 1990s, begins its process of transitioning from a centralized economy to a free-market economy. This process is accompanied by transforming existing economic mechanisms and infrastructure to better function the free-markets model, but above all, with the need to develop and create new legal, institutional, economic, and social instruments and spaces to increase the allocation and efficiency of public and private resources. The objective of this study is to give an appropriate answer to the question: What has been the impact of decentralization reforms on the performance of public services provided by local government? The research paper will focus on the role that improvements and legislative changes play in the country's economic growth. Within the past two decades, progress is made in advancing decentralization reform, but there are still many challenges ahead, such as the lack of a clear legal and regulatory framework. Adding to that concern is the financial autonomy of local governments, which remains a challenge for the future. The research methodology used will be a descriptive analysis of data obtained from the Ministry of Finance and Economy and local municipalities on the impact of the reforms. Recommendations and suggestions will be given on the reforming process, as well as ways to increase the efficiency of local government units.

Keywords: Public expenditure; challenges; reform; fiscal decentralization.

JEL Classification: H50, H71, H72

1 Introduction

In the last two decades, many countries around the globe have implemented fiscal and political decentralization. Garman et al. [4] shows that more than 80 percent of the seventy-five developing countries analyzed have been undergoing some sort of decentralization of authority by the beginning of the millennium. The situation is similar in developed countries. Albania is considered a country in transition. Transitional nations have implemented economic systems reforms through the 1990s, focusing them on free trade, improving the business environment, and the "business climate." The main focus is on developing the private sector, as previously in these countries, this sector is virtually non-existent. Numerous reforms in this sector accompany the first years of implementing a free-market economy. But an important factor in fostering further economic development in these countries is the public sector. During the transitional years, efforts are made to redefine the role of the public sector and to improve its performance. An essential component of these reforms is the introduction of decentralized policies for government functions. A common characteristic of almost all transitional economies is that they originated from a highly centralized public finance system with local governments acting primarily as administrative units with little fiscal responsibility and independence. Although these countries initially had similar economic structures and political systems, they chose very different paths and approached to decentralization.

Increasing fiscal decentralization itself has been seen as an essential tool for enhancing democratic participation in the decision-making process while increasing the responsibility, accountability, and transparency of governing bodies. In other countries, the tendency for greater autonomy to govern locally is driven by the need for national coherence in the face of centrifugal forces due to ethnic and regional problems or internal conflicts. The paper aims to analyze the progress and the current situation of fiscal decentralization in Albania over the years and to assess

whether the administrative-territorial reform is impacting and further improving the fiscal decentralization process.

2 Decentralization process in Albania

Albania commenced its path of political decentralization after nearly half a century of highly centralized governance. The first free elections were held in 1992. Despite the importance of this political start-up movement towards increasing democratic representation, local administrative and fiscal autonomy remains very weak. The reforms of 1992 set the stage for the creation of local democratic authorities; however, the decentralization process received a second impetus by the end of the nineties. In the period 1990–2000, the most critical decisions regarding the provision of services to the 3.1 million inhabitants are mainly from the central government, which has a significant presence throughout the country through its own deconcentrated agencies in all 36 districts controlled by 12 prefectures. During 1998–2000, the country formally ratifies the European Charter of Local Self-Government, embodied its core principles in the new Constitution, and adopted legal reforms for local self-government. This marks the second crucial moment, creating the framework for full administrative and fiscal decentralization. Both of these documents identify as one of the main objectives of decentralization reforms in Albania, the need for Local Government Units to be able to deliver on their own the functions once performed under the umbrella of the central government.

The formal ratification of the principles of local self-government consolidated the political decision for a decentralized governance structure. Adopting the laws on the organization and functioning of local government reduces the direct political influence of the state on local government activities. This creates a stable legal framework that would enable decentralized administrative and fiscal structures to function, which include self-governing counties, municipalities, and communes.

Since 2000, critical institutional amendments and regulations are made: (i) the adoption of the National Decentralization Strategy for Local Decentralization and Autonomy; (ii) the transfer of some special vital functions to local authorities (including some second-hand services passed to counties); (iii) creating a mechanism-based of a formula on how to allocate grants unconditionally (which partially replaces conditional, targeted transfers); and (vii) the adoption of an essential fiscal reform package in 2002 (including domestic small business tax, simplified income tax, property tax, and changes to the tax and fee system) that extend the fiscal autonomy of local governments. At the same time, the legislature is adopted regarding local borrowing [11] and local budgeting systems [12].

In 2014, the Albanian government initiated the Territorial Administrative Reform (RAT), one of its main reforms, and creates the premises for reforming local government and deepening decentralization in the country. The reform generates a new territorial map, reducing the number of first-tier local government units by six times, from 373 municipalities and communes to just 61 municipalities and 12 counties (2nd tier of local self-government). The concept of rural communes is finally abolished. The main criterion that guided the Administrative-Territorial Reform is the concept of "functional areas," which must be capable of generating income, creating space for commercial development, and a dense economic, institutional, social and cultural interaction between residents.

At the district level, the population ranges from the lowest level of 61,423 in Gjirokastra district to the highest level of 895,160 inhabitants of Tirana county. Continuing the enhancement of decentralization, the following legislations are designed and adopted into law: (i) 'Intersectoral Strategy for Decentralization and Local Government 2015-2020' and an action plan for its implementation; (ii) Law nr. 139/2015 'On Local Self-Government,' which, among other things exclusively transfers to local municipalities several new functions; (iii) Law nr. 68/2017 'On Local Government Finance,' which was further followed by the law nr. 106/2017 'On Some Amendments and Additions' to the Law nr. 9632, date 30.10.2006, 'On the Local Tax System.' The Small Business Tax is finally eliminated between 2014 and 2015. In 2016 the Albanian

government implemented the new tax reform. The change brings about the abolition of the simplified income tax payment for small businesses with an annual turnover of up to 5 million ALL (€40,000). The number of companies that will benefit from the fiscal changes, and specifically whose profit tax will be zero, is estimated at around 85,300. Reducing the fiscal burden on these businesses will improve their finances and bring about economic growth to the country. Recently, the government has granted tax exemptions to particular categories of companies, without necessarily compensating local governments for this revenue loss.

While Albania is far from completing the picture of political, administrative, and fiscal decentralization that could satisfactorily improve service delivery, governance, and accountability, it must be acknowledged that considerable progress is made in establishing institutions that will enable a fairer implementation of decentralization policies. In terms of the basic legal framework, all that is necessary for the successful continuation of this process is sanctioned by defining once more the rules of the game or better intergovernmental fiscal relations.

3 Literature review

Decentralization is known as the process of transferring authority and responsibility for public functions from the central government to subordinate or quasi-independent governmental organizations, or the private sector. There are different types of decentralization (political, administrative, fiscal, or market), and each has different characteristics, political implications, and conditions to be successful and productive. If local governments and private organizations effectively carry out decentralized functions, they must have sufficient revenues (locally realized or transferred from central government) and authority to make spending decisions.

Fiscal decentralization to be effective depends on a) appropriate expenditure assignments-with the division of functions between different levels of government depending upon their comparative advantage; b) applicable tax or revenue assignments; and c) the efficient design of a system of transfers and its proper implementation [9]. In this way, decentralization leads to minimal vertical imbalances and shortens the distance between the recipients and suppliers of public goods and services.

Davoodi and Zou [2] look at the relationship between economic growth and fiscal decentralization, measured as the subnational share of total government spending, and argue that fiscal decentralization is associated with slower economic growth. Different researchers acknowledge that fiscal decentralization has positive effects on economic growth ([3] for Switzerland, [15] for China, [5] for OECD countries). In contrast, many studies starting from the 1990s show that fiscal decentralization has a positive effect only up to some optimal level, and these levels are different from country to country. Thiessen [16] shows that exist a positive relationship when fiscal decentralization is increasing from low levels, but after reaching a peak, it changes and turns negative. Theoretically, more fiscal autonomy may be associated with a higher output per unit of labor and higher growth rates [1]. Some economists assume a vice versa relation: economic development increases demand decentralization. Martinez [14] shows that economic growth causes decentralization, but it seems that problems of decentralization in developing countries are related to low-efficiency issues from local governments.

Albania is a country that has a new democracy and aspires to become a member of the E.U., therefore strengthening local governance and democracy is an essential element to study. If countries have more significant financial autonomy or higher amounts of unconditional transfers to local levels of government, it will increase efficiency in both allocation and use of funds which ultimately, will bring about economic growth for the whole country. Kapidani [8], show that the new reform in Albania provides proper planning for local economic development and the reduction of problems between administrative boundaries and the area of influence of the services offered by neighboring local government units.

Guga [6], analyzed three indicators for the fiscal decentralization effect: 1) the proportion of subnational expenditure over national expenditure; 2) of total subnational revenues over total

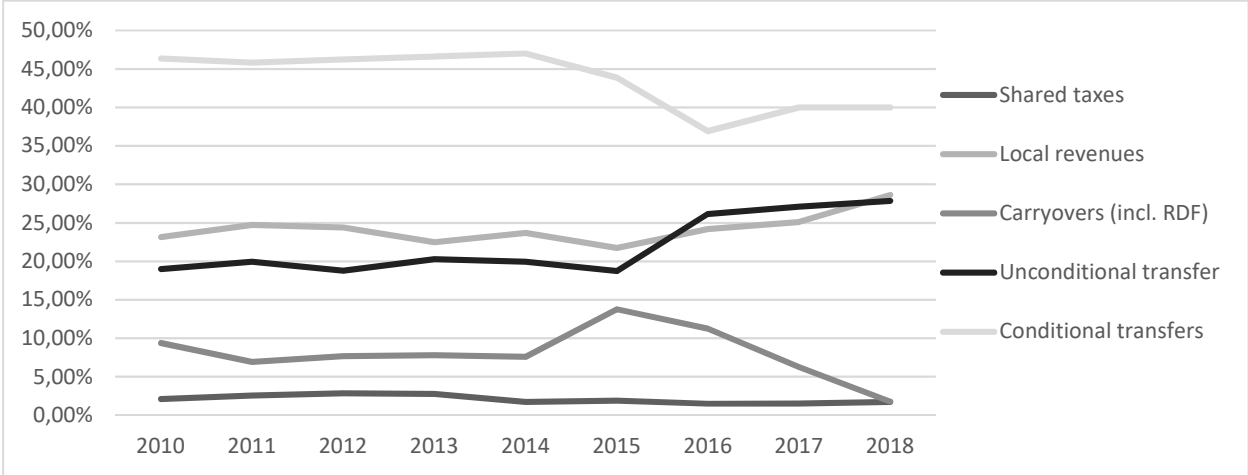
revenues of the central government; and 3) the indicator of own subnational revenues over total revenues of the central government. Her research concludes that the territorial and administrative reform have not generated the expected results. Toska and Bejko [16] suggest in their studies a lack of real vertical decentralization, high financial dependence on central government, and a high level of inequality between municipalities. Under the hegemony of a top-down approach, districts fail to capitalize on the informational advantages; they have to address the preferences of the population in the territories under administration and, consequently, to improve their quality of life.

4 Analysis

The administrative-territorial reform leads to the consolidation of small local government units into more extensive and more efficient groups that are capable of providing greater access and delivering high quality and adequate public services to their citizens and communities. 2015 is the first year of a fully implemented territorial reform and the transfer of new functions towards the local level.

Revenue from unconditional and specific transfers is an essential source for financing functions and exercising competencies by municipalities. In 2018 on average, for all 61 municipalities in the country, self-generated revenues account for about 28.6% of total resources, 27.8% from unconditional transfer income, 40% from conditional transfers, 1.7% shared tax revenue, and 1.75% from carryovers for complete funding sources. Data from 2010 -2018 are shown in figure 1. In the first half of 2018, about ALL 8.5billion (€ 69.8million) are transferred from the ministry responsible for health and social protection to the Territorial Administrative Ministry. About ALL 5.4billion (€ 44million) are allocated by Territorial Administrative Ministry for infrastructure and energy; education, sports and youth; and urban development (Regional Development Fund).

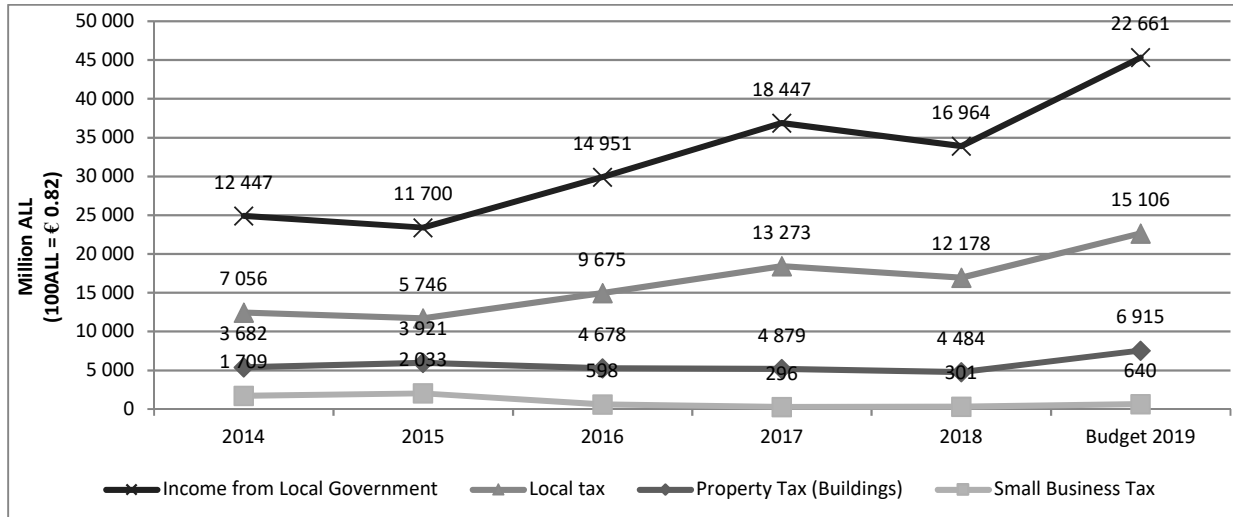
Figure 1. Total local income by financing sources



Source: Financat Vendore. Total income by financing sources [online]. Available at: <http://financatvendore.al/data/revenues>

Figure 2 shows that proceeds collected from the local self-government units during 2015–2018 have an upward trend, which reflects the increase in weight these shares have on revenue as a percent of total resources of the state budget, as well as revenue income to overall GDP.

Figure 2. Income from local government units



Source: Directorate of Local Finance, Ministry of Finance and Economy

In figure 2, the chart indicates revenue improvements for municipalities, especially after the year 2015, which is directly related to the increase in local taxes proceeds. Local taxes include:

Income from other local taxes and fees such as hotel accommodation tax, occupancy fees, administrative fees, parking fees, income from local asset management.

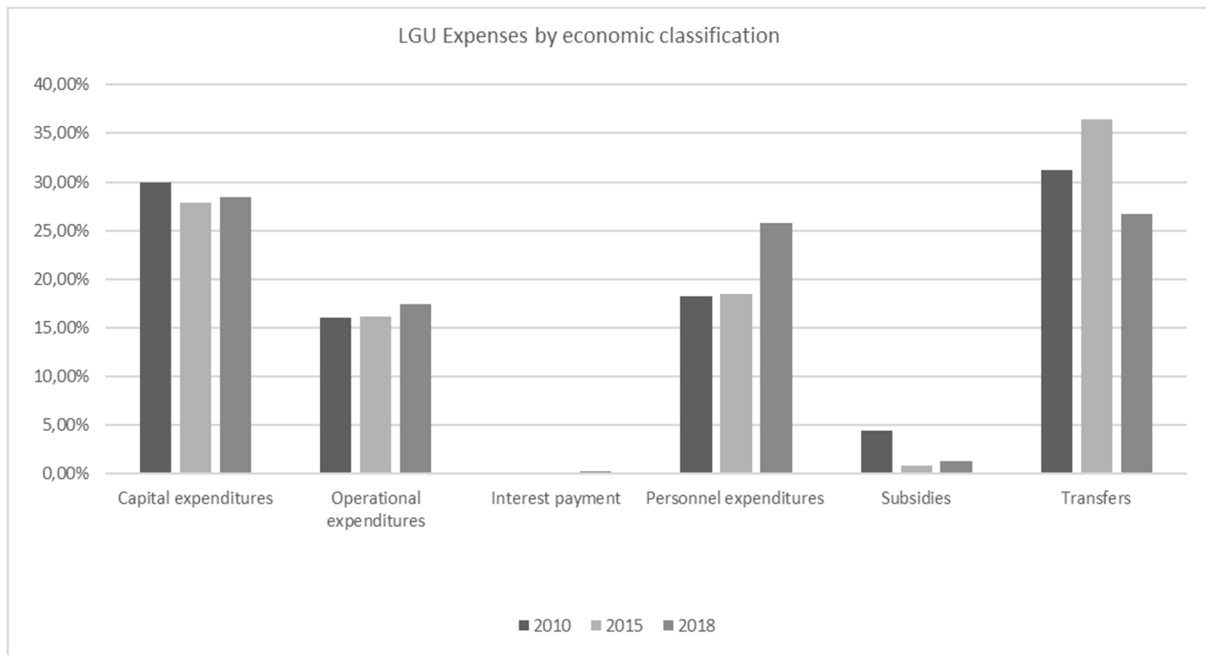
Revenues from local tariffs, which include yearly fees for waste collection and disposal services, street cleaning, greenery, and public lighting.

Local tax revenue shows an increase in recent years, doubling in 2018 compared to 2015. The upward trend is a significant indicator of the effects of implementing the territorial administrative reform. It conveys the improvements in fiscal management processes at the local level. Although part of the increase in revenue may also be due to the increased number of fees that the taxpayer is required to pay, nevertheless, the major part of the rise comes from expanding the taxable base or increasing the number of taxpayers and more effective administrative procedures.

Fees from building permits are an essential source of funding for municipalities. The income from this fee is directly related to the demand for land development and new construction and tends to be very volatile from year to year. In 2018, approved applications and building permits were high, reaching ALL 6.9billion (€ 56million). Proceeds from this fee should go towards financing the public infrastructure needed to serve and integrate new development zones with the rest of the territory.

The small business tax is a local tax that has been reformed more times than any other tax type on local government units. The tax reform implementation of 2016 reduced small business tax revenues by 71% compared to 2015, and in 2017 it was reduced by 51% compared to 2015. In 2018, revenues from this tax amounted to ALL 301million (€ 247million), with a slight increase of only 2% compared to the previous year. Currently, the share of this source of income for the local self-government units is meager. Now it is considered a separate tax, collected by the central government, and then fully shared with municipalities.

Figure 3. Local Government Expenses by economic classification



Source: Directorate of Local Finance, Ministry of Finance and Economy

Expenditures of local government units in Albania, including investment funding from the Regional Development Fund, have been on the rise. Figure no. 3, shows the structure of domestic expenditures by economic nature. In 2018 capital investments amount to about ALL 14.2billion (€ 116million) or 29% of total internal expenses. The local government is continuously placing an increasing emphasis on investments to improve the infrastructure managed by the municipalities. Operating expenses that are very important for local governments in providing daily services to its residents show a slight increase in 2018 compared to the previous year. Operating expenses account for about 29% of local government expenditure for 2018. Municipal expenses include:

- Maintenance and repair of schools and public recreational buildings
- Local public transport
- Repair of local roads
- Construction/maintenance of the sewage system
- Housing and communities' amenities
- Salaries of officials and other municipal employees, including payment of social and health insurance

In 2018 these expenditures reached about ALL 20.6 billion (€ 169million) or ALL 1.5 billion (€ 12.3million) more than 2017. These types of expenses are inconsistent with the objectives of the administrative and territorial reform in terms of better operational efficiency and a reduction in administrative costs. On average, local governments spend more than half of their budget on general public services, and about 30% on road infrastructure and transport services. Social assistance accounts for about 30% of the total local expenses. Sports organization and management, institutions and administration of institutions (day centers, nursing homes, and orphanages) account for about 5% of local government expenditure. Local roads, public lighting, parks, and public squares are mainly financed through local government spending itself, and in some cases, through conditional grants received in the competitive grant scheme.

5 Conclusions and recommendations

Analyzing the revenues for the past few years, the decentralization process since 2016 and onwards has had a significant effect in allowing local self-government units to collect more money. Comparing this to neighboring countries, local governments in Albania collect less per capita income from local taxes and tariffs than their counterparts. Increasing the efficiency of local government tax collection makes it possible to ensure a higher level of financial independence, indicating that a new period of financial management has already begun. All constituent items of local income are increasing except for the small business tax. This significant increase in general revenue mainly refers to the gain resulting from local taxes collected by the municipalities themselves. All these positive developments also create the preconditions for improving the quality of local services such as improving rural public transport, improving the irrigation and drainage system, increasing the number of forests and pastures, etc.

Local government units have had insufficient funding for years. This lack of financing, along with the territorial-administrative fragmentation makes it challenging to provide services in line with the needs and expectations of their residents. Recent legal changes transfer many of the spending competencies and functions to local units, but the financial resources for their support are still limited. Some services, such as education, health, and social protection, are almost entirely covered through public spending and local government contributions. Local governments spend more than half of their budget on general public services and about 30% of the expenditure on road infrastructure and transport services. Although recent years show progress and success in terms of improving the regulatory framework, expanding the tax base requires further steps to consolidate local government finances. It is vital that reforms are implemented and that improvements are made to the performance, will, or choices that local government units make regarding the administration of local taxes and tariffs and the public assets they own.

The following recommendations are given to increase the local government budget by improving local tax administration and the development of new policies:

- To provide continuous improvement of information exchange with the central tax administration and other agencies, the National Business Registration Center, Agency for Legalization of Urban Construction Zones, Agency for Property Restitution and Compensation, National Civil Registry, and the new address system.
- To increase and improve information systems for local taxpayers regarding their domestic obligations, the calculation method, and payment deadlines.
- To reduce the informal sector, and expand the taxable base with more taxpayers, installment of cash registers as a legal instrument to measure daily sales.
- To create a productive management system environment, efficient and in line with the expectations of taxpayers, adopting policies necessary to ensure a successful tax collection and effective management of public investments.

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