

Local Government Financing in Albania

Fatjola LUBONJA, Msc, PHD Candidate

Prof.As.Dr Fran BRAHIMI

1.Ministry of Internal Affairs, Albania

2.Agricultural University of Tirana, Finance-Accounting Department

Abstract

Local government and decentralization are the main challenges of the Albanian government reforms. Decentralization and urbanization are a greater pressure on local governments to finance public services and facilitate economic development. During the years, the local government responsibilities have been increased, while fiscal decentralization and transfer of funds have not progressed with the same speed, resulting in significant lack of funding. Local government budgets are generally small and cannot afford financing for major projects and infrastructure improvements. Funds from the state budget for infrastructure investments (mainly competitive grants/Regional Development Fund) have been increasing in recent years, their impact is still small compared to the needs. The main forms of financing of local government are: central government transfers and its own revenues. Vertical and horizontal transfer between different levels of governments (CG and LG) that takes place during the annual budget cycle is not based on clearly defined criteria and in a transparent way, or does not match the needs for expenditures at the local level. This creates a considerable level of instability (illogical movement) of revenues and expenses during the budget cycle units, as a result created a high degree of unpredictability of revenue and expenditure of local units. Currently, local government units funded from central government about 60 percent of local budget, which shows the low level of local autonomy. These and the other problems have made necessary by the territorial reorganization and together with the performance of a deep fiscal decentralization. This article through studying the local decentralization in the last years aims also to make a comparison to previous years and since 20016 is the first year of the complete implementation of the new Administrative and Territorial Reform and the transfer of certain new functions to the local government as well.

Keywords: Local government, local finances, transfers conditional, unconditional transfers, their income, responsibility, decentralization, Administrative and Territorial Reform, funding sources etc.

1.Introduction. The current state of local finances

The administrative structure in Albania has undergone radical changes since the end of 1990, which marks the launch of the decentralization reform. Decentralization policy has not always been stable and as a result has seen its ups and downs over the years. One of the main challenges for local government is to meet citizens' growing expectations for services and better governance. Decentralization and urbanization are a greater pressure on local governments to finance public services and facilitate economic development.

While the functions and responsibilities of local governments are increased during the last decade, but fiscal decentralization and transfer of funds have not kept the same pace, so they have lack of funding for local infrastructure.

The relative weight of local government expenditure to GDP and to total expenditures remain relatively low at around 3.4 percent in 2016. In 2012, this ratio was 2.9 percent of GDP. Strengthening local capacities to fulfil their functions and in particular to mobilize the necessary financial resources are dependent on several factors, in particular the strengthening of fiscal autonomy by the fiscal authority to generate revenue (tax and service fees) at local level; as well as the predictability and sustainability of intergovernmental fiscal transfers. However, during this period it occurred qualitative fundamental changes in the structure of local finance. Although a large part of the local government units continues to have very high dependence on revenues from national sources, the income generated by its resources have increased and new resources are being used.

In terms of "competition" for budget funds and modest capacity for generating local revenues, local governments continue to have a major lack of resources for investment, especially for those that require large capital, as road infrastructure and water/sanitation. Their budgets are generally small and cannot afford financing for major projects to improve infrastructure. Funds from the state budget for infrastructure investments (mainly competitive grants/Regional Development Fund) have been increasing in recent years, their impact is still small compared to the needs. Fiscal austerity policies that have started to be implemented by the Ministry of Finance to withstand the financial crisis also hinted that for some years to come these funds are not expected to increase significantly.

Except fiscal misbalance, decentralization process being implemented in Albania can also create financial instability for the units. Vertical and horizontal transfer between different levels of governments (QQ and PC) that takes place during the annual budget cycle is not based on clearly defined criteria and in a transparent way, or does not match the needs for expenditures at the local level. This creates a considerable level

of instability (illogical movement) of revenues and expenses during the budget cycle units and as a result created a high degree of unpredictability of revenue and expenditure of local units.

The process of preparing the transfer of funds includes two important steps. Firstly, a mechanism should be used to determine the total amount of funds to be transferred to local government units. The mechanism may enter the amount of the transfer to special sources of income, you can connect it to GDP, with specific plans expenses, or set amount under a fiscal rule as a percentage of total state budget expenditures. Second, choose a mechanism to determine how the unconditional transfer distributed among the beneficiary local government units. The most common mechanisms are by formula or through the annual budget process. To evaluate the effectiveness of the transfer system can be used multiple criteria. Since the transfers are to provide income to support the delivery of local public services it is critical that measures the transfers be sufficient to cover the costs of these services and, equally important, to show increasing transfers of income while the demand and the cost of public services increase. Also, the flow of transfers should be safe and predictable; LGUs should know that they will receive funds that are allocated to them. In the same way, the mechanism used for the distribution of transfers to local government units should be transparent and simple enough so to ensure that all local government units know what the transfer will take them and understand how their allocations will be determined.

It is desirable also that the mechanisms used for the distribution of funds between local government units to promote the autonomy of local government units to help ensure that the funds are used to provide public services that are needed and desired more from local communities. At the same time, transfers should encourage effective use of funds to not lose benefits. Use of the transfers to achieve equality between different local jurisdictions must meet the needs of differentiated demand (where communities with greater needs larger allocations) and differentiations in the fiscal capacity of local government to find its own resources to meet the needs for public services. This should be closely linked to measuring fiscal capacity, where the desire for large fiscal transfers not discourage the mobilization of local resources but rather they encourage the growth of revenues from local taxes and fees as well as through a better management fiscal

1.1 The territorial Administrative Reform and its expectations

The implementation of the Territorial reform was expected to reduce the costs of public services per capita and to provide the space needed, to create economic schemes, to develop small and medium business. Larger units of local government have more capacity to exercise a greater range of functions, so the territorial consolidation enables more delegation of local government services. Given that larger units of local government can perform more functions, there are more opportunities for citizens to be more interested in participating in political processes related to local governance, indicating that territorial consolidation helps to promote local democracy. A territorial organization with larger units of local government creates less inequality in income of municipalities, so there is less pressure to compensate local governments from the central government, an issue that costs the state budget and is associated with political sensitivity. Administrative-territorial reform was approved by Law 115/2014 adopted on 31.07.2014 "On the administrative and territorial units of local government in the Republic of Albania". The main and final purpose of the territorial administrative reform is to increase the efficiency of local administration, enhancing the quality and standards of service delivery, proper development of territory by enabling greater human and financial resources, more responsibilities and authority at the local level and orientation towards a transparent and participatory decision-making. In accordance with the new administrative map, the territory is divided in 61 new municipalities (from 373 municipalities and communes in the previous reform) and 12 regions. Such an administrative consolidation represents the merge of 8-9 current LGUs in one new unit. New LGUs will bear full responsibility for the management of human resources and financial capital within their territories. Regions are not affected directly by the territorial reform; therefore, their number does not decrease. This reform provides a good planning for local economic development and the reduction of problems between administrative boundaries and the area of influence of the services provided by neighboring local government units. It will also enable the effective use of funds through local government compaction, good management of expenses but also by increasing the capacity of tax administration and matching the functions of local government with the financial administration. According to the Ministry of Finances if the service of waste management is organized based on a territory that corresponds to district territory, the cost of this service will decrease by 40%, due to the economy of scale effect. In the same logic goes the administration of natural resources, and capital assets of local government. The well-administration of human resources is estimated to have an economic impact of around 80 million dollars. It also addresses the issues of beneficiaries (free-riding), situations where a resident living in a certain local unit consumes services provided by another local unit. In other words, territorial consolidation helps to reduce discrepancies between the boundaries and areas where the services are provided.

After the very first year of implementation from the fiscal and financial autonomy viewpoint, it results that by the end of year 2016:

1. The local fiscal autonomy is considered one of the main elements that are indispensable to the success of the decentralization reforms. The fiscal autonomy may be defined as the control over resources that are sufficient to plan and manage the offering of the local public services in line with citizens' preferences, without excessive and continuous interventions from the higher governance levels.

2. Considered from this viewpoint, the Albanian municipalities have the right to control 63% of resources of financing (75% if the funds planned for the new functions that have been transferred to the local government are included), while the central government controls 37% (or 25% if we remove the funds meant for the new functions) of the total of funds that are spent in local level through conditional transfers.

3. Income from taxes and fees makes for 35% of the total resources of financing, although a deeper view of each of 61 municipalities shows that this figure varies from 3% to 68%, pointing out the obvious restrictions of the fiscal capacity, financial autonomy and dependence on the governance.

4. Similarly, the transfers that are not conditioned by the state budget, which can be freely used by the municipalities, remain the main resource of financing, consisting more than 50% of revenues of 70% of the new municipalities.

5. The increase of the quantity of the conditional transfers against the resources, which are controlled by municipalities, shows an increasing interest of the central governance to influence or lead developments in a local level.

2. The financing of local government

From a study carried out for a period of 11 years (2002-2012) for local authorities in 61 municipalities grouped under the new reform the administrative territory of the main income of the local government consist of:

i) conditional transfers ii) unconditional transfers, and iii) its income.

- Conditional transfers

Conditional transfers is the amount of funding provided by central government investments and local government projects. These funds are very important but also one of the most affected by the political movements of various governments. They have a direct impact on the local budget, mainly for investments and public services performed by these units.

- Unconditional transfers

Unconditional transfer system has been applied since 2002. It is mainly a distribution system based on the formula and units of local government can spend unconditional transfers according to their own priorities. Determining the total amount of total transfers for distribution as unconditional transfers is the result of the annual budget process of the Central Government. Unconditional transfers to local government units distributed according to a formula which annually approved by the annual law of the state budget.

The total amount of unconditional transfer is part of the process and the annual budget debate was organized and directed by the Ministry of Finance. We start this total amount is determined as part of the scheme that local government financing after the entry into force of the law on the organization and functioning of local government (Law No. 8652, dated 31.05.2000). This amount is calculated based on the costs of functions transferred to local governments as well as the right of local government to generate revenue from local taxes and fees. Since 2002 and until now we generally unconditional transfers has increased in proportion to the increase of revenues of the state budget. In 2010 unconditional transfer compared with the previous year it decreased while revenues in the state budget resulted in the increase. Since the total amount of unconditional transfers determined by discussions on the annual budgets this practice carries and its risk reduction as occurred in 2010. It is this reason that in the context of radical reforms that are being undertaken in local government law is being discussed for local finances, which among other things will define a fiscal rule for income and local government spending. This form of benefit funds occupies a substantial part but not the most important financial resources of LGUs.

- Own revenues

Own revenues are revenues to the local government unit collects taxes and fees. Local taxes are an important instrument of local government revenue and also constitute a basic condition for local autonomy.

Local taxes are:

- Small business tax;
- Tax on immovable property, which includes taxes on buildings and tax on agricultural land;
- Tax on hotel accommodation;
- infrastructure impact fee on new buildings;
- Taxes (common) on the transfer of property rights to real estate
- Taxes (shared) for vehicles;
- The fee for use of public space;
- The fee schedules

• Temporary taxes.

Under the legislation in force local government units have the right to decide on the tax base and local level. Also, local government units have the right to collect his or delegate another operator collecting local taxes and fees.

Local fees are mandatory fees and not mandatory for local public services provided to citizens and / or businesses. The local government has full autonomy in setting the fee base and local level.

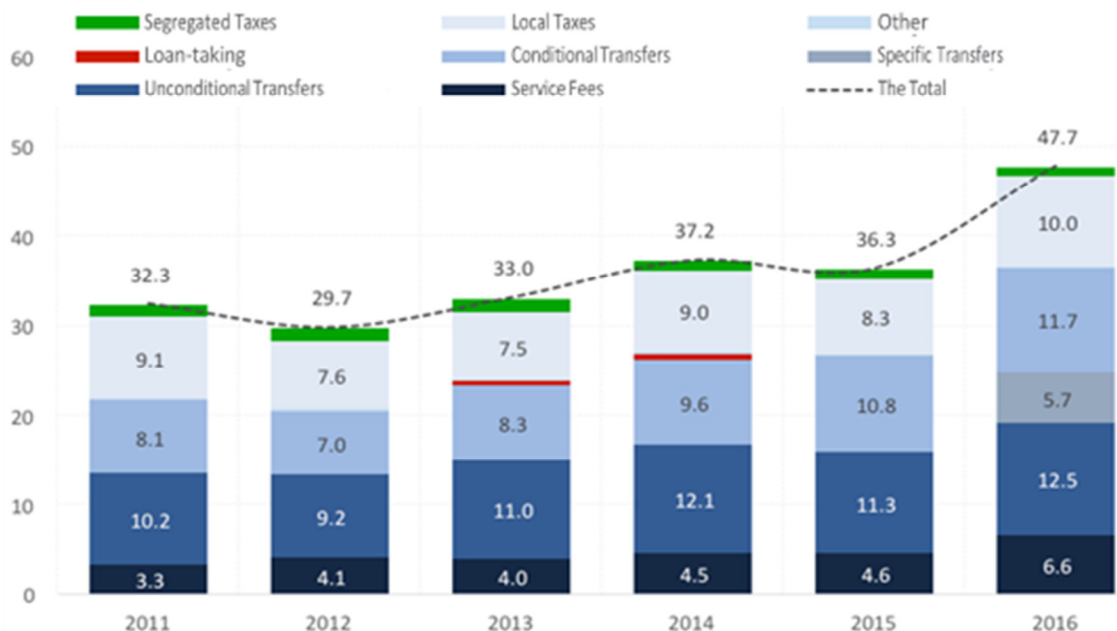
Local government revenues from taxes and fees of using autonomously according to the priorities that are set by their council.

Autonomy to generate income from local taxes and fees is important not only increase public funding and as a result there will be more investment and public services, but it can be exercised autonomy as an instrument of development fiscal policy in local level. In this sense, local governance through local fiscal policies affect economic growth and welfare of local communities. Revenue from taxes and fees are an important source of income to the local budget. Every year they are increasing but whether these revenues compare with the potential opportunities that exist for us to collect it turns out that they are still at low levels. The typical example is revenues from taxes on property that occupies only 0.15 per cent of GDP to or smaller in the region and certainly small compared with the average of European Union member countries. Revenues from this tax accounted for only 12 percent of the potential that it carries tax to be collected.

3. Analysis of Revenues

For the period 2011-2016, the structure of local government revenues presented in the table below.

Chart No. 1: Structure of local revenues



Conditional transfers in the local budget over the years take a considerable weight. During the years 2002-2008 conditional transfers accounted for 50-60 percent of the total local budget. While in the 2011-2016 period, it accounted for 25-30 percent of the local budget. These indicators show a lower real level of decentralization in general and fiscal decentralization in particular. Conditional transfers show financial dependence that local government has to central government. For this period we studied the Municipality of Shkodra and Kamëz as municipalities run by the Democratic Party and Vlore and Fier municipalities run by the Socialist Party. In the period 2002-2005 period in which the Socialist Party ruled the country (central government), Vlore and Fier municipalities receive conditional transfers more than Shkodra and Kamëz municipalities that belonged to the Democratic Party. For the period 2006-2012, Municipalities; Shkoder and Kamëz have taken more conditional transfers than municipalities Vlore and Fier.

This indicates that conditional transfers are used politically from central governments through the financial mechanism to favor more local government units belonging to the same party.

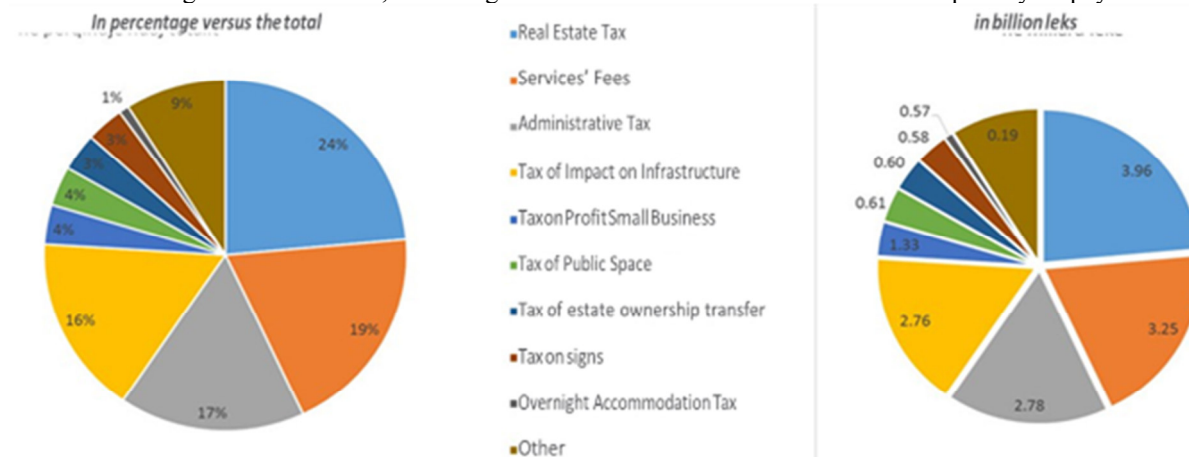
Unconditional transfers from year to year are increased. The growth has been dependent on income growth in its entirety from one year to the state budget. In the period under study, unconditional transfers in 2011-2016 was about 26-32 per cent followed by 21-25 percent decline in the years 2003-2008.

The new functions' transfer was accompanied with specific transfers totaling 5.7 billion ALL. If we eliminate the effect of specific transfers, which cannot be considered as an increase of revenues because they are used for the exercise of the new municipal functions and responsibilities, the local public finances in year 2016

amounted to 47.7 billion ALL and they increased with about 5.7 billion ALL (or 16%), out of which 4.6 billion ALL are funds which can be fully controlled by municipalities and around 1 billion ALL are conditional transfers.

Its revenue from three main sources of revenue from taxes and fees, they rank third. This indicator reflects a low level of fiscal autonomy.

If we consider local taxes and fees alone, which are the resources upon which municipalities exert full authority, in year 2016, revenues increased by 3.7 billion lek or 28% in comparison to 2015. Prior to analysis where does this growth come from, following are the main items of local taxes and fees paid by taxpayers



As it can be noticed, the property tax on buildings, the fees of public services offered by the municipality (waste disposal, greening, public lighting), the fees for administrative service and the tax of new buildings' impact on infrastructure consist the main weight of the own municipal revenues. Considered altogether, they amount to 12.8 billion ALL or 76% of the own municipal revenues that total 16.8 billion ALL. In the meantime, revenues from the simplified tax on profit consist only 4% of the own local revenues; the tax on public space occupation consists 4% of the local revenues; the tax on transfer of property ownership and the tax on signs generate 3% of own local revenues, while the overnight accommodation tax generates only 1% of own local revenues. Other financing resources consist around 9% of revenues and they include other local taxes and fees, donations, incomes from renting local assets etc.

Revenue from taxes and fees in relation to the total local budget from year to year increased jugs. From 2002 until 2006 the revenues from taxes and fees accounted for 6-8 percent of local revenues. From 2007 to 2009 they increased by 13-20 percent composed of local income, and in the years 2010 to 2012 they fell to levels 19-20 per cent of total local revenues. In weight reduction of revenues from taxes and fees in relation to the total local budget have affected several factors but the most important are:

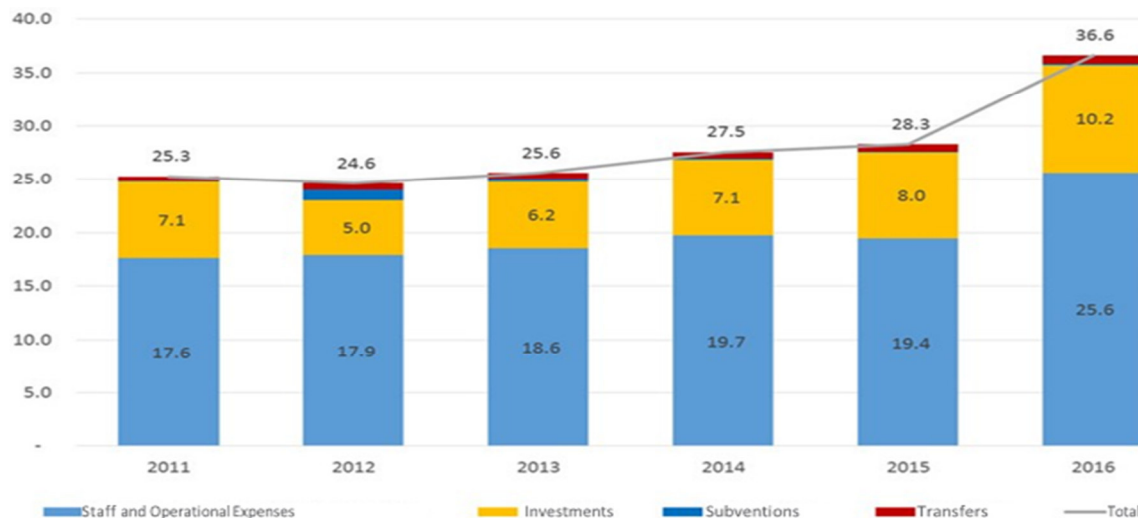
- Change the fiscal policies of the central government for local fiscal system. In the period under study have occurred changes in local fiscal policies. In 2005, the new government that came to power at the central level of local tax halved to small business.
- In 2009 it became a legal challenge to the autonomy of local governments in relation to the level of tariffs to restrict them. This meant that revenues from taxes and fees to fall after 2010.
- Coordinated work between the central tax administration and local government during the period under study found that has not been effective.

Also, it's worth noting that the major contribution to the realization of revenues occupied LGUs new conditional transfers and unconditional it which in the past has a decline (94-82 percent). They are at very high levels in which we say that new municipalities depend on about 82 percent of these forms of income of local government units. The analysis understands that in a situation without any of these forms of income, local government unit will not provide any investment even this would be negative causing a big fall welfare of local government areas.

Given that the main problems are still unresolved own income units also provide the voice graphically shows the weakness that it provides compared with others. It could be argued as a weakness that results from a centralized system of fiscal functions that local government has the jurisdiction. But it also conducts its own revenues implies that attention to form the collection of their use should be added in order to influence them to provide increased value and thus provide an added value to the citizens to help which is.

Local government revenues have a mismanagement in how spending, which see the graphic presentation.

Chart No. 2: Structure of local expenditures



From 2002 until 2009 the administrative costs were 12-18 percent of the local budget. After 2009 they have increased. Restraints of the central government that put in annual budget law of 2008 to use the unconditional transfer for administrative costs indicate that this problem has been troubling. But the measures taken to limit the use of unconditional transfer for administrative costs was not appropriate because in itself administrative expenses increased by use of local tax revenues. Instead of this measure they could have been offered measures related to structural reforms at the local level, measures relating to increasing transparency and accountability at the local level etc. These and other reasons have led to do the administrative-territorial reform which was concretized with the adoption of the new law on territorial division in July 2014.

One of the main aims of the Administrative and Territorial Reform was to reduce administrative and operational expenses by decreasing the number of local government units from 373 communes and municipalities to only 61 municipalities. The planned savings were expected to be used for public investments that were to be carried out by municipalities themselves. The following analysis helps us to better understand the performance of municipalities in relation to these expectations. At first, it should be taken into account that transfer of several new functions from the central government to municipalities is an important element that has influenced administrative expenses of year 2016. The functions' transfer was accompanied with the transfer of the staff and relevant expenses (for salaries and performance) from the ministries that till 2015 used to be responsible for these functions. The funds allocated through the Annual Budget Law of 2016 for the new functions totaled around 5.7 billion ALL. Chart 2 shows the structure of own local expenses according to the economic character for the last six years. The analysis has to be conducted in an aggregate level (expenses for salaries and operational expenses taken together) in order to enable a comparison before and after the new functions' transfer.

In year 2016, staff expenses and operational expenses totaled 25.6 billion ALL, out of which 5.7 billion were assessed to be specific transfers for the new functions. If we remove the new functions' effect, by the end of 2016, staff and operational expenses were equal to around 19.9 billion ALL, or about 2.4% (460 million ALL) higher than those recorded in the end of year 2015, or 0.9% (174 million ALL) higher than in 2014. This slight increase of expenses for salaries of the staff and the performance of the municipality may come as a consequence of some circumstances. From one side, it can show that the funds put at the disposal from the central government through specific transfer were not enough to finance the new functions and municipalities have augmented financing for these functions through their own funds

Conclusions

- After the Administrative Territorial Reform, the Strategy of Decentralization and the new Law on Local Governance, the fiscal administration and the sufficiency of local financing resources remain one of the main issues that should be solved by the Albanian authorities;
- Local government finances are dependent on central government transfers (as conditional and unconditional transfers). The progressive increase of the amount of the conditional transfers or the competing ones granted by the Fund for Regions' Development, might have influenced the deformation of the local fiscal policies, especially during the last three years, creating wrong expectations that municipal investments can and should be funded by the central government. As a matter of fact, in 37 out of 61 municipalities, the central government-funded investments made in 2016 were 1 up to 17 times higher than those funded by municipalities themselves. This reality shows that the central government carries on keeping a high control over activities and

developments in local level, despite of the decentralizing reforms;

- The level of their income realized from taxes and fees are at a low level. This leads us to another conclusion that the efficiency of local finances is again low. The frequent amendments to the legal framework, which regulates the own incomes of municipalities from taxes and fees, have been accompanied with inconsistent effects in the local finances. While the amendments to the legal framework on the tax of public space occupation, signs tax and overnight accommodation tax have brought about an increase of the local incomes in year 2016, the change and the reduction of municipalities' competences as regards the simplified tax on profit applied to the small business has caused municipalities losses;
- Real level of local autonomy is still low because it violated from the central government interference and lack of funds for the exercise of functions.
- Investments through conditional transfers to local government have positive effects on the development of local units on the other hand they affect local autonomy.

Recommendations

- The deepening of the process of fiscal decentralization and increased financial and fiscal autonomy for local governments. Through this decentralization the aim, should be increase spending per GDP.
- Reduce the maximum of the conditional transfers. Conditional transfers being used until now be added to the amount of unconditional transfer and distributed to local government units through the formula.
- In view of the new territorial division, the whole financial scheme should review.
- Making a new formula for the distribution of unconditional transfers to local governments

The formula used new criteria as:

- Population to be in groups, as for the group of; children, pupils, students and older.
- Surface criterion should be replaced with functional areas or population density.
- The fiscal potential capacity should be calculated on all local taxes.
- To add any criteria related to local development.
- Applying share tax as an opportunity to increase local government revenues.

Literature

- National Decentralization Strategy, January 2000;
- National Crosscutting Strategy for Decentralization and Local Governance (NCSDLG) 2015-2020;
- Bernard Dafflon et Styve Dafflon Perritaz-La Collaboration INTERCOMMUNALE: Proposition d'une méthode d'Analyse comparative des Aspects institutionnels, opérationnels socio-économiques et des diverses d'intercommunalité form. (BENEFRI, Working Paper 335-2000);
- Law No. 8652, dated 31.7.2000 "On the organization and functioning of local government";
- Law 115/2014 adopted on 31.07.2014 "On the administrative and territorial units of local government in the Republic of Albania";
- Zaimi, Violeta Ahmetaj, Arben Brahimi, Fran, Taxes and fees (Book), ISBN 99927-830-7-9, 2002;
- Status report of local governance finances for 2016. Where do the public funds come from and how are they used by the new municipalities? Co-PLAN
- Pige, Juliana H., P.Dervishi, and V.Bendo, "Albania Analysis of Small Business Tax and implications of Transfer to Local Governments: Policy Options and Recommendations," Albania Local Government and Decentralization Project Assistance, Washington: The Urban Institute (January 2002);
- Albania Decentralization in Transition (World Bank study in 2004);
- Law no. 9632 dated 30.10. 2006 "On the local tax system";
- Larry Schroeder, "Albania, Policy Study on Fiscal Decentralization", THE URBAN INSTITUTE, 2100 M Street, Washington, DC 20037 May 2004 (202) 833-7200 www.urban.org ;
- Brahimi, Fran "Decentralization of power and the impact on economic development", (PhD) in 2011;
- Haldeda Nezir, Fran Brahimi, Elvina Merkaj, "Borrowing Local Government Issues in Central and Eastern Europe. The case of Albania", Euro Economic Issue 1 (32) / 2013 ISSN: 1582-8859;
- Brahimi, Fran "Financial autonomy and financing schemes of Local Government"; Economics and Agribusiness Magazine 2012 , Number 4 page 10-2, ISSN 2223-7658;
- Haldeda, Nezir Salko, Drini Brahimi, Fran "The Fiscal Decentralization of Local Government and Its Impact on Small Business in Albania", International Journal "Management and Business Economics" (IJMBE), 2012, Volume 1 page 2-17.
- Dedja, Taulant and Brahimi, Fran (2006) "The Dilemma of the Revision of the Administrative and Territorial Division in Albania: Obligatory, Voluntary Amalgamation, or Inter-Communal nor a Transitory Collaboration Solution?" Conference Paper, Tirana, pp. 17- Institute for Contemporary Studies, St. Vaso Pasha 7, Tirana, Albania, ics@isb.icc-al.org / <http://www.ics-al.org> International Research and Consulting Centre, Institute of Federalism, University of Fribourg, Rte. d'Englisberg 7, 1763 pacco Granges,

Switzerland.

- Bernard Dafflon, socio-ECONOMIQUE Analyse de 32 fusions de Mediation dans le Canton de Fribourg, (BENEFRI, Working Paper 265, version mise à jour le 31 JUILLET 2003).
- Bernard Dafflon, fusions de Mediation: Elements d'Etude pour une dimension de Reference (BENEFRI, Working Paper 327, version mise à jour le 31 JUILLET 2003).
- Tony Levitas, Swedish Association of Local Governments, "Local Government Taxes, Fees and Charges in Albania: Current and Future Challenges: September 2010.
- Beci, Zyher, "Transparency and community participation in local government" (Published by these Centers of Parliamentary Studies, Tirana).
- Brahimi, Fran "Property tax and Increase of local government revenues in Albania", Fifth International Scientific Conference on: Globalization, Development, Public Policy & Management: A Business Development Perspective ", Globus, Institute of Economic Research", Pristina, Kosovo ISSN 2304-0270.