



USAID | ALBANIA
FROM THE AMERICAN PEOPLE

PLANNING AND LOCAL GOVERNANCE PROJECT IN ALBANIA

White Paper on Fiscal Decentralization
in Albania

DRAFT

September 5, 2012

This publication was produced for review by the United States Agency for International Development. It was prepared by Tetra Tech ARD.

Prepared for the United States Agency for International Development, USAID Contract
Number AID-182-C-12-00001

Tetra Tech ARD Contact:

Adrienne Raphael
araphael@tetratech.com

Tetra Tech ARD Home Office Address:

Tetra Tech ARD
159 Bank Street, Suite 300, Burlington, VT 05401
Tel: 802 658-3890, Fax 802 658-4247
www.ardinc.com

PLANNING AND LOCAL GOVERNANCE PROJECT IN ALBANIA

White Paper on Fiscal Decentralization in Albania

DRAFT

September 5, 2012

DISCLAIMER

The views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

CONTENTS

ACRONYMS AND ABBREVIATIONS	9
EXECUTIVE SUMMARY	11
ASSESSMENT OF CURRENT SITUATION WITH FISCAL DECENTRALIZATION	11
LEGAL FRAMEWORK FOR FISCAL DECENTRALIZATION	12
ADMINISTRATIVE TERRITORIAL STRUCTURES AND EXPENDITURE ASSIGNMENTS	13
REVENUES AND INTERGOVERNMENTAL TRANSFERS	15
LOCAL BORROWING	17
LGU CONSENSUS ON IMPROVEMENTS TO THE FISCAL DECENTRALIZATION SYSTEM.....	19
1.0 INTRODUCTION.....	20
1.1 PURPOSE OF THE WHITE PAPER.....	20
1.2 CONTENTS OF THE WHITE PAPER.....	20
2.0 OVERVIEW OF FISCAL DECENTRALIZATION SITUATION	21
3.0 LEGAL FRAMEWORK FOR FISCAL DECENTRALIZATION	26
3.1 LAWS RELATING TO FISCAL DECENTRALIZATION	26
3.1.1 Constitution.....	26
3.1.2 European Charter of Local Self-Government.....	27
3.1.3 Organic Law.....	27
3.2 Supporting Laws.....	28
3.3 Assessment of the Legal Framework.....	29
3.4. DECENTRALIZATION STRATEGY.....	30
3.5. ACTIONS TO IMPROVE THE LEGAL FRAMEWORK FOR FISCAL DECENTRALIZATION	30
3.5.1 Activate Revision and Adoption of the Decentralization Strategy.....	30
3.5.2 Clarifying the Expenditure Assignments	31
3.5.3 Amendment to Law on Local Governance	31
3.5.4 Administrative and Territorial Reform	31
3.5.5 Law on Local Tax on Small Businesses (annexes).....	32

3.5.6 Local Government Borrowing	33
3.5.7 Fixing the Unconditional Grant Formula	33
3.5.8 Local Finance Law	33
3.6 NEXT STEPS.....	34
4.0 ADMINISTRATIVE TERRITORIAL STRUCTURES AND EXPENDITURE ASSIGNMENTS .35	
4.1 ADMINISTRATIVE TERRITORIAL STRUCTURE AND LOCAL GOVERNMENTS	35
4.1.1 Distribution of the Municipalities and Communes by Population	36
4.1.2 Distribution of LGUs by Population Range on Regions and Country Basis	37
4.1.3 2011 Census Data and National Civil Register.....	37
4.1.4 Comparison of Albania LGUs Size to European Union	40
4.1.5 Assessment of the Administrative Territorial Structure	40
4.2 EXPENDITURE ASSIGNMENTS TO MUNICIPAL/COMMUNE LEVELS	40
4.3 LEVELS OF EXPENDITURES	45
4.4 LEVELS OF EXPENDITURE BY ASSIGNMENT.....	48
4.4.1 Assessment of Expenditure Assignments to local governments	50
4.5 RECOMMENDATIONS FOR IMPROVING ADMINISTRATIVE TERRITORIAL STRUCTURE AND EXPENDITURE ASSIGNMENTS	51
4.5.1 Administrative Territorial Structuring	51
4.5.2 Expenditure Assignments.....	52
4.6 NEXT STEPS.....	53
5. REVENUE ASSIGNMENT AND INTERGOVERNMENTAL TRANSFERS	54
5.1 GENERAL LEGAL FRAMEWORK FOR LOCAL GOVERNMENT REVENUES.....	55
5.1.1 Legal Framework for Own Revenues	55
5.1.2 Legal Framework for Grants and Shared Taxes.....	56
5.2 LOCAL GOVERNMENT REVENUES	57
5.2.1 The Composition of Local Government Revenues	62
5.2.2 The Composition of Local Government Own Revenues.....	63
5.3 THE EQUITY OF THE INTERGOVERNMENTAL FINANCE SYSTEM	
5.3.1 Allocation of the General Grant	
5.3.2 Per Capita Revenues and Horizontal Equity	
5.4 RECOMMENDATIONS FOR IMPROVING THE INTERGOVERNMENTAL FINANCE SYSTEM	

5.5 NEXT STEPS

6.0 LOCAL GOVERNMENT BORROWING.....	79
6.1 LAWS RELATING TO LOCAL GOVERNMENT BORROWING	79
6.2 CURRENT SITUATION OF PUBLIC DEBT IN ALBANIA	80
6.3 USE OF BORROWING BY LOCAL GOVERNMENT	81
6.4 RECOMMENDATIONS FOR IMPROVING LOCAL BORROWING	83
6.4.1 Provide for Increase in Debt Limitations.....	84
6.4.2 Need for Central and Local Government Dialogue	84
6.4.3 Provide for Local Borrowing Through Separate LGU Entities with Authority to Borrow.....	84
6.4.4 Innovative Methods Linking Development and Borrowing	86
6.4.5 Examine Alternatives for Borrowing	87
6.5 NEXT STEPS.....	87
7.0 SUMMARY AND CONCLUSIONS.....	89
7.1 REFORM PATH	89
7.2 PRIORITY AREAS FOR IMPROVING FISCAL DECENTRALIZATION	90
7.2.1 Areas of Consensus	90
7.2.2 Sequencing of Fiscal Decentralization Actions.....	93
7.2.3 With Territorial Restructuring	94
7.2.4 Without Territorial Restructuring	94

Tables

2.1 Assessment of Fiscal Decentralization in Albania

4.1 Number of Municipalities and Communes as per population range

4.2 Number of Municipalities and Communes as per population range

4.3 Comparison of Population Data used from MoF, NRO, and Preliminary Results Census 2011

4.4 LG Functions in Albania

4.5 Local Government Expenditures 2000-2011

5.1 Changes in the Rules Governing the Allocation of the General Grant

5.2 Per Capita Revenues of Albanian Local Governments by Quartile in 2008

5.3 Ratio of Richest to Poorest Local Governments and Quartile of Local Governments in Albania, Serbia, and Macedonia 2008

6.1 Central Government Debt

6.2 Status of Country's Debt

6.3 Local Borrowing Data for 2011

7.1 Reform Priorities for Fiscal Decentralization in Albania

Figures

- 4.1 Population Range in the Albanian LGs Grouped by Counties and at the Country Level
- 4.2 Average Population of 1st Level Local Government
- 4.3 Local Government Discretionary Expenditures Compared to GDP and Consolidated Public Expenditures
- 4.4 Sub national Public Sector Expenditures 2009
- 4.5 Functional Structure of Local Government 2008-2011
- 4.6 The Economic Composition of Local “Own” Expenditures
- 5.1 Local Government Revenues as % of GDP and Total Public Revenues
- 5.2 Local Government Revenues as % of GDP and Total Public Revenues in the South-East Europe and the EU in 2010
- 5.3 Composition of Local Government Revenues 2002-2011
- 5.4 Composition of Local Government Revenues in % in 2002-2011
- 5.5 Composition of Own Revenues in bln Lek 2006-2011
- 5.6 Composition of Own Revenues in % 2006-2011
- 5.7 Property Taxes as % of GDP in 2009

ACRONYMS AND ABBREVIATIONS

ADF	Albanian Development Fund
CG	Central Government
CIT	Corporate Income Tax
DCM	Decision of Council of Ministers
EC	European Commission
EU	European Union
FAR	Floor Area Ratio
FY	Fiscal Year
GDP	Gross Domestic Product
GoA	Government of Albania
INSTAT	Institute of Statistics
LG	Local Government
LGU	Local Government Unit
LLTS	Law on Local Government Tax Systems
LOFLG	Law on the Organization and Functioning of Local Governments
LOFLG	Law on the Organization and Functioning of Local Governments
MLSAEO	Ministry of Labor, Social Affairs, and Equal Opportunities
MoF	Ministry of Finance
Mol	Ministry of Interior
NRO	National Registry Office
OSCE	Organization for Security and Co-operation in Europe
PIT	Personal Income Tax
PLGP	Planning and Local Governance Project
PPP	Public-Private Partnership
SBT	Small Business Tax
SWOT	Strength, Weakness, Opportunities, Threats

TPL	Territorial Planning Law
UNDP	United Nations Development Program
USAID	United States Agency for International Development
VAT	Value Added Tax
WB	World Bank

DRAFT

EXECUTIVE SUMMARY

This White Paper on Fiscal Decentralization in Albania is prepared under the auspices of the USAID funded Planning and Local Governance Program (PLGP) to support the effort to further fiscal decentralization in Albania. It is written to accomplish two main objectives:

1. Provide a comprehensive overview of the current situation and possible actions that should be considered by policy makers to implement further decentralization.
2. Provide a means to stimulate central and local level dialogue and consensus building on what further actions can be implemented to support the continuation of the fiscal decentralization effort in Albania.

This White Paper examines the main areas of fiscal decentralization with assessment of the current situation supporting decentralization and a more detailed examination of the main areas to include (1) legal framework, (2) administrative territorial structures and expenditure assignments, (3) revenues and intergovernmental transfers, and (4) local borrowing. These issues are addressed in the main sections of this White Paper and are summarized in this executive summary.

ASSESSMENT OF CURRENT SITUATION WITH FISCAL DECENTRALIZATION

In reviewing the progress that Albania has achieved over the past decade there are a considerable number of improvements in the local government system that has provided a foundation for further improvements. However, a realistic assessment should also indicate that little progress toward a more decentralized system has occurred over the past several years and several challenges to achieve a more decentralized system have not been met.

An assessment of progress on fiscal decentralization can be summarized with a strengths, weaknesses, opportunities and threats (SWOT) analysis that is more fully detailed in the main section of this report and briefly highlighted here.

Strengths

The main strengths supporting progress toward fiscal decentralization are the (1) enactment of the basic legal frameworks that describe and define the authorities and functions of the local government units, (2) expenditure assignments are relatively clear with the exception of some shared functions, (3) own source revenues have been defined, (4) the unconditional grants have attempted to promote equalization across the local government units, and (5) local government budgeting capacity and citizen involvement has generally increased.

Weaknesses

However, even with this progress over the past decade a number of weaknesses still exist that need to be overcome in the next several years. These weaknesses can be grouped into three main areas: (1) National Policy Development Framework, (2) Legal and Regulatory Framework, and (3) Local Government Authorities and Capacities.

The main weakness in the National Policy Development Framework is the failure to formally adopt a National Decentralization Strategy, although much effort was put into this over the past several years. This is primarily due to the lack of a national level organizational policy and coordination mechanism

that is actively working to develop this National Decentralization Strategy document. Another weakness contributing to this is the fragmentation of the local government associations, which prevents the development of a coherent policy for the local government units. These factors have inhibited the promotion of a policy dialogue and consensus building effort that would produce a national level decentralization policy document.

While there has been substantial progress in the overall legal framework with several different laws enacted; the main weakness is a comprehensive Law on Local Finance that would provide a more logical and consistent legal framework. The existing laws have some major deficiencies and inconsistencies that have been the source of conflicts at the local government level. In some instances, such as with the small business tax and the local borrowing; national level regulations have impacted these fiscal instruments from being effectively utilized by the local governments.

Within the local government level the continuation of a number of small local government units that are unable to provide services is an ongoing problem. Additional weaknesses creating some confusion with the local government structures are (1) the role of the regions, (2) shared functions are not clearly defined, (3) lack of capacity for collecting some revenue sources, particularly the property tax and small business tax, and (4) unpredictability of the transfers to the local government units.

Opportunities

Identifying weaknesses always produces some opportunities for improvements. The primary opportunities for improving the fiscal decentralization situation are (1) improving the dialogue between the national and local government stakeholders, (2) enacting a Law on Local Government Finances that was drafted several years ago, (3) revising the intergovernmental transfers to provide more objective, transparent, stable and simple allocation criteria, and (4) enhance the revenue raising capacity of the local government units for own source revenues.

Threats

The main threats to overcoming the weaknesses and grasping the opportunities for improvements remains (1) the continuation of divisions with the local government associations, (2) lack of national level effort to promote policy dialogue through organizational structures, (3) no improvement in the legal framework on local finances to clarify areas of expenditures, revenues and transfers, and (4) no adjustments in the administrative territorial structures that would improve service delivery in a more rational and economic manner.

PLGP Support

The USAID funded PLGP program components are directed toward improving the fiscal decentralization situation in Albania. The PLGP will be providing support in the areas of fiscal decentralization policy development beginning with this White Paper on Fiscal Decentralization and supporting the development of a national and local level dialogue on the issues identified in this paper through a conference on fiscal decentralization and subsequent roundtables to discuss these issues in more detail in the coming months. The program mandate provides for supporting the enactment of a Law on Local Government Finances and improving the intergovernmental transfer system. Other components of the PLGP will address the improvement of service delivery at the municipal and commune level through working with 15 local government partners.

LEGAL FRAMEWORK FOR FISCAL DECENTRALIZATION

The basis legal framework has been put in place over the past decade with laws defining the authorities, functions, and resources for the local governments. These have functioned reasonably well in spite of some inconsistencies within this legal framework that defines these authorities in a clear and specific

manner. There is a need to clarify the role of the mayor and local councils with regard to budget authority among other issues.

The main gap in the legal framework is the lack of a Law on Local Finance that would clarify the fiscal and financial authorities, stabilize the transfer system with definition of the source of the transfers, the allocation formulas based on objective criteria, and improvements in the revenue raising capacity of the local governments. While a comprehensive Law on Local Finances has been drafted since 2008, it is yet to be fully debated or adopted by the central government.

This framework shall provide the following:

- Definition of the key budget and finance terms
- Rules/methods/ways for ensuring openness and transparency of local public finances;
- Rules for the separate national taxes, including specific taxes that are to be shared, the percentage to go to the local government and the procedures for the transfer of funds to the local account.
- Rules for unconditional transfers, including the principles and the formula for their calculation and allocation.
- Rules for local government borrowing

The legal framework is also missing a Law on the Regions, which are beginning to evolve as a more important level in the administrative territorial structures. This is a necessary addition to the legal framework that is needed. The need for a Law on the Regions has been identified as one of the main areas for further improving the decentralization situation in Albania.

The legal framework would be greatly enhanced through the National Decentralization Strategy that was developed in 2010 and would be revised and adopted as the main guide for furthering decentralization. This would serve as the focal point for the central/local dialogue and consensus building that is necessary in order that further progress can be achieved.

The PLGP can provide support to improving the legal framework and the national decentralization strategy through the following activities:

- Activate a National Level Working Group on Decentralization to revise the Decentralization Strategy and have the strategy adopted by the Central and Local Governments
- Establish a technical working group consisting of national and local level officials with expertise in the laws on local government to review and identify specific areas of the present legal framework that needs amending
- In the context of the working groups created establish a central-local consultation and dialogue mechanism through roundtables supported by the USAID PLGP

ADMINISTRATIVE TERRITORIAL STRUCTURES AND EXPENDITURE ASSIGNMENTS

Albania has a fragmented local government system with too many small LGUs that do not have the either the fiscal or human capacity to deliver reasonable public services. There appears to be bipartisan agreement that addressing the administrative territorial structures is one of the main priorities in furthering fiscal decentralization and improving service delivery.

A significant complicating factor in determining appropriate restructuring of the administrative territorial structures, expenditure assignments, and the intergovernmental transfers to the LGUs is the significant differences in the population data on which these changes would be based. The recently completed census indicates significant differences to the population data that comes from the civil registry. In most cases, the census data is much lower than the civil registry data. Some reconciliation of the variation in this population data is needed and a clear transparent decision has to be taken on which data will be used for which purpose to guarantee the needed reforms on administrative territorial structures, expenditure assignments, and intergovernmental transfer formulas.

An example of the problem with the population differences is presented in the following based on the different sources of population data. According to civil registry data there are 46 communes in Albania with a population of less than 2.000 inhabitants, and another 107 LGUs (103 communes and 4 municipalities) with 2.000 to 5.000 inhabitants, comprising a total of 41% of LGUs with less than 5.000 inhabitants. These numbers are even higher according to INSTAT population data with 69 LGUs (68 communes and 1 municipality) with population less than 2.000 inhabitants, and other 125 LGUs (110 communes and 15 municipalities) with 2.000 to 5.000 inhabitants, comprising a total of 52% of LGUs with less than 5.000 inhabitants.

The present method of expenditure assignments provides for exclusive and shared functions. The exclusive functions are assigned to both municipal and commune levels even though there are substantial differences in the capabilities of these local government units to provide these services. A new approach should be taken to provide for an asymmetrical assignment of functions based on population size and capabilities to deliver services.

The alternative of introducing asymmetric expenditure assignments at the local government level (municipalities and communes) should be considered in conjunction with the voluntary or compulsory amalgamation of the LGs. This strategy, could take different forms, but it would basically give fewer responsibilities to smaller LGs in some critical services that are negatively affected by small size and would give to regions (qarks) the responsibility for providing those critical services in the smaller municipalities. The responsibility for additional services, and the funding sources to accompany them, would devolve in the future to LGs that reach the minimum prescribed scale through voluntary amalgamation.

Shared functions are a confusing area for expenditure assignments. The roles of different government levels should be clarified. Some of the shared functions could be assumed by some LGUs within their levels of capability. This transfer of shared functions should be based on some size, capabilities, and willingness of the LGUs to undertake these tasks and with appropriate transfer of funds from the central to local levels to compensate for the additional costs.

The PLGP can support the improvement of the administrative territorial structures and expenditure assignments with the following activities:

- Facilitate a dialogue on administrative territorial restructuring and reconciling population data
- Support the development expenditure assignments based on population data and asymmetrical assignment of functions to LGUs based on the providing support for service delivery capacities within the 15 LGUs participating in the PLGP program
- Assist in clarifying the roles of different government levels in relation to shared functions.
- Support definition and adoption of national level service standards for the LGUs

REVENUE ASSIGNMENT AND INTERGOVERNMENTAL TRANSFERS

The revenue sources for the local governments need substantial improvement, both in terms of the sources as well as the collection of the available own source revenues. This should be an area where there is substantial consensus between central and local authorities to improve over the next year.

There is a very worrying trend in the decline of the intergovernmental transfers and changes to the local revenue sources that needs to be addressed. A review of the fiscal changes from 2009 through 2011 reveal the magnitude of this trend. In 2009, local government revenues as a percent of GDP were 3.1%, but this declined to 2.6% in 2010 and to 2.2% in 2011. Local government revenue as a percent of total public revenue declines from 11.9% in 2009 to 9.8% in 2010 and 8.8% in 2011. The unconditional grant declined from 14,859,000 Lek in 2009, to 11,215,700 Lek in 2010 and 11,113,200 Lek in 2011. The drop in the conditional grant was even more dramatic. In 2009, the conditional grant was 5,500,000 Lek and then dropped to 2,867,000 Lek in 2010 and, then rose slightly to 2,900,000 in 2011.

To reverse this trend the central government should set a policy objective of slowly increasing local government revenues to between 5-6% of GDP over the next 5 years and to between 15-18% of total public revenues.

It should be noted that during this same period the national level budget also suffered a significant decline. This decline was approximately 10% for each of these years as reflected in the following data.

PUBLIC REVENUES

Year	Forecast	Supplemental Budget	Collection (actual)	Reduced by Supplement budget	Reduced by actual
2009	334,823,000	326,117,000	299,502,000	3%	11%
2010	360,955,000	333,658,000	324,721,000	8%	10%
2011	362,223,000	344,047,000	330,475,000	5%	9%

Source: Ministry of Finance

In comparison with other countries of the region, Albania has provided less funding to local governments on a comparable basis of expenditures and revenues. Some attention to moving Albania closer to these levels should be examined. Some of the changes would be realized by providing more revenue authority to the local governments by allowing them more flexibility in setting of the tax rate and base on some taxes. Also, providing for shared taxes for assuming the existing shared functions would rebalance the expenditure and revenue levels.

The improvement in the collection of the property tax should be one of the main areas for further development. One of the key requirements for this improvement is a more coordinated sharing of information between the central and local authorities. There is also a need to move more quickly to a market based valuation system for property taxes. The World Bank and other donors have provided substantial support and the basics of a market valuation system are in place. Until this is achieved the property tax will not be a significant source of local revenues or impact the land development practices that need more attention.

The application of the small business tax by the local governments has not proven to be effective. The decisions of the central government to limit the rates and the lowering of the VAT threshold have severely constrained this tax as a source for local governments. Given this situation; the small business

tax needs to be eliminated within the next two years and this gap filled with other own source revenues or transfers.

One of the key constraints on improving the revenues of the local governments is the limited use of tax sharing from the central to local level. While this is allowed under the present legal framework and is continually mentioned as a solution to some of the problems with local government revenues; shared taxes of PIT/CIT have not been provided. This should be considered and tax sharing implemented in the very near term. PIT sharing may be based on either the origin of the taxpayer (residence) or on a per capita basis. Both methods are used in European countries.

Utilizing PIT on an origin basis must be examined in the light of the high concentration of the PIT revenue to Tirana municipality and the low level of PIT across all the other LGUs. For the year 2011, approximately 70% of the PIT was collected in Tirana. The sharing of PIT on an origin basis would significantly enhance the revenue to Tirana and require a substantial increase in the transfers to the LGUs to overcome this inequitable distribution. Presently, the PIT cannot be assigned on an origin basis since tax districts do not overlap with local government boundaries. Changes in the present taxpayer identification system would need to be introduced.

There are a number of advantages and disadvantages to a tax sharing system for local governments. The main advantages are the efficiency in tax collection by the national level, broadening the tax base for local governments, provides more expenditure decision authority at the local level if shared taxes are transferred as unconditional grants, and can provide some stability in revenues to the local governments. The disadvantages include the possible instability of the tax sharing rates from year-to-year due to national level tax policies, lessens the accountability of local governments for revenue raising decisions in some cases, may require substantial efforts to promote fiscal equalization depending on the variations of the shared taxes across the jurisdictions, and may influence the central government to focus on collecting other taxes, rather than the shared taxes.

The local governments are beginning to receive the motor vehicle tax on a shared 18% basis and a shared mining royalty within the past year. While it is still too early to get data on the amount of collection, it appears that the shared motor vehicle tax may produce a substantial increase in LGU revenues. However, since this is distributed on LGU basis, this may be concentrated in the larger LGUs, especially Tirana and Durres.

Because of these sharing tax problems, the possibility of allowing for LGUs to apply a surtax on the PIT should be examined as this is utilized in other countries of the region to increase the own source local government revenues. A surtax could provide additional own source revenues to the LGUs, and overcome the limitations of a shared tax as a form of unconditional transfer that does not really increase fiscal decentralization.

The growth of the conditional versus unconditional grants over the past several years is a trend that needs to be reversed. Much of this growth is due to the provision of the competitive grants, now Regional Development Fund, as means of providing more directed capital expenditures funding for specific projects at the local government level.

The transformation of the competitive grants has been extensively analyzed by the UNDP in terms of improving the new Regional Development Fund. The UNDP report recommends improving the criteria for selection of projects, maintaining the level of funding to a constant level of GDP or national investment budget, and distribution of funds based on regional, rather than national or local, priorities. These recommendations should be implemented.

The difficulty of tracking the expenditures and revenues due to changes in the accounting for funds makes an assessment of the equity of the transfers very difficult. There are nearly yearly changes in the transfer formula from year to year within the annual budget are not a recommended practice and needs to be addressed through a Law on Local Finance. As well, there should be a definition of the source of

the transfers as a percentage of GDP or total public revenues. These issues should be addressed in the near term with more stability, sustainability, and predictability of the transfers.

A per capita analysis by population quartiles indicates a large number of small local governments by population size have limited own source revenues, but receive a substantial share of the grants to produce relatively high level of horizontal equalization. The situation is closely linked to the existing administrative territorial structures. Supporting adjustments in the size of the LGUs would provide a more rational and efficient allocation of funds to across all LGUs.

There is a need for a comprehensive review of the equalization system and stabilizing the rules for allocation of grants with greater certainty. This should be done within the context of adopting a Law on Local Government Finances that should be a priority effort in the next year.

The central level of government has repeatedly complained that the LGUs have not assumed more responsibility and accountability for their revenue situation. However, the central level has constrained the LGUs ability to achieve more through restricting revenue sources and inhibiting the implementation of the property registration records as well as the transfer of public assets to the LGUs that could have been utilized for their purposes. More dialogue with intent to cooperate is needed to improve the revenues and transfers for the local governments.

The PLGP can support the efforts to improve the revenue collection and intergovernmental transfers through a number of activities within the overall program components.

Within the Fiscal Decentralization Policy Development Component the PLGP can support

- Assist in defining the level of transfer as percentage of total public revenues
- Provide technical support for enacting a Law on Local Government Finance with support for updating the existing draft law
- Develop analysis of the impact of the sharing of PIT/CIT on the equity of the intergovernmental transfers and develop alternative formulas to ensure equalization is maintained
- Develop analysis of the efficiency of the collection methods for the Small Business Tax and the Property Tax
- Assist in clarifying the use of the Regional Development Funds with technical support on the allocation criteria and transparency of the project selection procedures.
- Support the development of a new transfer formula for unconditional transfers based on more transparent, simple and objective criteria
- Support the development of local government revenue sources linked to improving land use planning and development
- Support the establishment of an Intergovernmental Finance Commission to provide national level policy on the development of local government revenues, expenditures and transfers.

Within the other components of the PLGP support can be provided for developing the means for improving the collection of the property tax, assist in moving toward a market based valuation system, and support the use of local taxes and fees as a means for improving land use developments decisions at the LGU level.

LOCAL BORROWING

The legal framework for local borrowing has been provided in a Law on Local Borrowing enacted in 2008. With this law the LGUs demonstrated a considerable interest in using borrowing for capital investments. With the assistance of a USAID project the local governments were able to initiate some borrowings from banks and agreements were reached for this borrowing. Unfortunately, the central government issued administrative orders that severely restricted the use of debt by the local

governments and some agreements were cancelled because of this action. This has effectively eliminated the possibility for local governments to borrow under the present circumstances.

In addition to the centrally imposed limitations the central government has adhered to a total public debt limit of 60% of GDP. The extensive use of external and domestic debt by the central level now approaches the 60% limit and further restricts the possible use of borrowing by the local governments within this overall public debt limitation.

In summary, unless the restrictions are relaxed on the local governments, there is little possibility that the LGUs will be able access any borrowing to provide much needed funds to finance capital investments and infrastructure improvements.

There are some potential solutions that should be considered to improve the situation and allow for local governments to borrow. These need to be innovative methods that provide some new approaches to local governments borrowing.

One approach would be to revise the debt limitation and allocate some level of debt to the local government units. One possibility is to revise the debt limit to 65% of the GDP and allocate this additional 5% to the domestic debt limits for the local governments to utilize. This would need to be done in conjunction with loosening the present overly restrictive limits on the use of debt.

An additional approach would be to allow local governments to utilize special entities and special funds to support borrowing outside the present local government limits. The use of water authorities or the creation of public private partnerships with some borrowing capacity may be feasible under the existing laws or amendments to existing laws.

Local governments might also be empowered to utilize some innovative financing methods, such as special assessment for capital improvements, more directed use of impact fees to the infrastructure projects, and the use of tax increment financing to fund projects in some areas of the local government.

A longer term solution would be to transform the Albania Development Fund into a bond bank that would pool credit needs of the local governments, issue bonds to fund these needs, and distribute the bond proceeds to the municipalities with repayment provisions to support the investment projects.

The USAID PLGP is very strategically positioned to support the development of local government borrowing. The predecessor program provided substantial technical support to local governments in applying for commercial bank loans. The USAID program also developed a manual for local governments to use in developing their credit worthy projects and apply for these loans. This experience is available under the present PLGP program. In addition, the USAID has supported the development of local government borrowing in other countries of the region and this is valuable addition to the experience required in Albania to develop a local government credit market.

The PLGP can also promote a dialogue among the main stakeholders from central, local and financial organizations to review existing legal framework and identify new approaches to borrowing. In addition the PLGP can support the technical work in applying methods of supporting the development of capital investments and land use planning within the overall local borrowing capacities.

The potential for the Albania Development Fund to be transformed into a bond bank to support local borrowing is another area where the USAID experience and the PLGP can provide significant technical assistance and advice based on prior experience in Albania.

LGU CONSENSUS ON IMPROVEMENTS TO THE FISCAL DECENTRALIZATION SYSTEM

With the multitude of problems and issues to be resolved it is difficult to prioritize these and which issues should be addressed in the local government system. Hopefully, a consensus can be reached through this White Paper and the use of roundtables to develop a dialogue that will achieve some consensus on what needs to be done.

Within the participating local governments of the PLGP a survey was conducted to attempt to determine what priorities existed among this limited number of local governments. The results begin to reveal some levels of consensus on the problems and solutions that need further dialogue between the central and local governments.

Among the PLGP participating local governments, there was agreement that improving the revenue capacity of the LGUs was a high priority with clarifying the expenditure assignments and the basis of the intergovernmental transfers ranking very close.

As far as improving the legal framework, the overwhelming consensus was that a Law on Local Finances was the most important. No other issues even ranked close to this priority.

The expenditure assignment problem would be solved with assigning functions based on the size of the LGU population. The problem of administrative territorial restructuring and the clarifying of the shared functions ranked close behind.

The surveyed LGUs overwhelmingly considered that the revenue capacity problem should be improved by providing more authority for the LGUs to establish the rate and base of the taxes. There was more limited support for using shared taxes or improving the collection of the property taxes.

The problems with the intergovernmental transfers require a more objective and transparent allocation criteria according to most of the LGUs. This was followed with improvements in the stability of the transfers and assigning a percentage of GDP or total public revenues as the basis for determining the transfer pool of funds.

Finally, there was overwhelming consensus that the present restrictions on local borrowing should be relaxed in order that local governments can meet their borrowing needs and finance important capital investments.

The search for solutions to the problems that have been identified in this White Paper on Fiscal Decentralization needs to be continued with some significant level of effort and dialogue across the levels of government. There are practical and feasible solutions to these problems based on experience from other countries facing similar problems that can be applied in Albania with a spirit of cooperation and compromise that will improve the overall financial situation of the central and local governments.

The PLGP can serve in an ongoing basis the further development of the dialogue and consensus that is needed to address these priority areas. One of the main purposes of the PLGP is to promote this dialogue and this White Paper on Fiscal Decentralization is the beginning of that effort. Further efforts will be made to promote this dialogue and discussion with a conference on fiscal decentralization and the development of roundtable discussions and formation of working groups to further support this dialogue among all the stakeholders.

1.0 INTRODUCTION

The USAID is continuing to support the Government of Albania (GoA) in its effort to achieve a more decentralized and effective system of local governance. In order to achieve this goal the USAID has funded the Planning and Local Governance Project (PLGP) in Albania being implemented by Tetra Tech ARD. This five-year project has several components to support the development of local governments. Component 1 is focused on supporting GoA's effort to implement effective government decentralization policies and legislation.

1.1 PURPOSE OF THE WHITE PAPER

The starting point for achievement of this Component 1 objective is the development of a White Paper on Fiscal Decentralization, which is to be accomplished in the first six months of the project. A White Paper is defined as an authoritative report or guide that helps solve a problem. White papers are used to brief policy makers and for achieving dialogue and consultation for drafting new legislation and policies to be implemented. The purpose of this White Paper is to provide an objective framework for priority problem identification and development of policy issues and options for the consultation processes that are envisioned in the PLGP through the Decentralization Roundtables that will begin in the coming months.

1.2 CONTENTS OF THE WHITE PAPER

The White Paper on Fiscal Decentralization will provide a brief, but comprehensive assessment of the fiscal decentralization environment in Albania and identify the key policy issues and options in these areas. The assessment will examine the five key areas of fiscal decentralization including (1) legal framework, (2) administrative territorial structures and expenditure assignments, (3) revenue assignments, (4) intergovernmental transfers, and (5) local government borrowing and debt. Finally, there is an effort to identify the most important and priority areas to be addressed with a survey of the participating PLGP local governments. This is intended to encourage discussion toward a consensus on these issues.

2.0 OVERVIEW OF FISCAL DECENTRALIZATION SITUATION

This section provides an overview of the fiscal decentralization situation in Albania and reflects the progress that GoA has made in recent years toward fulfilling the goal of a more decentralized system of government. The section will address this progress in a brief review with the more detailed information in the following sections.

2.1 FISCAL DECENTRALIZATION PROGRESS

The efforts toward improving local governance and decentralization have varied over the past decade by most accounts. The main accomplishments have been to develop a strategic policy framework for decentralization and enacting a number of laws to implement some areas of fiscal decentralization. These efforts began in early 2000 with the National Decentralization Strategy and were followed with the enactment of Laws on Organization and Function of Local Government and Administrative and Territorial Division of Local Governments. However, there are still some areas within the legal framework that need to be addressed.

The other significant achievement is the growth in local government own source revenues in these early years, but changes in the authority of the local government to establish the tax rates on the small business tax decline in the intergovernmental transfers has reversed this growth trend. Additionally, the enactment of a Law on Local Borrowing had the potential to improve the possibility for greater capital investments and the local governments were eager to utilize this possibility. But subsequent Administrative Orders greatly restricted this possibility and limited the amount of borrowing which local governments would be able to access.

Overall, the progress toward fiscal decentralization has not continued as was envisioned and some reversals have occurred in the fiscal and financial management capacities of the local government units (LGUs). The following sections address some specific strengths, weaknesses, opportunities and threats to improving the progress toward more fully developed fiscal decentralization system.

2.2 ASSESSMENT OF DECENTRALIZATION EFFORTS

The following sections address some specific strengths, weaknesses, opportunities, and threats for improving the progress toward more fully developed fiscal decentralization system. Table 2.1 at the end of this section provides a comprehensive assessment of the decentralization efforts. In the following sections, a brief summary of the main strengths, weaknesses, opportunities and threats to further progress is provided.

a. Strengths

The main strengths of the fiscal decentralization effort may be highlighted as follows:

- The basic constitutional and legal framework for decentralization has been achieved
- National Decentralization Strategy Developed and Updated 2010
- Public Finance Sector Strategy 2007-2013 addressing intergovernmental transfers, local budget process and local borrowing developed
- Some administrative territorial restructuring has occurred with creation of regional level
- Expenditure assignments for the most part are relatively clear with some exceptions concerning the shared functions
- Local Government Own Source Revenue progressed to some extent over this period
- The balance of conditional to unconditional grants improved toward unconditional grants
- The intergovernmental transfer formulas were formula based and relatively equitable across LGUs
- A Law on Local Borrowing was enacted
- A Law on Budgetary System and relevant bylaws and regulations are in place
- The improvements in local government budgeting capacity and citizen involvement showed improvement

b. Weaknesses

The main weaknesses in further progress toward fiscal decentralization may be summarized as follows:

National Policy Development Framework

- National Decentralization Strategy not completed or formally adopted
- Weak organizational support at the national government level to further support decentralization
- Division Among National Level Associations representing LGUs
- Weak consultation mechanisms with LGUs
- Dialogue and Consensus Not Achieved Among the Main Stakeholders

Legal and Regulatory Framework

- Lack of Local Finance Law (drafted but never enacted)
- Changes in Law on Local Taxes affecting local units ability to utilize the small business tax and other related taxes
- Capacity for borrowing restricted by Administrative Orders
- Clarification of More Objective Simple and Transparent Criteria for Competitive Grants

Local Government Framework

- Need for Administrative Territorial Restructuring
- Role of Regions Not Fully Defined
- Unclear Functional Assignments with shared functions
- Revenue capacity limited with property tax collections
- Transfers unstable with potential horizontal inequity of urban/rural areas
- Limited use of tax sharing sources
- Limited possibility for local government borrowing
- Unpredictability of funding sources (unconditional and competitive grants)

c. Opportunities

The slow pace of decentralization over the past several years has provided an opportunity to assess the situation and more carefully target some of the best opportunities for reinvigorating the decentralization effort. The important opportunity is to define areas of consensus among the various stakeholders from the central to the local level and determine some win-win possibilities. From the identification of these consensus areas a prioritization of the

opportunities can be developed through an effective dialogue and consultation process that will build confidence and provide a less conflict oriented focus to the development of practical problem solving approaches. The purpose of this White Paper on Fiscal Decentralization and the PLGP is to support this effort. These opportunities and policy options will be more fully developed in the later sections of this White Paper on Fiscal Decentralization. The main opportunities are briefly summarized here.

- Establish the national level dialogue on decentralization through Working Groups and Roundtables that will address the main issues identified in this White Paper and achieve consensus on those areas where there is broad agreement
- Address deficiencies in the legal framework through support to enacting a Law on Local Finances based on earlier drafts and with amendments to existing laws
- Clarify the assignment of functions and determine more specifically the role of the regions
- Address the issue of administrative territorial reform and support more effective service delivery through alignment of boundaries
- Revise the transfers to take into account new population data and provide more horizontal and vertical equity across the local governments of various sizes
- Enhance the revenue sources with improvements in tax collection and use of property tax at the local level and balanced with addition of shared taxes or other tax sources from the central government
- Provide more unconditional grant transfers relative to the conditional grants to the local governments and improved criteria for the conditional grant allocations
- Relax restrictions on local borrowing to promote the use of these funds for local investments

d. Threats

As with all decentralization efforts there are potential threats to continuing on the path toward a full decentralized system. In this section a few of these threats are identified.

- Continuation of the divisions within the local government associations
- Lack of national level commitment and organizational support to promote the decentralization agenda
- Macroeconomic conditions that prevent further revenue growth to achieve more equitable distribution of resources and fiscal capacity at the local government level
- No improvements in legal framework and, particularly, the enactment of a Law on Local Finance that would stabilize the budget and transfer system as well as strengthen the use of property tax, small business tax, and other revenue sources
- No changes in administrative territorial structures based on population data or changes to functional assignments and definition of regional level authorities

Table 2.1: Assessment of Fiscal Decentralization in Albania

	(A) OVERALL POLICY STANCE AND POLICY EFFECTIVENESS	(B) CONSTITUTIONAL & LEGAL FRAMEWORK	(C) CENTRAL GOVT INSTITUTIONAL AND REGULATORY FRAMEWORK	(D) LOCAL GOV'T INSTITUTIONAL AND REGULATORY FRAMEWORK	(E) PARTICIPATION BY CIVIL SOCIETY AND PRIVATE SECTOR
(1) Structure and role of public sector	Decentralization Strategy not adopted Administrative Territorial Restructuring Needed	Constitutional Framework Exists Organic Law (8652) needs update	Ministry of Local Government was replaced with simple department of decentralization (MoI) in 2005	No job description on the municipalities and communes; Effective HRM needed, Civil Status for local government employees missing	Division among LGU association hampers progress
(2) Functional and expenditure assignment	Unclear Functional Assignments of shared functions Regional Role not Defined	Law on Local Government Assign Functions		Local Budget Process Needs Strengthening	Need to increase community participation/advisory bodies
(3) Assignment of revenue sources	Limited Taxation Authority of LGUs (reduced taxation and fees authority-April 2009)	No Local Finance Law	Provide Shared Taxes	Need Improved tax collection	Lacking culture of paying taxes and relating to benefits by citizens/businesses
(4) Intergov. Fiscal transfers incl. the scope of unfunded mandate	Mix of Conditional and Unconditional Grants Unconditional Funds formula not updated	No Intergovernmental Finance Law	Lack objective criteria and transparency of competitive grants	Lack of capacity in many cases to take advantage of competitive grants application	

	(A) OVERALL POLICY STANCE AND POLICY EFFECTIVENESS	(B) CONSTITUTIONAL & LEGAL FRAMEWORK	(C) CENTRAL GOVT INSTITUTIONAL AND REGULATORY FRAMEWORK	(D) LOCAL GOV'T INSTITUTIONAL AND REGULATORY FRAMEWORK	(E) PARTICIPATION BY CIVIL SOCIETY AND PRIVATE SECTOR
	Unclear Formula basis				
(5) LG borrowing and infrastructural dev	Highly restrictive borrowing policy due to debt policies	Law on Local Government Borrowing 2008	Administrative Orders 857 and 17752 severely restrict municipal debt capacity	Strong Interest of Municipalities to utilize borrowing to finance infrastructure	Need for citizen input on borrowing due to long term financial impact

DRAFT

3.0 LEGAL FRAMEWORK FOR FISCAL DECENTRALIZATION

This section will provide a brief overview of the legal framework relating to the promotion of fiscal decentralization system in Albania. It will highlight some of the achievements in developing this legal framework, assess the progress toward a complete legal framework within a fiscal decentralization system, and identify some policy options for improving the legal framework. Some proposed Next Step actions are provided at the end to begin the process of completing the legal framework.

The legal framework defines the basic authorities, functions and resources for the local governments to achieve the degree of fiscal decentralization within the central and local government structure. This legal framework for fiscal decentralization is derived from the full scope of constitution, laws, and regulations that define the parameters in which local governments operate. Consequently, a starting point for assessing and improving the efforts toward fiscal decentralization should begin with a review of the legal framework and its key features.

Section Highlights

1. **The basic legal framework has been established over the past decade,**
2. **There are some conflicts among these laws that need to be resolved in amended or new laws.**
3. **The main legal framework gap that needs to be filled is a law on local finances, which have been drafted, that would consolidate and stabilize the central/local financial relationship and clarify the tax sources and the basis of the conditional and unconditional transfers.**
4. **A law on the regions is also needed to define the role, authorities and functions of the regions.**
5. **A national level strategy for decentralization has been drafted, but has not been adopted.**
6. **The revision and updating of the decentralization strategy can serve as a focal point for a central/local dialogue that has been mission**

3.1 LAWS RELATING TO FISCAL DECENTRALIZATION

3.1.1 Constitution

The Constitution of Albania addresses local governance in its Article 13, and Chapter VI with its Articles 108 through to 115, 131, and 163. The Constitution sets forth the framework for local governance relying on principles of decentralization of power and provides for local government units to operate on principles of local autonomy.

The basic characteristics of local government autonomy are provided in Article 113

1. The councils of the communes, municipalities and regions:
 - a) **regulate and administer in an independent manner local issues within their jurisdiction;**
 - b) **exercise the rights of ownership, administer in an independent manner the income created, and also have the right to exercise economic activity;**
 - c) **have the right to collect and spend the income that is necessary for the exercise of their functions;**
 - d) **have the right, in compliance with law, to establish local taxes as well as their level;**
 - e) establish rules for their organization and functioning in compliance with law;
 - f) create symbols of local government as well as local titles of honor;
 - g) undertake initiatives for local issues before the organs defined by law.
2. The organs of units of local government issue directives, decisions and orders.
3. The rights of self-government of the units of local government are protected in court

3.1.2 European Charter of Local Self-Government

The impetus for decentralization reforms began in Albania with the signing of the European Charter for Local Self-Government in (Law Nr.8548 date 11.11.1999 “On the ratification of ” The European Charter of Local Autonomy), and its basic principles are incorporated into the new Constitution (Law Nr.8417, date 21.10.1998), and the adoption of the first “National Strategy on Decentralization and Local Government”.

Upon ratification of the European Charter of Local Self Government in 1999, the Albanian Parliament voted to adopt the European standards and principles of local governance, which comply with the provisions of the Charter in Article 2 of the Constitution – Constitutional and legal foundation for local self-government which states: The principle of local self-government shall be recognized in domestic legislation, and where practicable in the constitution.

3.1.3 Organic Law

The Constitution and principles of the European Charter is supported by the Organic Law on Local Government (8652/2000) and basic laws that further define the local government system. These are highlighted in the following paragraphs.

The Law on Organization and Functioning of Local Governments

The law No. 8652/2000 “On the organization and functioning of local governments’ is the main pillar for the decentralization reforms of local governments and expenditure assignments.

Fundamental Principles

Article 4 of the Organic Law specifies some fundamental principles on the functioning of local government units (LGU):

- a) The organs of Local Government exercise their authority on the basis of local autonomy.
- b) The relationship between Local Government and Central Government, and among the Local Government units (LGUs) themselves, will be based on the principle of subsidiarity and collaboration for solving mutual problems.

Expenditure Assignments

The functional responsibilities of the local governments are indicated in some of the paragraphs of Article 12 of the Organic Law and define the relationship between the two levels:

- a) The Central Government institutions, when allowed by law, may authorize the municipality to undertake a function under their jurisdiction. The Central Government should describe the procedures for carrying out these functions and the manner in which it will control its provision.
- b) The Local Government units may be authorized to undertake other functions or competencies of the Central Government, which are non-mandatory. This should be done solely through agreement between a Central Government representative and the Local Government unit.
- c) In any case, Central Government guarantees the necessary financial support to the Local Government units to exercise their delegated functions and powers.

Municipalities and Communes exercise three types of functions:

- a. Exclusive functions are functions given by law to the LG unit, for the realization of which it is responsible and has the authority to make decisions and use means for their realization, within the norms, criteria and standards generally accepted by law. LGUs shall exercise full administrative, service, investment and regulatory authority over these functions.
- b. Shared functions are functions for which the LG unit has its share of responsibility, distinguished from the share of responsibility granted to central government. These functions are accompanied proportionally with competencies, which are exercised autonomously.
- c. Delegated functions are functions of central government or its institutions that by law or by a contractual agreement between the central government and the LG unit are assigned to a LG.

Revenue Assignment

The basic authority for the local governments to exercise their fiscal and financial authorities is provided in the Chapter III, Article 8/1/III Right to Fiscal Autonomy. It states:

- a. Local governments may obtain revenues and make expenditures related to the execution of their functions.
- b. Local government units have the right to set taxes and fees in compliance with the legislation in force and the interest of the community.
- c. Local governments have the right to adopt and execute their budget.

The main features of the local government finance are provided in Article 15: Fundamental Principles of Local Government Finance. These features are:

1. National fiscal policy shall guarantee the fiscal self-sufficiency of local governments through diversified sources of revenue.
 1. The local government units are financed with the revenues from locally derived taxes and fees, funds transferred from the central government and funds derived from shared national taxes.
 2. Through law, communes and municipalities are empowered with sufficient authority to obtain revenue independently to finance the exclusive functions under their jurisdiction.
 3. The central government shall provide local governments with funds that are sufficient to meet the requirements for the provision of shared and delegated functions:
 4. Each local government shall adopt, carry out and administer a budget each year that does not include a deficit in compliance with the Law No. 8379, dated 29.7.1998 “On the drafting and execution of the State Budget of the Republic of Albania.”

3.2 Supporting Laws

In addition to the Constitution and Organic Law there are a number of laws that support the basic features of the local government system. These include the following.

Law on the Administrative and Territory Structures

An important and supporting law is the Law No. 8653, dated 31.7.2000, “On Territorial and Administrative Division of the Local Government Units in the Republic of Albania”. This law does not provide a narrative description, but has introduced the administrative units, such as regions, municipalities, communes, and villages in both levels of governance in Albania.

Article 63 (Administrative and Territorial Reorganization) of the Law On Local Governance (8652/2000) (Chapter X: “Reorganization of Local Governments) states: “*The existing administrative-territorial division can be reorganized either with or without a change in boundaries, in compliance with the local economic, social interests, tradition, culture, and other local values for the efficient provision of functions to the benefit of the local community and the implementation of local, regional and national policies*”.

Law on Financial Resources

The law No. 9632 date 30.10.2006 “On the system of the local Taxes” is the crucial law for the decentralization reforms of local governments. This law sets out the rules on exercising the rights and duties of local government units in terms of establishing local taxes, their collection and administration.

Law on Management of Budgetary System

The Law on Budgetary System on the Republic of Albania, No. 9936, dated 26.06.2008 is one of the most important laws in the legal framework of the local financial and administrative issues.

This law regulates the budgetary system in the Republic of Albania, its structure, its principles and the foundations of the budgetary process, intergovernmental financial relations and responsibilities for the execution of the entire budgetary legislation.

Article 6 provides the basis for local budgets with the following provisions:

Local budget includes all the revenues, expenditures and financing of the local government units.

Local budget shall be balanced, except in cases when there is borrowing to finance investment projects.

Local budget shall be balanced in terms of receipts and payments. All revenues and expenditures of the local budget shall be stated in gross terms.

Law on Local Government Borrowing

The Law Nr. 9869, date 4.02.2008 “On Local Government Borrowing” regulates the conditions upon which Local Governments may assume debt and provides for matters connected thereto. This law aims at expanding local autonomy through regulation of local government borrowing and creation of appropriate opportunities and rules to ensure a transparent borrowing process in compliance with overall development policies and which ensures macroeconomic stability and credibility of public institutions in financial markets.

3.3 Assessment of the Legal Framework

From this review of the legal framework it is clear that the basic elements are in place and have provided the main features of a system that would support fiscal decentralization. While there are some legal gaps that might be improved by amending existing laws or adopting a new law, the main legal requirements are in place and well established. In the following sections, a more detailed examination of some of the specific needs for improving the legal framework will be described.

The main legal framework gaps are the lack of a law on local finances and a law on the regions that would clearly define the evolving role of the regional authorities and their functions.

3.4. DECENTRALIZATION STRATEGY

While the legal framework is sufficient for the most part to promote a democratic and decentralized system of governance there is still a need for the implementation of these laws into actions through an authoritative and effective strategy. The basis for this implementation in a coordinated manner is provided in the draft document titled “Decentralization and Local Government Cross Cutting Strategy of April 2010”. This document addressed the issues for continuing progress toward a decentralized system, and described a timeframe and Action Plan for the implementation of these decentralization policies.

Unfortunately this document has not been adopted and further progress toward decentralization has largely stalled in the past few years. It is a key requirement for further progress that this decentralization strategy document be updated, revised, and adopted as a roadmap for implementing the Constitution, organic laws, and other supporting laws that will enable local governments to achieve a decentralized system of governance. Specific areas in which further progress is needed by an explicit decentralization strategy document would be the following:

- a. Improve the institutional capacity from the central to local level to implement the decentralization strategy.
- b. Address the administrative territorial structures and the number of units lacking fiscal and service delivery capacity and the role of the regions in a more clear and definite manner.
- c. Further clarification of the expenditure assignments with specific reference to the shared functions and the different levels of capacity at the municipal and commune levels to deliver services
- d. Improve the local revenue capacity with additional effort to improve collection of existing taxes and fees and add additional revenue capacity to meet the needs for delivering more services
- e. Improve the stability, simplicity and equity of the transfer system with more objective and formula based factors that will remain consistent over several fiscal years and improve the overall legal framework for the conditional and unconditional transfers
- f. Provide more capacity for local governments to utilize borrowing and debt to finance the needed capital investments

3.5. ACTIONS TO IMPROVE THE LEGAL FRAMEWORK FOR FISCAL DECENTRALIZATION

3.5.1 Activate Revision and Adoption of the Decentralization Strategy

A starting point for developing the legal framework toward addressing the problems identified above is to activate the efforts toward updating, revising and adopting the Decentralization Strategy document that was developed in April 2010. The substantive areas and recommendations presented in this document are still relevant and this strategy could be quickly updated.

An important element of any new effort to develop and adopt a decentralization strategy is to provide for more dialogue and consultation among the relevant stakeholders in order that a broad based consensus and commitment can be achieved on the elements of the decentralization strategy and changes to the legal framework. The USAID Planning and Local Governance Program (PLGP) is charged with developing a fiscal decentralization component in its activities and will provide support for undertaking this dialogue and consultation through a series of roundtables and conferences to deal with these issues.

A working group on decentralization should be activated to address the revision and updating of the Decentralization Strategy and identify areas for improving the legal framework, particularly for a law on local finances and a law on regional authorities.

3.5.2 Clarifying the Expenditure Assignments

There is a need for clarifying the legal framework with regard to the competencies across the local government units by taking into consideration their capacities to deliver the services and functions assigned to them. Some of the issues and possibilities for doing this will be examined in a later section of this White Paper. There will be a need for a broad based consensus to achieve this and improve the legal framework that defines these competencies.

This can only be done through amending the present Organic Law on Organization and Functioning of Local Governments of 2000, which defines these functions in Chapter IV, Articles 9-12. Since this is an Organic Law it will require a 3/5 vote of Parliament to approve any amendments.

This is an issue of considerable concern among the local governments and was identified by the Prime Minister as well during recent PLGP project launch event.

One key area to be addressed with clarity of the functional assignments is the shared functions. There needs to be a clearer definition of the assignments for the following areas in the law:

1. Pre-University education,
2. Primary Health Care,
3. Social Care.
4. Environment

3.5.3 Amendment to Law on Local Governance

Article 111/2 of the Albanian Constitution states: “The units of local government have an independent budget, which is created in the manner provided by law.” The Constitution also states that municipal/communal council is the decision-making and representative body. According to the Organic Law on Local Governance (Article 72/1/d), the authorities granted to the local council include the fiscal rights.

There is a conflict between the competencies given to municipal council and the manner of election of the mayor, who is elected by direct vote, thus having a strong mandate. The Law No. 8652 (Article 32) provides 19 competencies to the councils and Article 44 gives 11 competencies to the mayor including the obligations to enforce, report, inform, etc. to the local council.

There is a need to review and amend these articles to further clarify the situation and avoid future conflicts within the LGUs.

3.5.4 Administrative and Territorial Reform

The Albanian Constitution (Article 108 of Chapter VI) states: “1. The units of local government are communes or municipalities and regions. Other units of local government are regulated by law. 2. The territorial-administrative divisions of the units of local government are established by law on the basis of mutual economic needs and interests and historical tradition. Their borders may not be changed without first taking the opinion of the inhabitants.”

Almost all political actors, including those of the ruling and opposition parties, agree to change the administrative and territorial configuration of the local government units.

According to the data provided by the local government associations, one third of LGUs provide no services to their citizens. The population of 153 LGUs is under 5,000 inhabitants. The deficient capacities in these LGUs will increase as their population is moving to the main urban areas in the Western plains of the country.

There appears to be bipartisan agreement that this situation must be resolved. In the PLGP launching conference, the Prime Minister, Mayor Basha, and Socialist Party Member of Parliament Mr. Fino articulated the need to undertake this reform on an urgent basis. Since the strengthening of fiscal decentralization and consolidation of local fiscal autonomy is closely linked with the political will to grant more competencies as well as with the LG capacities to perform their duties, undertaking this reform will be a key element in the framework of a action plan to update the decentralization strategy. The new administrative map would also clarify the functions of both levels of local governance.

3.5.5 Law on Local Tax on Small Businesses (annexes)

On 23 April 2009, the Albanian Assembly approved changes to the *Law on the System of Local Taxes No.10117, 23.4.2009*. Essentially, the amendments to the law severely limit the amount of taxes and fees that Local Government Units (LGUs) can charge small businesses.

The amendments raise several legal issues primarily under the authorities provided to LGUs in Law 8652 *On the Organization and Functioning of Local Government* as amended by Law 9208 on 18 March 2004. There are several relevant clauses in this law including:

- *Article 15.3:* Through this law, LGUs are empowered with the authority to obtain revenue independently to finance public service functions and infrastructure under their jurisdiction.
- *Article 16.2:* The law defines the tax base as well as the minimum and/or maximum rates. LGUs have the right to apply (or not) a local tax. If they decide to apply the tax, they decide the tax rate, as well as the manner for collection and administration within the limits and criteria set forth in the respective law.
- *Article 16.3(a):* LGUs derive revenues from local fees to provide public services.
- *Article 16.4:* LGUs set the level of the local fees, determine the manner of collection of local tariffs and their administration in line with policies and general principles defined in the normative acts of central government.

The changes, in particular, the limitations on other taxes and temporary taxes, contradict the *Law on the Organization and Functioning of Local Government* that grants LGUs the right to establish fees in connection with the cost of service provision.

The approved changes to the law have had significant negative impact by:

- reducing funds available for local government budgets
- diminished the efforts toward promoting decentralization
- further limited funds for capital investment
- impaired the effort to achieve cost recovery for services provided.

There is a need to review the application of the Small Business Tax within the overall legal framework of revenue sources available to the local governments. These issues are addressed in a later section of this White Paper.

3.5.6 Local Government Borrowing

The GoA, with the support of the USAID, submitted the Law on Local Borrowing to the Parliament and adopted it in 2008. This law complemented the administrative and fiscal framework of a broader fiscal autonomy.

This law has a chapter (No. 4) on Limitations on Debt. This need of the central government is the result of a macroeconomic oversight of the public debt. According to this law, the Ministry of Finance is entitled to issue sub regulatory acts that limit or disapprove of loan agreements of LGUs. Among others, this has led to unpredictability of budgetary expenditures, mainly for public investments.

This law should be revised to establish a fairer ratio to public debt between central government and local government units. This ratio should clearly specify the percentage of public debt belonging to local governance to the total public debt. This would protect local government from actions undertaken by the Ministry of Finance, with some of the actions identified by local leaders as political attitudes.

Additional changes in the legal framework regarding local government borrowing should be examined in the context of the overall review of the local governments' capacity to borrowing and the restrictions presently placed on their ability.

3.5.7 Fixing the Unconditional Grant Formula

The stability of the unconditional grant formula is an essential element in developing the legal framework for the functioning of the local governments. This has been called for in regional meetings and all political sides, including the Prime Minister, SP members of Parliament and local elects of all political affiliations.

The change of formula must be made to the Law on State Budget, which is adopted annually in reliance of Article 78, paragraph 1 of Article 83, and Article 158 of the Constitution of Albania as well as Article 30 of the Law No. 9936, dated 26.6.2008, "On Management of Budgetary System in the Republic of Albania".

This situation needs to be clarified within these laws or through a new Law on Local Government Finance or Law on Intergovernmental Fiscal Relations.

3.5.8 Local Finance Law

A Law on Local Government Finance was drafted in 2007 and is yet to be adopted. A new law would provide more a clearer legal framework and eliminate some of the problems in the existing laws.

This framework shall provide the following:

- Definition of the key budget and finance terms
- Rules/methods/ways for ensuring openness and transparency of local public finances;
- Rules for the separate national taxes, including specific taxes that are to be shared, the percentage to go to the local government and the procedures for the transfer of funds to the local account.
- Rules for unconditional transfers, including the principles and the formula for their calculation and allocation.
- Rules for local government borrowing

The GoA has recognized the need to address issues pertaining to local government finance in its Economic and Fiscal Program 2012-2014 has indicated the following.

Local financing – In order to consolidate the local finances during the year 2012 and onwards, the government efforts shall concentrate on identification of problems pertaining to the need of a regulatory framework for local finances, which will aim to determine the procedure for drafting and implementing local budget, the funding scheme of unconditional transfer to local governments, accounting problems and internal and external audit, assisting local units that want to borrow, transparency. This process shall be subject to discussions with the different interest groups and at the end of this process will be drafted a special law on “Local Finance”

3.6 NEXT STEPS

In this final part of this section on assessing the legal framework for promoting fiscal decentralization a time frame of actions to be completed to support this is provided below. These are identified in terms of the actions and mechanisms for implementing the recommendations on improving the legal framework.

Short-term (within one year)

- Adopt a new Law on Local Finances
- Draft a Law on Regions
- Activate a National Level Working Group on Decentralization to revise the Decentralization Strategy and have the strategy adopted by the Central and Local Governments
- Establish a technical working group consisting of national and local level officials with expertise in the laws on local government to review and identify specific areas of the present legal framework that needs amending
- In the context of the working groups created establish a central-local consultation and dialogue mechanism through roundtables supported by the USAID PLGP

Medium-term (1-3 years)

- Propose amendments to the Organic Law in areas of the functional assignments to the local governments and the administrative territorial organization
- Propose amendments to the Law on Local Borrowing and regulations in the borrowing process and the establishment of ratio between central government and LGUs in the public debt limitations
- Begin the process of restructuring the administrative territorial organization based on merging of local government units lacking sufficient capacity to provide services
- Clarify the legal basis for shared taxes and the use of surtax and piggyback taxes for use by the local governments
- Develop a Law on the Regions that more clearly defines the role of the regions and the functions to be performed by regions and the fiscal relationship between the central and local governments
- Adopt a Law on Regions that more clearly defines the role of the regions and the functions to be performed by the regions and the fiscal relationship between the central, regional and local government units

Long-term (3-5 years)

- Complete the administrative territorial reorganization
- Finalize the assignment of functions to the local government units based on restructured administrative territorial units

4.0 ADMINISTRATIVE TERRITORIAL STRUCTURES AND EXPENDITURE ASSIGNMENTS

This section examines in some detail the situation with regard to the organization and size of the administrative territorial structures and the expenditure assignments given to local government units. There are significant issues that need to be resolved with regard to the size of the local government units and their capacity to provide for the service delivery function that are assigned to them.

Section Highlights

- 1. The differences in population data between the census and civil registry needs to be resolved and an agreement reached on the population data for the purposes of restructuring the local government units and for use in the transfer formulas.**
- 2. Establish a voluntary and compulsory timeframe process for restructuring the local government units on a regional basis**
- 3. Following the amalgamation process, clarify the assignment of functions on the basis of population and capacities of the local government units to deliver services on an asymmetrical basis**
- 4. Clarify roles of different government levels in relation to shared functions and transfer to the local government units willing and capable to assume fragments of these functions with appropriate transfers of funds from the central to local government units**
- 5. Clarify the role of the regions and their responsibilities through a Law on Regions**

4.1 ADMINISTRATIVE TERRITORIAL STRUCTURE AND LOCAL GOVERNMENTS

One of the most natural results of the decentralization process in Albania has been the administrative territorial organization of the country for effective decentralized fiscal and administrative structures within the unitary state. The administrative reform framed by the Albanian Constitution (part xi, art. 108); Law on Organization and Functioning of Local Government (8652/2000; chapter x) and effected by Law on Administrative – Territorial Division of Local Government Units in Albania (8653/2000), led to the reorganization of government and to the creation of 374¹ local units of first level and 12

¹ Today there are 373 first level local government units, out of which 373 communes. Commune of Barbullush and Bushat in Shkodra Qark consolidated with their own request and this was reflected in the amended Law on Administrative-Territorial Division (9123/2003)

second-level local units, named ‘qark’ (regions). The first were classified in 65 urban municipalities and 309 rural communes, while the later – qarks, group in their territories a number of units of the first level (both municipalities and communes).

4.1.1 Distribution of the Municipalities and Communes by Population

For historical reasons, Albania has inherited a territorial-administrative structure characterized by too many small local government units. At present there are 46 communes in Albania with a population of less than 2,000 inhabitants, and other 107 LGUs (103 communes and 4 municipalities) with 2,000 to 5,000 inhabitants, comprising a total of 41% of LGUs with less than 5,000 inhabitants. These numbers are even higher according to INSTAT population data: there are 69 LGUs (68 communes and 1 municipality) with population less than 2,000 inhabitants, and another 125 LGUs (110 communes and 15 municipalities) with 2,000 to 5,000 inhabitants, comprising a total of 52% of LGUs with less than 5,000 inhabitants.

The distribution of municipalities and communes by population ranges are presented in the following tables based on two national official sources. They indicate the rather high number of very small communes within the total number of LGUs.

Table 4.1 Number of Municipalities and Communes as per population range

Number of LGs /Population Range	Population Range								Total
	< 2000	2000 > 5000	5000 > 10000	10000 > 15000	15000 > 30000	30000 > 100000	100000 > 200000	> 200000	
Municipalities	0	4	17	18	10	11	3	2	65
Communes	46	103	102	41	15	1	0	0	308
Total	46	107	119	59	25	12	3	2	373

Source: National Civil Register 2011, Own Calculation

Table 4.2 Number of Municipalities and Communes as per population range

Number of LGs /Population Range	Population Range 2009								Total
	< 2000	2000 > 5000	5000 > 10000	10000 > 15000	15000 > 30000	30000 > 100000	100000 > 200000	> 200000	
Municipalities	1	15	21	6	12	8	1	1	65
Communes	68	110	99	27	4	-	-	-	308
Total	69	125	120	33	16	8	1	1	373

Source: INSTAT 2009, Own Calculations

There are two main sources that we can refer for population data in the case of Albania: (i) Institute of Statistics (INSTAT) and (ii) National Registry Office (NRO). INSTAT data on population refer on the Census 2001, which gives information on population and housing in Albania. For the following years (2001 – 2010), INSTAT uses the trends and projections to estimate population numbers. NRO reports

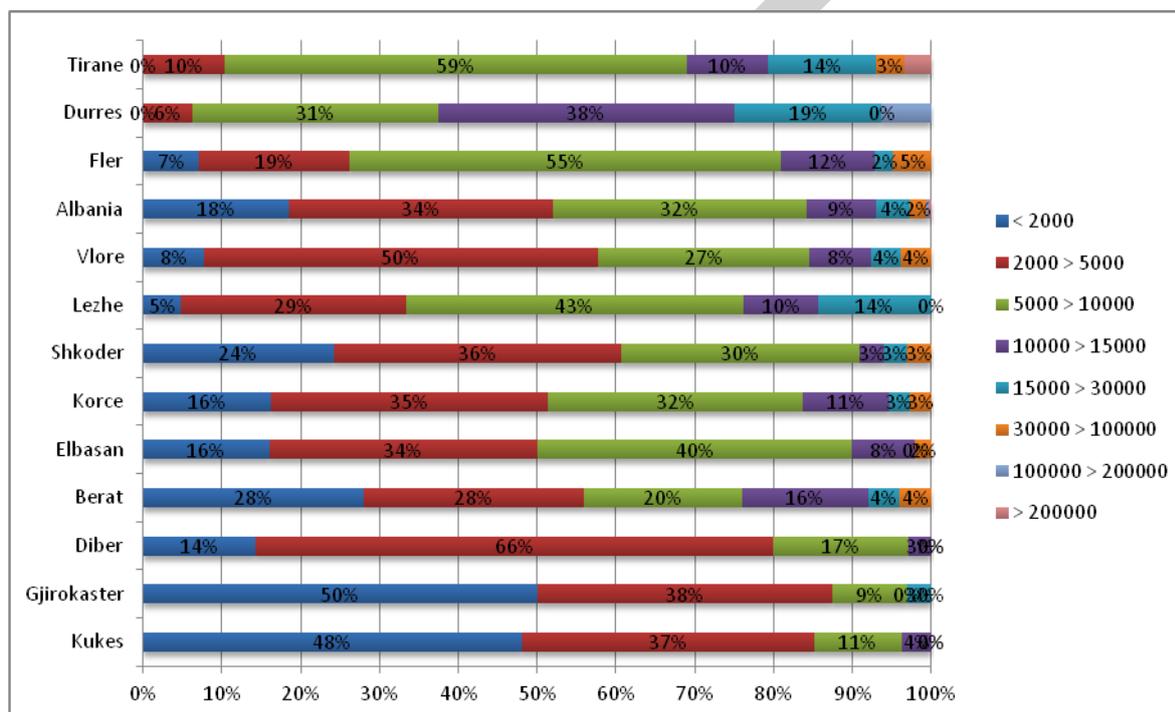
data from National Civil Register, which on the other ‘is argued’ to have many duplications and outdated information, due to unreported movement of people from one area to the other.

Although the discrepancies in numbers reported from these sources are high, the general trends remain almost the same, both in terms of total population trends, or population as per local government units. In this section, for the purposes of analysis we refer to both these sources for the population data.

4.1.2 Distribution of LGUs by Population Range on Regions and Country Basis

The concentration of small communes is even more evident in the figure below, which shows the percentage within population ranges grouped by counties and country level.

Figure 4.1 Population range in the Albanian LGs grouped by Counties and at the country level



Source: INSTAT 2009, Own Calculations

Most of these LGUs lie on mountainous areas in the parts of Kukës, Shkodër, Berat, Gjirokastër and Diber (see Figure 4.2 Population range in the Albanian LGUs grouped by Counties). This is related to the migratory movements happening after ‘90s within the country, which has resulted with loss in population especially in the northeastern and southwestern part. On the other hand, the rate of urbanization has increased rapidly after ‘90s and the 2011 Census² preliminary reports for the first time a predominantly urban population in Albania (53,7% of the population), concentrated mainly in the western lowland (Tirane, Durres, Fier, Vlore, Lezhe, etc.)

4.1.3 2011 Census Data and National Civil Register

The Census 2011 in Albania is the 11th in the history of the Albanian censuses. It was conducted as in the most of the European countries following UNECE/Eurostat recommendations, within the framework of the 2010 World Population and Housing Census Program of the United Nations. Although, so far, only preliminary results were published, controversial discussions have begun.

² <http://census.al>

While the National Registry Office (NRO) reports in National Civil Register (NCR) 4.282.930 inhabitants for 2011, the Census 2011 preliminary results report 2.831.741 total population of Albania, commenting on a 7,7% decrease from the Census 2001³ population data. There are several discussions saying that NRO data are redundant due to duplications, resulting from the fact that people do not de-register when they migrate from one LG to the other, or emigrate abroad the country. Still the 7,7% decrease from 2001 population, reported from Census 2011, has raised many questions on the accuracy and reliability of the Census 2011.

Following the Law on Budgetary System (9936/2008), Ministry of Finances (MoF) must refer to official data⁴ for macroeconomic assessments and forecasts, intergovernmental transfers, etc. Both the NRO and INSTAT data are considered official sources for population data, and in fact MoF seems to refer to both sources for different purposes. So, the macroeconomic and fiscal framework is prepared based on the population data reported from INSTAT (see Microeconomic and Fiscal Framework, MoF), while the unconditional transfer for LGUs is calculated based on the NRO population data. On the other hand, discrepancies are noted even in the population data used from the MoF for calculating unconditional grants and NRO population data (see Table 4.3 Comparison of population data used from MoF, NRO and preliminary results Census 2011)

Table 4.3 Comparison of population data used from MoF⁵, NRO and preliminary results Census 2011⁶

County	LGU	M/C	MoF 2011	NCR 2011	difference MoF-NCR	Census 2011	Difference MoF-Census
Tiranë	Tiranë	M	618.288	620.540	-2.252	421.286	197.002
Durrës	Durrës	M	201.947	202.913	-966	115.550	86.397
Vlorë	Vlorë	M	135.278	135.325	-47	79.948	55.330
Elbasan	Elbasan	M	123.884	123.998	-114	79.810	44.074
Shkodër	Shkodër	M	113.719	113.185	534	74.876	38.843
Korçë	Korçë	M	87.199	86.923	276	51.683	35.516
Fier	Fier	M	84.794	85.555	-761	57.198	27.596
Tiranë	Kamëz	M	79.404	80.471	-1.067	67.301	12.103
Berat	Berat	M	62.850	63.087	-237	36.467	26.383
Fier	Lushnjë	M	53.403	53.417	-14	31.424	21.979
Vlorë	Sarandë	M	40.368	40.450	-82	17.587	22.781
Tiranë	Kavajë	M	39.304	39.280	24	20.312	18.992
Korçë	Pogradec	M	38.958	38.687	271	20.912	18.046

3 Census 2001 (REPOBA) reports 3.069.275 total population of Albania <http://census.al/census2001>

4 Law on Budgetary System (9936/2008), article 23 states that the Minister of Finance shall prepare for revision and approval of the Council of Ministers a report on macroeconomic assessment and forecast...which shall include beside others "recent assessments of economic situation based on official data and comparison with previous forecasts"...

5 Ministry of Finance refers to the National Registry Office (NRO) for the data that are used for calculating the unconditional grant transfers to LGUs.

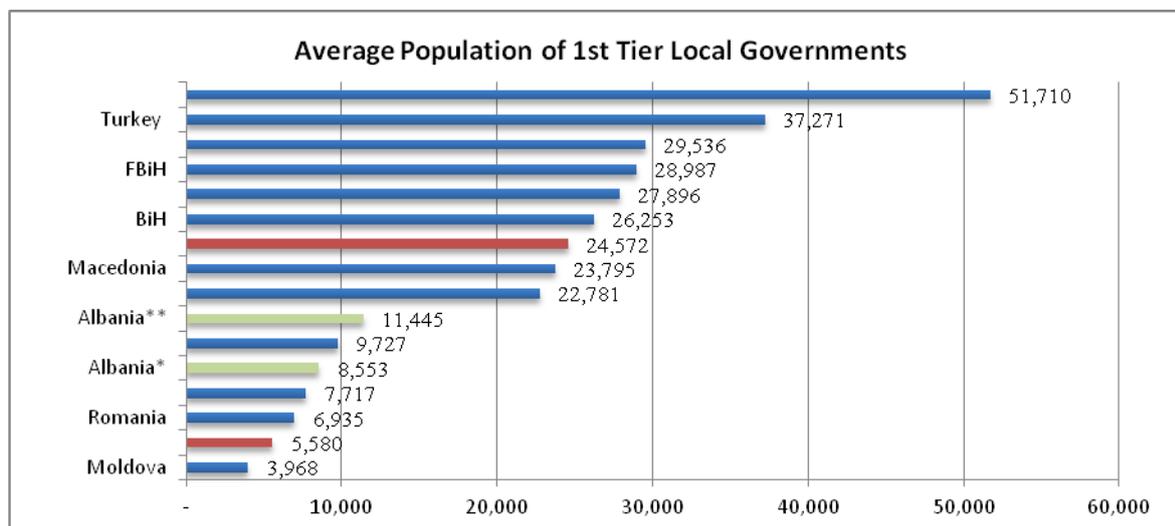
6 Preliminary Census 2011 results for LGs above 10'000 inhabitants, <http://census.al/> (07.06.2012)

County	LGU	M/C	MoF 2011	NCR 2011	difference MoF-NCR	Census 2014	Difference MoF-Census
Gjirokastrë	Gjirokastrë	M	33.975	33.646	329	19.570	14.405
Fier	Patos	M	31.706	31.406	300	15.765	15.941
Berat	Kuçovë	M	30.105	30.059	46	12.602	17.503
Lezhë	Laç	M	29.596	29.342	254	17.588	12.008
Lezhë	Lezhë	M	27.415	27.863	-448	15.644	11.771
Durrës	Sukth	M	25.344	25.684	-340	16.516	8.828
Durrës	Fushë- Krujë	M	24.566	24.788	-222	18.024	6.542
Kukës	Kukës	M	22.547	21.729	818	16.765	5.782
Lezhë	Mamurras	M	22.168	22.569	-401	15.884	6.284
Dibër	Peshkopi	M	18.660	18.663	-3	13.227	5.433
Tiranë	Vorë	M	18.393	18.789	-396	12.135	6.258
Dibër	Burrel	M	16.926	16.841	85	10.895	6.031
Durrës	Krujë	M	16.149	16.201	-52	11.642	4.507
Tiranë	Paskuqan	C	39.511	39.359	152	37.313	2.198
Durrës	Rashbull	C	27.615	27.918	-303	23.997	3.618
Tiranë	Kashar	C	21.311	21.793	-482	45.742	-24.431
Durrës	Xhafzotaj	C	17.297	17.554	-257	11.789	5.508
Korçë	Pojan	C	17.166	17.066	100	10.720	6.446
Korçë	Buçimas	C	17.017	17.294	-277	15.701	1.316
Lezhë	Shënkoll	C	15.302	15.340	-38	12.289	3.013
Durrës	Katund i Ri	C	15.256	15.322	-66	10.209	5.047
Durrës	Kodër Thumanë	C	15.199	15.351	-152	12.254	2.945
Dibër	Maqellarë	C	13.271	13.346	-75	10.577	2.694
Elbasan	Bradashesh	C	12.428	12.462	-34	10.548	1.880
Tiranë	Dajt	C	11.862	12.381	-519	20.935	-9.073
Tiranë	Farkë	C	11.476	11.770	-294	22.713	-11.237
Total			2.231.657	2.238.367	-6.710	1.515.398	716.259

4.1.4 Comparison of Albania LGUs Size to European Union

The average size of local government units is 11,445 inhabitants and is comparable favorably with European Union 27 average and with other regional countries as Croatia, Slovenia, etc. (see Figure 4.2, Average Population of 1st level Local Government). Still, there are 153 LGUs (41%), which count for about 9,6% of the population, of less than 5,000 inhabitants.

Figure 4.2 Average Population of 1st level Local Government



Source: NALAS, INSTAT, NCR, Own Calculations (2009 data)

4.1.5 Assessment of the Administrative Territorial Structure

The existing administrative territorial structure of Albania raises serious concerns in terms of efficiency and service delivery. The high fragmentation of the country (in 373 local government units) indicates that about 10% of the population lives in small LGUs with communities of less than 5,000 inhabitants, where the level of the services provided for the citizens due to the lack of economic efficiencies is very poor. On the other hand, only a small number of municipalities and communes, mainly in the western lowlands of the country, have a high population density providing for a better efficiency of service delivery.

The poorly defined role of regions is not working in the favor of the situation either. The voluntary delegation of the functions and assignments in the case of small LGUs that cannot afford good quality of services is not happening. Neither the voluntary amalgamation nor the inter-communal cooperation for guaranteeing economies of scale on providing some of the local government services has happened.

In this context, government should play an important/active role to provide incentives that could work for inter-local government cooperation, so that local citizens could see the results of improved services due to efficient provision; or to take responsibilities from (and corresponding resources) the small local government units that cannot guarantee efficient service delivery and do not engage in the process of amalgamation or inter-cooperation with other local government units.

4.2 EXPENDITURE ASSIGNMENTS TO MUNICIPAL/COMMUNE LEVELS

The Law on Organization and Functioning of Local Government (8652/2000, chapter iv) broadly assigns responsibilities to local governments. It associates responsibilities with the theoretical concept of benefit areas building on the principle of subsidiarity adopted by the European Charter of Local Self

Governance⁷ (local governments are assigned responsibilities for services that benefit the local jurisdiction, so that authorities will be accountable to their own citizens -- chapter ii, art. 4.2). Although the organic law on local government has established a sound foundation for the assignment of expenditure responsibilities, the initiative for further specifying responsibilities and powers has essentially been left to the decisions of the line ministries, and in many cases this approach has brought unclear assignments⁸ for local governments.

Figure 4.6 Overall framework of function's allocation in Albania⁹

The Organic Law assigns only generic responsibilities to local governments according to three functions' categories: exclusive, shared, and delegated functions.

- ***Exclusive Functions:*** functions given by law to the local government unit, for the realization of which it is responsible and has the authority to make decisions and use means for their realization, within the norms, criteria and standards generally accepted by law. Local governments shall exercise full administrative, service, investment and regulatory authority over these functions (8652/2000, art. 2). Public services related to infrastructure and public utilities form the core of exclusive functions of local governments in Albania, including water supply, sewage, drainage systems; construction, rehabilitation and maintenance of local roads; public lighting; public transport; cemeteries and funeral services; city/village decoration; parks and public spaces; waste management; etc. Some areas of social, cultural and recreational functions together with some assignments on local economic development and civil security are also exclusive functions legally assigned to local governments.

Although, most of the local infrastructures and public utilities services were decentralized, the transfer of the respective state properties has not been finalized yet¹⁰, thus creating difficulties for local governments to perform their functions and responsibilities¹¹.

The Organic Law, which defines the exclusive functions for local governments, was followed from a series of other sectoral strategies and specific laws that give the overall policy of the government on respective sectors and define the specific legal framework within which functions and assignments are delivered from the local government.

In the case of **water supply and sewage**, a series of laws, bylaws and regulations have been drafted and approved aiming to improve the performance of the sector and ensuring the necessary legal regulatory bases that defines responsibilities and assignments¹². The process of

7 See European Charter of Local Self-Government, Council of Europe, Strasbourg, October 15, 1985

8 The case of urban planning, environmental protection, education and health, social assistance, etc.

9 Toto, R., 2009, Decentralization and Analysis of Government Functions: National, Regional and Local – Draft Report

10 The transfer of state properties started in 2001, pursuant the Law on The Transfer of Real-estate Assets from Central Government to Local Government Units (8744/2001, art. 2, 3 and 4) amended by Law on Immoveable State Property (9558/2006) and is still on – going. Although there are 363 Decisions of Council of Ministers (DCM) for the approval of the inventory list of local assets; 220 DCMs on approval of the preliminary lists for transferring local assets to LGs and 120 DCMs for the approval of the final lists of properties/assets for LGs, the process of transferring local assets is reported with many delays and difficulties. (Draft Crosscutting Strategy on Property Issues 2012-2020, Ministry of Justice, June 2012)

11 The assignment of functions and the transfer of properties are seen as separate processes so they couldn't influence each-other. The transfer of asset was totally in block and not separate by function being assigned. Still local governments rely on the potential of local assets for economic development purposes and funding possibilities – such as public private partnerships, etc.

12 The basic norm for addressing the applicable law relative to the state public companies is Article 213 of Law on Entrepreneurs and Commercial Companies (9901/2008). The corporate form of water companies in Albania is referred as "joint stock companies" and they are regulated under this law. According to the water utilities "draft statute" approved by DCM 678/2007, the legal activity of a water supply and sewerage joint stock company is defined as to ensure and sell the service of potable water supply and sanitation, production and/or purchase of water to meet customer demand and maintenance of both water supply and sanitation services. The Supervisory Council represents a governing body of a water supply and sewerage joint stock company according to the Statute. On the basis of the Law on the Regulatory Framework in the Water and Sanitation Sector (8102/1996) as amended with Law 9352/2005 and Law 9915/2008, the Water Regulatory Authority (WRA) is the independent body that has the exclusive right to set tariffs and license operators in the water sector.

registering the ownership of water utility assets against company shares, owned by the LGUs is still ongoing in the cases that water utilities were transferred to local governments¹³.

In the case of **local roads, public lighting, parks and public squares**, local government units have the responsibility to build and maintain infrastructure situated within their administrative boundaries. These facilities, as public properties, are still in a process of transfer to local government units. Thus while LGUs have the competency over the services, most of them still have not acquired ownership. The major issue for this assignment is the investment funds. LGUs do not have sufficient own revenues to cover investments, and there is a strong debate on available public funds for capital investments at local government level. The available competitive grant schemes result in inefficient defragmentation of the investments¹⁴.

Solid waste collection is an exclusive assignment completely transferred to local governments. Part of the service is covered by the solid waste collection tariff, which does not cover full cost. Given that there are no service standards, the quality of the service varies from one LGU to the other and in several communes it is not offered at all. Solid waste treatment remains an issue of major concern. Municipalities, being urban areas, do not have land to accommodate landfills¹⁵. There is a general understanding that landfills should be built and used upon an inter-local cooperation agreement and serve a number of LGUs that form economies of scale. However, LGUs do not have funds to support construction of regional landfills. Country wide, there are two cases of regional landfill construction with donor support. (Toto, 2009)

Public transport is other exclusive function transferred to local government and very discussed in terms of performance and efficiency. LGUs are responsible for designing transport policies, traffic management plans, registering private cars, licensing public transportation vehicles for the transportation systems within the region, and are the ones struggling with the deficiencies of the sector.

- *Shared Functions*: are functions for which the local government unit has its share of responsibility, distinguished from the share of responsibility granted to central government, and the functions are accompanied proportionally with competencies, which are exercised autonomously (8652/2000, art. 2). The Organic Law on Local Government broadly defines the pre-school and pre-university education; primary health service and public health protection; social assistance and poverty alleviation; public order and civil protection and environmental protection as the main shared functions between central and local government, but without assigning clear competences to local government level.

Regarding **education and health care**, local governments were given full responsibilities on the operation and maintenance of the facilities (kindergarten, school buildings, clinics, etc.), but no decision making over personnel or investments¹⁶. This has resulted in a problematic guarantee of good quality of the physical infrastructure in place, especially in terms of maintenance.

Social protection and poverty alleviation – defined by The Organic Law as shared functions, are in practice implemented as delegated functions, for which local governments are performing as “agents” (de-concentrated agencies). Within the existing legal framework of the sector¹⁷, local governments are providing the listing of beneficiaries and approving these, as well as delivering the payments established from the central government.

13 The transfer of water supply and sewage was done as the transfers of properties and not as the transfer of the function as an exclusive one where administrative, maintenance, investment and regulatory authority are not regulated as should be by law

14 See Co-PLAN, Intergovernmental Transfers in Albania: A reflection on how local revenues are derived from national sources, LGI/OSI 2010

15 So far, incineration is not considered as a feasible option in Albania.

16 Capital investment on these functions are mainly done through conditional transfers deriving from line ministries

17 Law 9355/2005 “On social welfare”, amended with Law 9602/2006 and with Law 10 137/2009

Environmental protection is the other shared function between central and local government. Even the new Law on Environmental Protection (10431/2011) does not bring clarity on the role of LGUs on environmental management. Regional Environmental Agencies that operate at county level and under the authority of the Ministry of Environment, Forests and Water Administration (MEFWA), oversee legal compliance, approve procedures for Environmental Impact Assessment, measure the air pollution and collect data from the other central institutions for the quality of the environment.

Delegated Functions: “The delegated functions and powers are mandatory and non-mandatory” and authorized by the central government. “The central government should describe the procedures for carrying out these functions and the manner in which it will control its provision ... In any case, the central government guarantees necessary financial support to the local government units to exercise delegated functions and powers”. (8652/2000, art. 12) The Organic Law on Local Government defines social protection and poverty alleviation as shared function between levels of government, but the way, in which it has been assigned so far, de facto it presents more features of a delegated function.

Regional Councils are also considered autonomous second level local government units. As such they have been organized as coordinating bodies with very little exclusive responsibilities for preparing regional policies and implementing them in harmonization with national policies¹⁸. Law on Organization and Functioning of Local Governments (8652/2000) also gives regional councils the right to perform any other function that is voluntary delegated from communes or municipalities, in case they do not have capacities do deliver that function. On the other hand, regional councils do not have any fiscal power, even in the cases of voluntary delegated functions from LGUs; they cannot raise revenues or levy taxes. Regional councils remain very dependent on the voluntary delegation of assignments (which has not happened so far) and keep on living on transfers from central government and LGUs constituent. Many LGUs suffer from a very high fragmentation of services, lack of economies of scale, inefficiency and lack of human capacities to respond to citizens needs.

¹⁸ Focused mainly in inter-urban and rural roads, regional strategies and urban planning, regional transportation services and environmental protection

Table 4.4 LG Functions in Albania

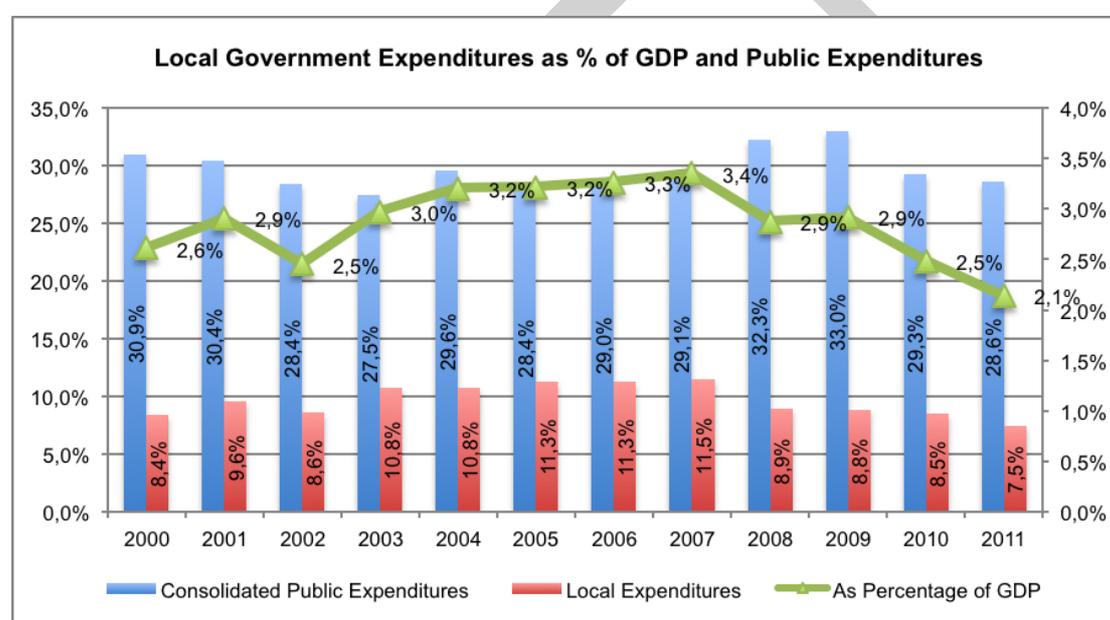
EXCLUSIVE FUNCTIONS				SHARED FUNCTIONS
Infrastructure and Public Services	Social Cultural and Recreational Functions	Local Economic Development	Civil Security	
<ul style="list-style-type: none"> • Water supply; Sewage, drainage system • Construction, rehabilitation and maintenance of local roads • Public lighting; • Public transport; • Cemeteries and funeral services; • City/village decoration; Parks and public spaces; • Waste management; • Urban planning, land management and housing 	<ul style="list-style-type: none"> • Saving and promoting the local cultural and historic values, organization of activities and management of relevant institutions; • Organization of recreational activities and management of relevant institutions; • Social services including orphanages, day care, elderly homes, etc. 	<ul style="list-style-type: none"> • Preparation of programs for local economic development; • The setting [regulation] and functioning of public market places and trade network; • Small business development • Services in support of the local economic development, as information, necessary structures and infrastructure; • Veterinary service; • The protection and development of local forests, pastures and natural resources of local character. 	<ul style="list-style-type: none"> • The protection of public order to prevent administrative violations and enforce the implementation of commune or municipality acts; • Civil security. 	<ul style="list-style-type: none"> • Pre school and pre university education; • Primary health service and protection of public health; • Social assistance and poverty alleviation and ensuring of the functioning of relevant institutions; • Public order and civil protection; • Environmental protection; • Other shared functions

4.3 LEVELS OF EXPENDITURES

The following section brings an overview of the patterns identified on local government expenditures during the last 15 years and analyzing the main trends identified.

Table 4.3 below shows local government expenditures in Albania as percentage of GDP and total consolidated public expenditures between 2000 and 2011. As can be noted from the table, local government expenditures increased substantially both as percentage of the GDP and of public expenditures between 2000 and 2007, when they peaked at 3,4% of the GDP, declined somehow during 2008 and 2009 to 2,9% of the GDP and then declined dramatically during 2010 and 2011 to the levels of 2,1%. This share of local expenditures compared both to GDP -- 2,1% and public expenditures -- 7,5% is quite lower even than the levels of local expenditures reported in 2000 – considered as the milestone for the beginning of the fiscal decentralization reform.

Figure 4.3 Local Government Discretionary Expenditures compared to GDP and Consolidated Public Expenditures

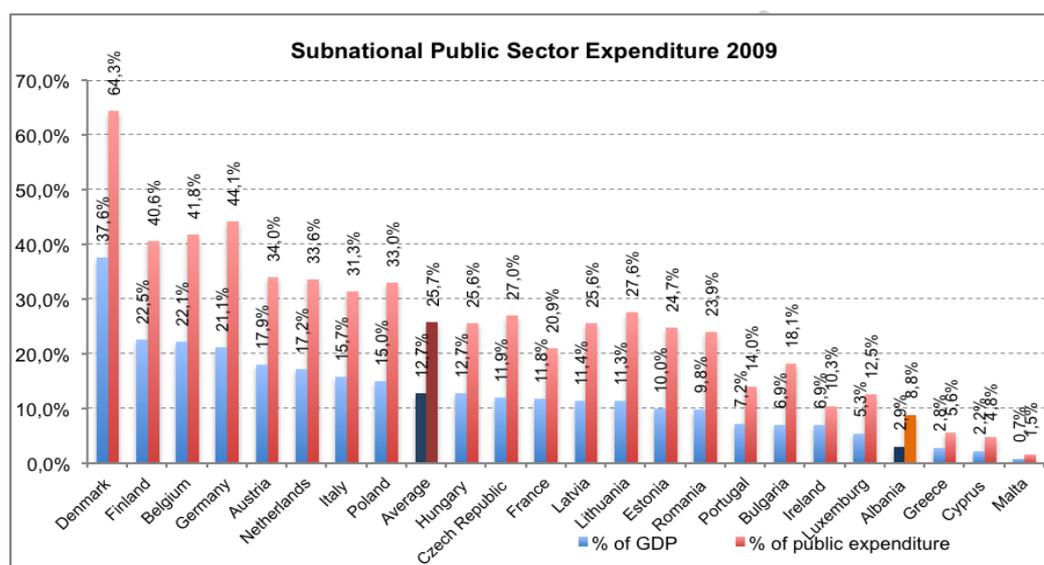


Source: MoF, data 2000 – 2011, Own Calculations

What is interesting to note from the figure 4.5 is that both general public expenditures and local expenditures were increased in nominal terms during 2008 and 2009, but while general public expenditures peak to the highest levels of 33% of the GDP, due to the huge investments undertaken from the GoA in road infrastructure, the local government expenditures declined to the levels of 2,9% compared to 3,4% of the GDP. During 2010 and 2011 although the GDP increases in total by almost 15%, the public expenditures decline to the levels of 28,6% of the GDP while the local expenditures fall down to the lowest level ever reported 2,1% of the GDP and 7,5% of the general public expenditures.

While the situation for the local expenditures in Albania is presented more dramatically, even in the best years the local government expenditures levels remain quite low compared to the European Union countries where sub national public expenditure levels count in average for 12,7% of the GDP and 25,7 of the public expenditures. (see Figure 4.4, Sub national Public Sector Expenditures 2009)

Figure 4.4 Sub national Public Sector Expenditures 2009 (Albania compared to EU countries¹⁹)



Source: Dexia 2011, own calculations

¹⁹ Dexia, Subnational Public Finance in European Union, July 2011

Table 4.5 Local Government Expenditures 2000 – 2011

Description	2000	2001	2002	2003	2004	2005	2006	2007	2008 ²⁰	2009	2010	2011
GDP	551.282	611.622	677.272	739.048	751.024	817.374	893.006	980.103	1.089.300	1.151.000	1.238.100	1.314.700
Cons. Public Expenditures	170.620	186.049	192.517	203.000	222.439	232.339	258.816	285.674	351.492	379.863	362.752	376.189
<i>As % of GDP</i>	30,9%	30,4%	28,4%	27,5%	29,6%	28,4%	29,0%	29,1%	32,3%	33,0%	29,3%	28,6%
Local Expenditures	14.391	17.785	16.613	21.948	24.050	26.272	29.121	32.852	31.325	33.582	30.764	28.119
<i>As % of GDP</i>	2,6%	2,9%	2,5%	3,0%	3,2%	3,2%	3,3%	3,4%	2,9%	2,9%	2,5%	2,1%
<i>As % of Cons. Public Expend.</i>	8,4%	9,6%	8,6%	10,8%	10,8%	11,3%	11,3%	11,5%	8,9%	8,8%	8,5%	7,5%

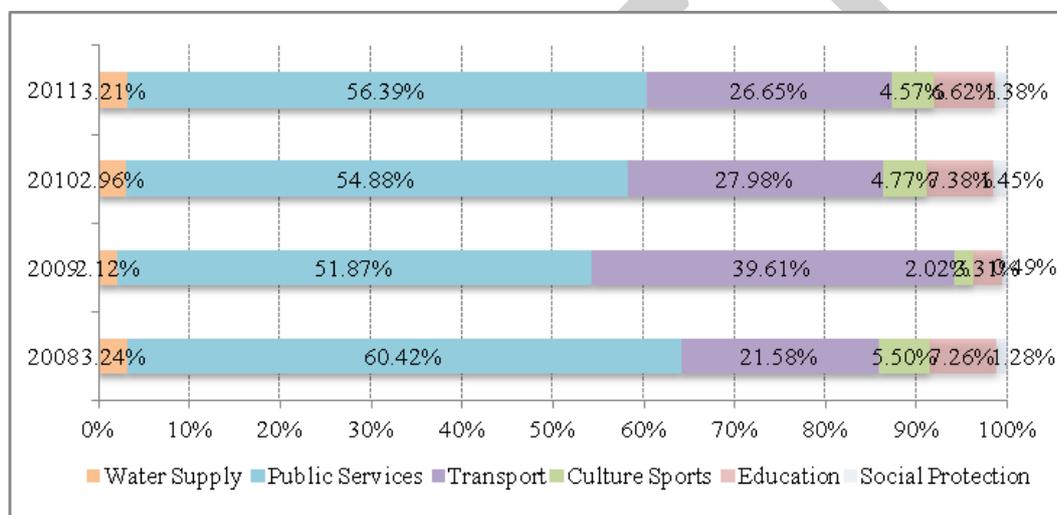
Source: MoF, data 2000 – 2011, Own Calculations

20 Starting from 2008 the data on local government expenditures disclosed from Ministry of Finance are not clear when reporting the expenditures done through conditional and competitive grants for local government. For this reason, we stress that the figures presented as local government expenditures for local governments for 2008 to 2011, unlike previous years, might not include all the data for expenditures done through conditional grants and competitive grants (or regional development fund). Ministry of Finances mentions that due to the new redesigned treasury system and program based reported expenditures, the data for expenditures done at local level through conditional grants and competitive grants (regional development fund) --- other from infrastructure investments --- are reported as expenditures of the Line Ministries.

4.4 LEVELS OF EXPENDITURE BY ASSIGNMENT

The share of local government budget (both conditional and “own” budget) in the total public expenditure between 2008 and 2011 has been fluctuating from 12,8% to 14,3% in 2009; 13,6% in 2010 and again 12,5% in 2011. Although many functions and expenditure assignments were transferred to local government level, still the financial sources for supporting them remain limited. Shared functions like healthcare, education and social protection are almost fully covered through public expenditures and local government contributions for all of them together only account for around 6,4% of its own budget (with discretion). On average, local governments have executed more than half of their own budget (with discretion) on general public services (public administration) and about 30% of spending on road infrastructure and transport services. (see Figure 4.5. The functional structure of Local Government)

Figure 4.5 Functional Structure of Local Government (2008 – 2011)



Source: MoF, data 2008 – 2011, Own Calculations

Social Assistance: presented as the largest single category of local government expenditure. It accounts for around 30% plus of total local expenditures. Still from the features with which this function is presented in the series of local government assignments, it can be considered more as a delegated function at local government than a shared function. It is completely financed through earmarked grants from the central government and is executed based on the guidelines issued by the Ministry of Labor, Social Affairs, and Equal Opportunity (MLSAEO).

Education: both primary and secondary educations are a shared function between central and local government. Central government is responsible for the management of the education process (designing the curricula, assigning personnel, deciding and financing investments, etc.) while local government is responsible for the operation and maintenance of the respective facilities²¹. Teacher salaries, which until 2007, were paid from local governments (through conditional grants) are now are directly paid from the Ministry of Education. The operating and maintenance spending of local government on educations count for an average 6,2% of local government own expenditures.

²¹ Capital investments are also responsibility of local governments and are covered through conditional grants assigned from line ministries, through the annual budget law

Other social services: organization and management of sports; institution and the administration of the institutions such as daycare centers, elderly homes and orphanages, count for about 5% of the local government own expenditures.

Local roads, public lighting, parks and public squares: local government units have the discretion to spend on building and maintaining infrastructure situated within their administrative boundaries. The costs of these assignments are mainly financed through local government own expenditures, and in some cases through conditional grants obtained in the competitive grants scheme (regional development fund, since 2010). This group of exclusive assignments consumes about 30% of the local government own budgets.

Water Supply: local governments have the authority and the responsibility for the provision of water supply and sanitation services in their respective service areas. 90% of the water utility shares and assets were transferred to the LGs. The ownership of water utility assets by law is registered against company shares, which are owned by the LGs.

The major portion of the water utilities are not able to cover operating costs due to a combination of low tariffs, low bill collection rates, high levels of non-revenue water, and overall service inefficiencies. Average total cost coverage, based on revenues (amount billed) is at the level of 66.6%, while based on actual current collections, the total cost coverage is 56.1%. (National WSS Sector Strategy 2011 – 2017)

Water utilities obtain subsidies based on Decision No. 6569, of 27.06.2006, jointly issued by the Ministry of Public Works and Transport, and the Ministry of Finance, “On the Criteria and Procedures for the Usage of State Subsidies for Water Supply Utilities”. These subsidies are issued on an annual basis to cover energy and social security contribution costs. The government policy has been to reduce the amount of subsidies over the last four years. On the basis of the sector decentralization reform, subsidies should be phased out and terminated in the near future.

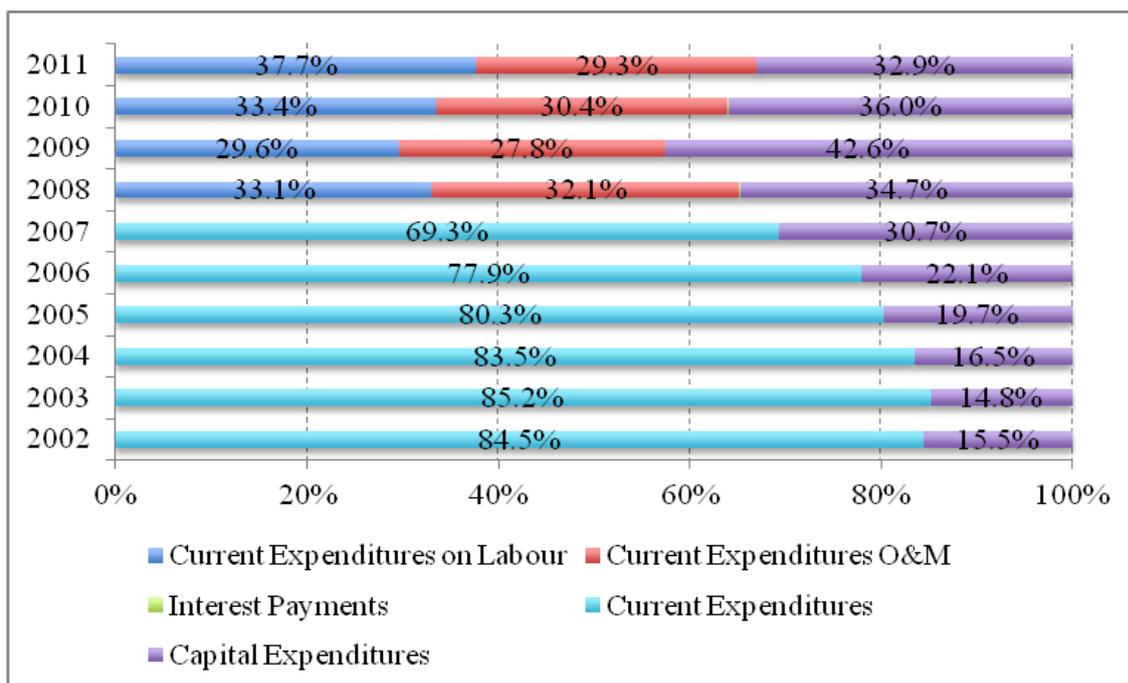
While capital investment needs are quite high due to the deteriorated infrastructure to responsibility to offer the service are not clear. It seems the central government has the primary role of channeling donor and other funds for capital improvements, but is not clear on what basis and how the need for investment is defined at the central level. The local governments have to struggle with the huge need for better service delivery; high fragmentation of the service that results in a very inefficient service delivery; and the dramatic lack of funding opportunities in the sector.

A series of clear decisions should be made to guarantee that the local governments can take full responsibility and can better managing the water supply companies.

General public services: have to do with the variety of administrative functions carried out of local governments. This is the biggest category of spending within local government “own” budget and consumes more than 55% of the spending. In smaller LGUs this category of expenditures counts for even more than 80% of the local “own” expenditures.

The economic composition of local expenditures has changed through years, from being quite concentrated on ‘wages and salaries’ to a more balanced division between expenditures for operation and maintenance and capital expenditures. While operation and maintenance expenditures remain to the same levels, expenditures on labor (wages and salaries) continue to grow. To prevent this and keep a reasonable balanced level of expenditures on labor, central government has introduced caps and limitations on the unconditional transfer delivered to local government, which based on the population number of the LGUs, define the amount (as share) of the unconditional grant that can be used for expenditures on labor.

Figure 4.6 The Economic Composition of Local “Own” Expenditures (2002 – 2011)



Source: MoF, data 2002 – 2011, Own Calculations

Capital expenditures grow from 2002 (15%) to come to their maximum in 2009 (42%) and fall again after 2009, mainly due to the financial crisis and limitations set for local borrowing, and to the drawdown of the unconditional grants. The capital investments remain at the moment the most controversial issue in the structure of the local finances in Albania. While the assignments of local government functions generally have been accompanied with the necessary financial sources or revenue raising instruments, capital investments remain in most of the cases unfunded, although central government have experimented and is still experimenting through different instruments (competitive grants scheme, regional development fund, etc.)

4.4.1 Assessment of Expenditure Assignments to local governments

After almost twelve years since Albania seriously undertook the fiscal decentralization process, quite a number of responsibilities and functions have been assigned to local governments both as exclusive or shared. While in terms of type of responsibilities and functions assigned at the local government level Albania is quite well compared with the countries in the region, the situations is not presented the same in terms of the share that local government expenditures have as part of both GDP and general public expenditures. On the contrary it results in the lowest in the region, despite the range of responsibilities and functions. Local governments in Albania are strongly complaining about unfunded mandates (functions and responsibilities assigned to LGs without funding possibilities)²².

The issue of the unfunded mandates accompanied with the series of other issues²³ identified in this section should be addressed as part of the reform needed to be undertaken for moving forward the fiscal decentralization.

²² The water supply is one of the most evident cases, but the same can be said for social services, education, environment, etc.

²³ (a) a still unclear assignment of responsibilities for specific competences (both for first level and second level of local governments) especially with respect to shared functions, which can bring concurrent authority or un-clarity to the provision of the services (education, social protection, environment, etc.); (b) insufficient delivery of local services to the citizens caused mainly due to the high fragmentation of the local government units and delayed process of local asset transferring. Both this issues have led to inefficiencies, high costs of local service provision and poor quality of services and rapid deterioration of the capital stock; (c) unclear separation in the assignments of responsibilities for capital expenditures, which has resulted with increased levels of capital investments, but lack of general big picture and fragmentation of the investments

4.5 RECOMMENDATIONS FOR IMPROVING ADMINISTRATIVE TERRITORIAL STRUCTURE AND EXPENDITURE ASSIGNMENTS

4.5.1 Administrative Territorial Structuring

The existing administrative territorial division of Albania and its impacts on the efficiency of services and effectiveness of governance brings many arguments to support the discussion on a needed administrative-territorial reform.

There are a number of other arguments that emphasize the need for an administrative-territorial reorganization:

- *Albania's territorial reorganization has been and remains a political priority.* Currently, and in general during pre-election periods, this issue is at the forefront of political agendas;
- *Albania's territorial reorganization is the recommendation of the revised Decentralisation Strategy, in 2007 and also of the 2010 reviewed draft.* This recommendation is based primarily on a generic discussion on the efficiency of services provided by local units;
- *In the context/discussions of regional development and further regionalization of Albania,* one of the determining factors is the territorial reform;
- *Territorial reform is a "hot topic" of the national debate,* at least since 2003; several proposals have been made from Council of Europe²⁴ and other donors²⁵ on restructuring territorial division in Albania.

Voluntary and Compulsory Amalgamation

The current debate on territorial administrative reform can be informed by the examples of compulsory amalgamation efforts in many European countries (Denmark, Sweden, Belgium, England, etc. in 1970's and Greece, Scotland, Latvia, Macedonia, etc. in the late 1990's beginning of 2000's) or by adopting regulations, which promote cooperation and associations among existing local governments (France, Spain, Italy, etc.)²⁶. The compulsory reform amalgamation model has the advantage of being more effective and simple to operate, but it risks to create political turmoil in some societies, since top-down reforms may confront some traditional local costumes. The liberal/voluntary model has the advantage of respecting these costumes and letting the inter-local government administrative arrangements be made in their own pace, but has the disadvantage of being much more complex. (WB, 2004)

A combination of both approaches has been proposed recently by OSCE, considering a three-step process, which starts with a voluntary amalgamation, continues with incentives and support to the consolidated local governments and finalizes with the compulsory amalgamation. The proposed process respects the legal framework set from the Albanian Constitution (article 108) and Law on Organization and Functioning of Local Government (chapter x, article 63 – 71) and will require changes in the Law on Administrative-Territorial Divisions (8563/2000).

Today, there are 46 communes (12% of LGUs) in Albania with a population of less than 2.000 inhabitants, with population 1,47% of total population; and 153 LGUs (41% of total) with less than 5.000 inhabitants, with population that counts for 9,6% of the total population.

24 In September 2003, Council of Europe has shared a proposal on administrative-territorial reform with Ministry of Local Government and Decentralization (today Ministry of Interior)

25 World Bank 2004, UNDP 2005, OSCE 2012, etc.

26 Compulsory vs. Voluntary amalgamation of small communities, Decentralization in Transition, World Bank, 2004

It would be too superficial to start the discussion on an amalgamation process from the perspective of the proposed criteria. However, given the political sensitivity of the issue, if the proposed thresholds would be 2.000 inhabitants the impacts on the population will be low. On the other hand, there is a substantial impact on the communities if the population criteria will be less than 5.000. To address this, the Government of Albania may consider undertaking a flexible approach by: assigning responsibilities and relevant resources to local governments asymmetrically – means according to their respective capacity of delivering the specific local public service efficiently. This should be considered in conjunction with the voluntary or compulsory amalgamation of the LGs. This strategy, could take different forms, but it would basically give fewer responsibilities to smaller LGs in some critical services that are negatively affected by small size and would give to regions (qarks) the responsibility for providing those critical services in the smaller municipalities. The responsibility for additional services, and the funding sources to accompany them, would devolve in the future to LGs that reach the minimum prescribed scale through voluntary amalgamation.

Incentive instruments (including technical support, training, and financial/fiscal support) can be introduced in such a way that local governments could easily understand the benefits of the voluntary amalgamation in terms of increased efficiency and better performance.

The number of small LGUs under 2,000 and 5,000 population is concentrated in approximately 7-8 regions. Consequently, this argues for a regional solution to this problem in order that local characteristics can be more adequately addressed. The regional council could appropriately be assigned the responsibility of restructuring these small LGUs within their territory.

A timeframe period should be defined in which voluntary restructuring could occur. But, if this does not succeed then the regional council would be authorized to undertake a compulsory restructuring based on agreed upon criteria for the size and characteristics of the LGUs in the region.

4.5.2 Expenditure Assignments

Following the main issues in the assignment of responsibilities identified by this paper the main recommendations in terms of expenditure assignments are the following:

- (a) clarify assignment of responsibilities for specific competences (both for first level and second level of local governments) especially with respect to shared functions (education, social protection, environment, etc.);
- (b) introduce incentives for voluntary amalgamation or inter-cooperation of very fragmented local governments in providing services for citizens and prepare to undertake the necessary reforms for compulsory amalgamation;
- (c) finalize the process of transferring water supply enterprises to local governments through clear decisions²⁷, so to guarantee that the local governments can take full responsibility and can better manage the water supply companies.
- (d) clarify the separation in the assignments of responsibilities for capital expenditures, so to guarantee increased levels of capital investments and efficient investment both at local and regional level.
- (e) make more money available for the local government expenditures to solve the problem of unfunded mandates through different funding possibilities: providing higher level of

²⁷ Regarding responsibilities on the debt the companies are still carrying; needed subsidies for operation costs, service fees and tariffs that should cover the full supply and operational costs, and opportunities for borrowing and covering capital investments

intergovernmental transfers or shared taxes, and/or giving more discretion on raising local revenues and relaxing the borrowing conditions in place for local governments.

4.6 NEXT STEPS

Near Term (within 1 year)

- Initiate a dialogue on administrative territorial restructuring
- Adopt a national level policy and criteria for administrative territorial restructuring
- Enact Law on Voluntary and Compulsory Amalgamation of Territorial Amalgamation with authority to the Regional Councils for implementation

Medium Term (1-3 Years)

- Reconcile census and civil registry data and define for each purpose what source of information will be used (especially in terms of administrative territorial reform, expenditure assignment, intergovernmental transfers, etc.)
- Utilize reconciled population data for purpose of LGUs amalgamation and unconditional grant transfers
- Begin process of voluntary amalgamation
- Develop expenditure assignments based on population data and asymmetrical assignment of functions to LGUs
- Clarify the roles of different government levels in relation to shared functions. Start transferring some of the shared functions to LGUs on basis of their willingness and capacity to assume these functions with additional transfers to cover the costs of these assignments
- Develop national level service standards

Long Term (3-5 years)

- Complete voluntary and compulsory amalgamation of local governments by regional councils
- Complete transfer of shared functions with appropriate financing from the central to the local level

5. REVENUE ASSIGNMENT AND INTERGOVERNMENTAL TRANSFERS

This section will examine the relationship between the revenues assigned to the local government units and the impact on the intergovernmental transfers. It focuses on the range of possible local government revenues and examines the extent to which these are being fully utilized to provide adequate fiscal capacity to the local governments. In addition, the section discusses the trends of the conditional and unconditional transfers over the past several years and addresses the stability, sustainability and predictability of the transfers.

Section Highlights

- 1. While a basic legal revenue and intergovernmental framework exists, there are inconsistencies in these laws relative to appropriate definition of taxes and fees that needs to be corrected**
- 2. There is a lack of clarity and use of grants and shared taxes in the legal framework**
- 3. There is great difficulty in tracking revenues and transfers from year-to-year due to technical and accounting practices within the Treasury system that needs to be addressed.**
- 4. Local government revenues and grants increased from 2002 to 2009, then dramatically declined even though total public revenues continued to increase.**
- 5. The decline of local government revenues poses a serious threat to improving the fiscal capacity of the LGUs and further progress in achieving fiscal decentralization.**
- 6. Changes in the Small Business Tax and the VAT have contributed to substantial difficulties in local government revenues from the data analyzed.**
- 7. Improving the efficient collection of taxes, including the property tax, should be a high priority at the national and local government levels.**
- 8. There is a great deal of complexity and confusion in defining the transfers from year-to-year in the Annual Budget Law that needs to be corrected to make these more objective, transparent and simple.**
- 9. A per capita analysis by population quartiles indicates a large number of small local governments by population size have limited own source revenues, but receive a substantial share of the grants to produce a relative high level of horizontal equalization.**

10. There is a need for a comprehensive review of the equalization system and stabilizing the rules for allocation of grants with greater transparency and certainty from year-to-year.

5.1 GENERAL LEGAL FRAMEWORK FOR LOCAL GOVERNMENT REVENUES

Article 1 of Chapter V of the Law on the Organization and Functioning of Local Governments (LOFLG) of 2000 states that “National fiscal policy shall guarantee the fiscal self-sufficiency of local governments through diversified revenue sources.” The law then states that local governments in Albania may receive revenues from four basic sources:

- Revenues derived locally through the imposition of own taxes, fees, fines and penalties, as well as from the rental or sale of local government assets.
- Revenues derived from unconditional and conditional grants from the national government
- Revenues derived from shares in the Personal Income Tax (PIT) and the Corporate Profit Tax.
- And income derived from borrowing.

These basic categories correspond to the most important categories used to define local government revenues in other countries. Unlike in many countries, however there is no single piece of framework legislation in Albania that defines the fundamental rules governing each and every important local government revenues. Instead, these rules are located in a variety of different laws, including the Law on the Organization and Functioning of Local Governments (LOFLG), the Law on Local Government Tax Systems (LLTS), Law on Budgetary System, the Law on Local Government Borrowing, and – importantly— the annual Budget Laws of the national government.

More importantly, these laws are not entirely consistent with one another and the definitions of particular types of revenues that they contain are not always in agreement. Moreover, some local government revenues that are important in other countries and possible under Albanian Law have yet to be introduced in practice. In the following, we briefly discuss the major problem in the legal framework for own revenues, and for grants and transfers from the national government. Later in the chapter we discuss the regulation of local government borrowing.

5.1.1 Legal Framework for Own Revenues

The LOFGL creates a catalogue of locally derived taxes that includes recurrent property taxes on agricultural land and urban buildings; a tax on small businesses; a hotel tax, a tax on the transfer of immovable property, and income taxes on gifts and inheritances. It also states that local governments should have the right to set the rate of these taxes within the limits determined by other laws, and to establish fees for the use of public space, and for the provision of local public services.

This catalogue of locally derived revenues was augmented in 2002 by the passage of the Law on the Local Government Tax System (LLTS), a law that has been amended in 2006, 2009, 2010. This law defines in greater detail the tax and fee powers of local governments, and importantly adds an Infrastructure Impact Fee to the catalogue of local taxes. We discuss these in greater detail later on. Here, however, it is important to note that while the LLTS sought to clarify the own-revenue powers of local governments, it has also introduced a number of definitions that are not consistent with the LOFLG and which need to be clarified.

The first set of problems concerns the Tax on the Transfer of Immovable Properties and the Tax on Vehicle Registration both of which are considered to be local government taxes under both the

LOGFLG and the LLTS. Article 28 and 29 of the LLTS however defines the bases and rates for these taxes in ways that make it clear that they should not be considered local government taxes at all. Instead, they should consider shared taxes because their rates, bases and collection are completely controlled by the national government (though 100% of their yield is earmarked for local governments on an origin basis).

The second and more important set of problems concerns repeated confusion of the idea of a fee for a public service, and general-purpose local government tax. For example, Article 32 and 33 of the LLTS on “Other Taxes” and “Temporary Taxes” describes as *taxes* what the LOFLG rightly defines as local government *fees* for the use of public space. Article 35 of the LLTS then compounds this confusion by referring back to LOFLG for its (weak) definition of what constitutes a local government fee. Finally, and perhaps most significantly, these problems were deepened in 2009 when amendments to the LLTS designed to limit local government taxation of small businesses, placed restrictions on their ability to charge businesses for legitimate public services²⁸.

These tensions in the legal framework governing local government own revenue should be resolved, ideally by passing a comprehensive Law on Local Government Finance that contains a complete catalogue of local government revenues with clear and consistent definitions.

5.1.2 Legal Framework for Grants and Shared Taxes

While the LOFLG clearly gives local governments the right to receive grants and shared taxes from the national government in order to “guarantee the(ir) fiscal self-sufficiency...through diversified revenue sources” it says remarkably little about how these grants and shared taxes should be regulated. Indeed, so little is said that the stated purpose of the law in ensuring the “fiscal self-sufficiency” of local governments is in question. Here, there are three basic points to be made.

First, while the LOFLG gives local governments the right to receive shares of PIT and CIT these shares are not specified in the LOFLG or indeed in any other law. As a result, local governments in Albania do not receive shares of either PIT or CIT on an origin basis. This is unusual for both post-communist Europe and indeed much of the EU where shared PIT revenues constitute a significant percentage of total local government revenues. In other words, Albania is not providing local governments with revenues through shared PIT (or CIT), despite the fact that this is made possible by the LOFLG and despite the fact that it is common in the region to do this.

Second, the LOFLG says very little about the nature of unconditional grants. In particular, the law makes no effort to define the size of the pool of funds that will be allocated to local governments every year, by for instance, stating that the pool will be equal to X% of the state budget or Y% of last year’s GDP. Moreover, the law says almost nothing about the formula to be used to allocate unconditional grants to local governments. Instead, the regulation of both issues is left to the annual Budget Law.

This is extremely problematic because it makes an important source of local government revenue completely dependent on the annual decisions of the national government. As a result, local governments cannot reasonably forecast their revenues over the medium term. This undermines their “fiscal self-sufficiency” by impeding their ability to plan major investments or to prudently incur debt. Indeed, because the passage of the state budget often occurs after local governments must set their own budgets, the failure to define the basic parameters of unconditional grants in framework legislation disrupts the entire coherence of the local government process. Not surprisingly –given the absence of these parameters—the LOFLG also does not require the national government to provide

28 See Levitas, Local Government Taxes, Fees and Charges in Albania: Current and Future Challenges, Swedish Association of Local Authorities and Regions/ Association of Albanian Communes September 2010, pp. 1-33

local governments with a budget circular defining the size of their unconditional grants –something that should be a standard practice.

Finally, the LOFGL says very little about the rules governing the allocation of conditional grants. At present there are at least three distinct types of conditional grants in the Albanian system. There are conditional grants:

- For the performance of delegated functions, such as paying the wages of social welfare workers, civil registry employers etc.
- For transfer payments to various recipients of social welfare benefits.
- For investment purposes, known between 2005 and 2009 as “competitive grants” and since then as part of the operation of a Regional Development Fund (established by the Budget Law for 2010).

In financial terms, the most significant category of conditional grants is for transfer payments to social welfare beneficiaries. For example, in 2011 conditional grants for transfer payments amounted to 16.7 billion lek, a sum equal to 40% of total local government revenues (40.5 billion lek). In practice, local governments have extremely limited control over the allocation of these payments. Indeed, the government still does not consider them as local government expenditures. Moreover, there are now pilot projects in four municipalities that are designed to eliminate local governments as the payment agents for social sector assistance. For these reasons, we have excluded these grants in our accounting of local government revenues in what follows.

Conditional grants for delegated functions and so-called competitive grants are regulated by ordinances of the GoA. In theory, these ordinances oblige line ministries to establish priorities and criteria for the allocation of conditional grants. In practice, however, these priorities and criteria are often unclear and non-transparent. This raises serious questions about both the efficiency and the equity of conditional grants, particularly those used for investment purposes²⁹. Local governments also have no way to anticipate how much of these grants they will receive from these grants in any given year because as with the unconditional grant, the Ministry of Finance does not provide them with a budget circular containing this information prior to the formulation of their own budgets. This uncertainty impedes the rational planning and contracting of conditional grants and decreases the transparency of the entire budget process. Reflecting these problems, and in some sense compounding them, is the fact that the financial accounting of conditional grants seems to vary considerably from year to year, and it is very difficult to say how much of the money spent on conditional grants is for delegated functions, and how much is for capital investment through the competitive grants program.

In short, just as Albania needs to review and clarify the legal framework for local government own revenues it needs to revisit the legal framework for grants and transfers in order to increase the stability, sustainability and predictability of local government revenues. Ideally, this should be done through the drafting of a comprehensive law on local government finance³⁰.

5.2 LOCAL GOVERNMENT REVENUES

The fundamental question that needs to be answered when assessing the operation of an intergovernmental finance system is whether the total revenues local governments are receiving is sufficient to allow them to reasonably fulfill the expenditure responsibilities they have been assigned. Answering this question is always difficult because arguments can always be made that local governments need more money. Worse, answering this question is particularly difficult in developing countries in which public service responsibilities have only recently been decentralized to democratically elected governments for two reasons:

29 UNDP, Assessment of design and performance, recommendations for improvements and support in reforming the Regional Development Fund, November 2010 pp 1-11

30 In 2007, a good start towards this end was made but the document was never completed.

- First, recently created local governments typically inherit a huge backlog of local investment needs precisely because central governments have historically failed to fund them. On the one hand, part of the objective of decentralization is to make sure these local needs are met. On the other hand, there is never enough money to meet all these needs at once.
- Second, costing out both these investments and the service responsibilities that have been assigned to local governments is extremely difficult in environments where data is poor, and service standards difficult to establish or agree on.

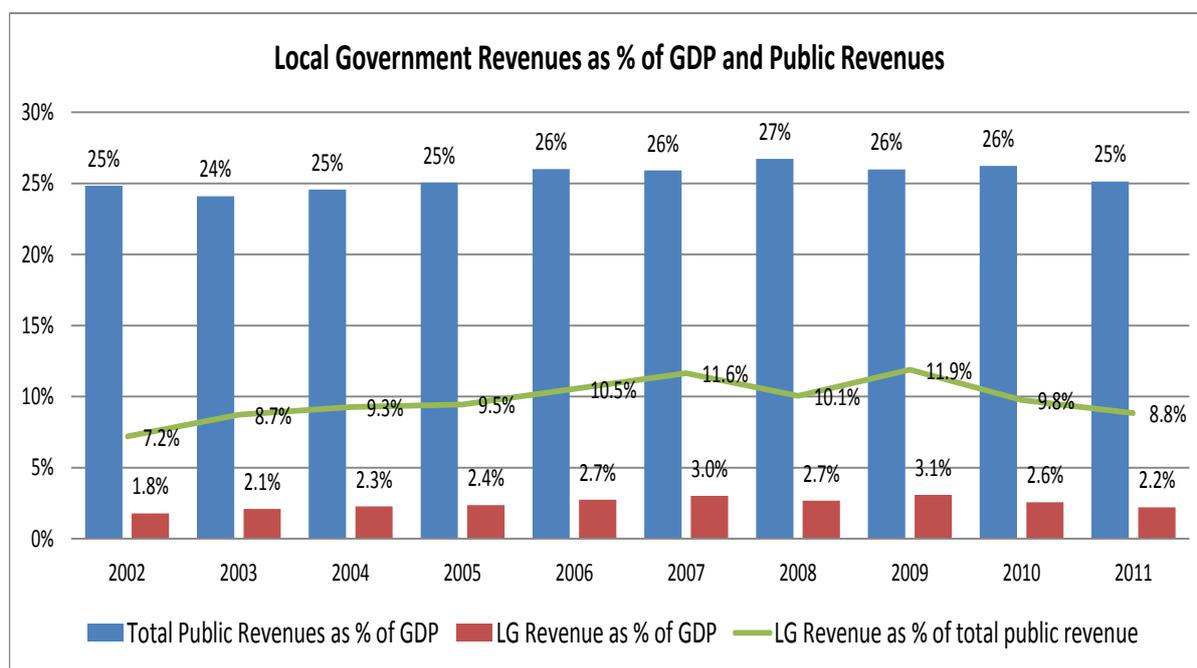
As a result, there is no simple way to establish how much money local governments really need to fulfill the service responsibilities that have been assigned. One way to get a handle on this problem is to compare local government revenues as a share of GDP (and of total public spending) in a particular country, with those of other countries at a similar level of development and in which local governments have been assigned similar functions.

In this section, we look first at the evolution of local government revenues over the last decade and then compare this picture to the situation in other countries in the region. Getting a clear picture of local government revenues over the last decade however is less straightforward than it should be. In part this is because a new Treasury system was introduced in 2008 and the Ministry has yet to align the revenue categories it used in the past with the categories used in the new system. And in part it seems to be because there are technical difficulties in separating competitive grants from other forms of conditional transfers.

As a result the data presented below should be treated with caution until greater certainty can be obtained. Equally importantly, it is imperative that the Ministry of Finance takes immediate steps to clarify the data, standardize codes and categories over years; and resolve any technical difficulties that may remain.

Figure 5.1 below show local government revenues in Albania as percentage of both GDP and total public revenues between 2002 and 2011. As can be seen from the figure, local government revenues both as percentage of GDP and of total public revenues increased very substantially between 2002 and 2007, peaked in 2009, and then have rapidly declined in 2010 and 2011. This decline is quite striking given the fact that both the Albanian GDP and total public revenues actually increased by over 30% (in nominal terms) between 2007 and 2011. Indeed, unlike virtually everywhere else in the region, Albania's GDP has continued to grow in every year since the global recession of 2007.

Figure 5.1 Local Government Revenues as % of GDP and Public Revenues



What this means is that local governments are not only getting about the same amount of total revenue expressed as a percentage of GDP as they did 10 years ago, but that they are now getting less in total public revenues than in any year since 2003.

While it is difficult to determine the main reasons for this decline other than overall fiscal condition and the economic crisis over the past several years, it should be noted that the national budget also suffered some significant declines over these years as well. This is indicated in the following data.

PUBLIC REVENUES

Year	Forecast	Supplemental Budget	Collection (actual)	Reduced by Supplement budget	Reduced by actual
2009	334,823,000	326,117,000	299,502,000	3%	11%
2010	360,955,000	333,658,000	324,721,000	8%	10%
2011	362,223,000	344,047,000	330,475,000	5%	9%

Source: Ministry of Finance

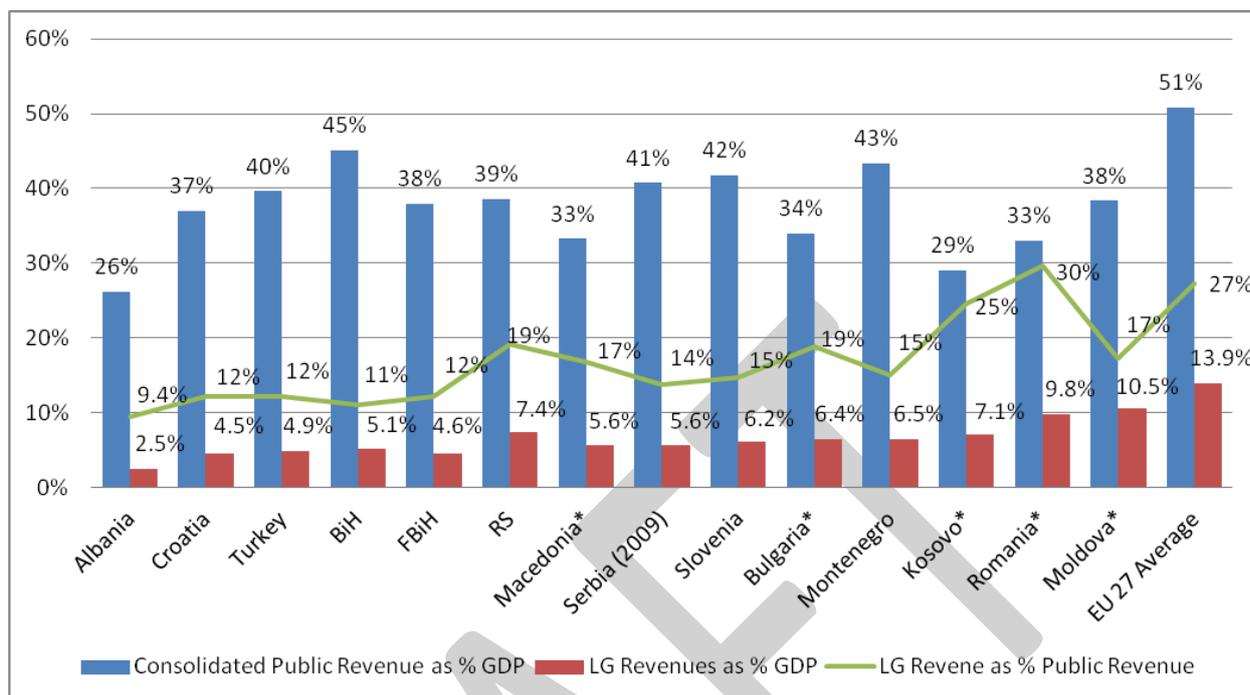
Figure 5.2 below puts local government revenues in Albania in comparative perspective. The figure shows local government revenues as percentage of total public revenue and as percentage of GDP for 12 countries in South-East Europe as well as the average for the EU as a whole. In countries marked with an asterisk (Macedonia, Bulgaria, Kosovo, Romania, and Moldova), local governments are tasked with important social sector functions, most notably paying the wages of primary and

secondary school teachers. These wages amount to between 2.5 and 3.5% of the GDP, and need to be taken into account when reading the data. Elsewhere, in the region, however local governments are primarily responsible for the same basic urban functions³¹.

DRAFT

31 For greater discussion of this graph and the indicators used in it see NALAS, "Fiscal Decentralization Indicators in South East Europe, March 2012. Pp. 1-52

Figure 5.2 Local Government Revenues as % of GDP and total public revenues in the South-East Europe and the EU in 2010



As can be seen from the Figure 5.2, Albania has the smallest public sector of any of the countries presented. Indeed, Albania's public sector is only about half the EU average. This means that Albania –like other countries in the region, but more so-- has problems collecting the public revenues --taxes, fees, and charges-- necessary to support a government that provides adequate public services to its citizens. Or to put the matter another way, one of the most fundamental challenges facing Albania today is improving the country's overall tax culture, and with it the collection of public revenues necessary to support reasonable public services at both the national and local levels. A corollary of this statement is that while both the national and local governments need to improve the collection of public revenues, the national government will have a hard time increasing grants and transfers to local governments so long as it does not improve its own collection of taxes.

For our purposes, however, the most important aspect is that at 2.5% of GDP, local government revenues in Albania in 2010 were the lowest in the region (before falling further in 2011). Similarly, and independent of the national government's difficulties in collecting public revenues, the GoA provides its local governments with a lower share of total public revenues –9.4%-- than any other country in the region. Indeed, the only country in South-East Europe in which the financial situation of local governments is arguably as bad as that of Albanian local governments is probably Macedonia. In 2010 local government revenues in Macedonia were equal to 5.6% of GDP. But this is misleading in comparison to Albania because Macedonian local governments pay the wages of primary and secondary school teachers, wages that amount to between 2 and 3% of GDP. If these wages are taken out of the picture, the revenue of Macedonian local governments are equal to somewhere between 2.6 and 3.0 and thus similar to those of their Albanian counterparts.

This situation should clearly be changed and given the functions that Albanian local governments perform, it would probably be reasonable for the national government to set a policy objective of slowly increasing local government revenues to between 5 and 6% of GDP over the next 5 years and to between 15 and 18% of total public revenues.

5.2.1 The Composition of Local Government Revenues

In Figure 5.3 below is shown the composition of local government revenues by their three main categories –own source; unconditional grants; and conditional grants in billion lek over the last decade³².

Figure 5.3 Composition of Local Government Revenues 2002-2011

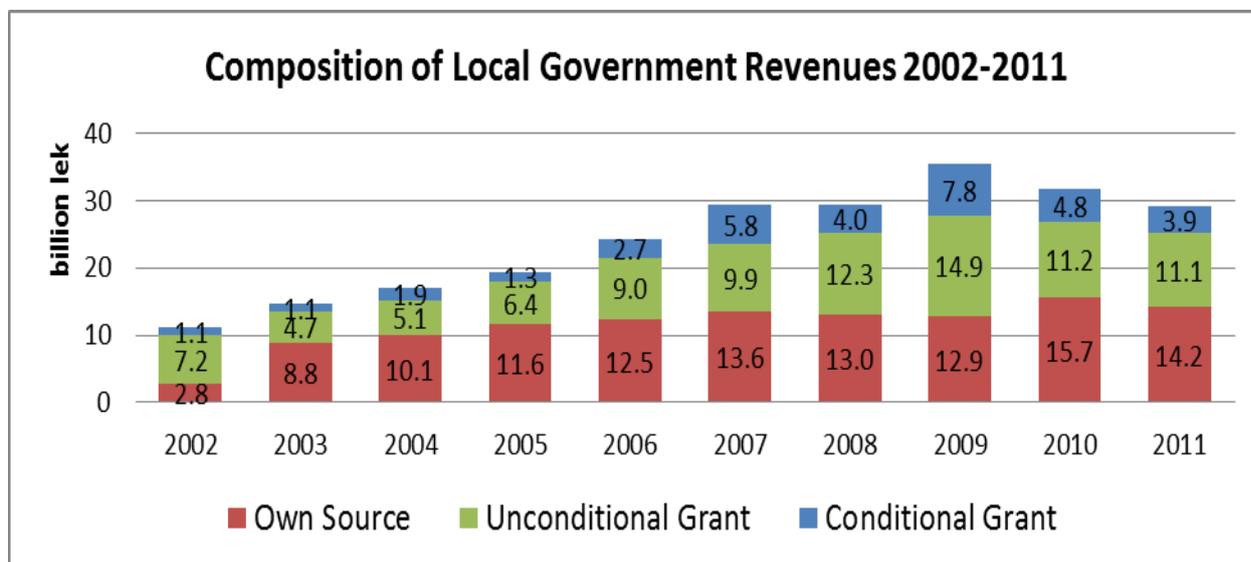
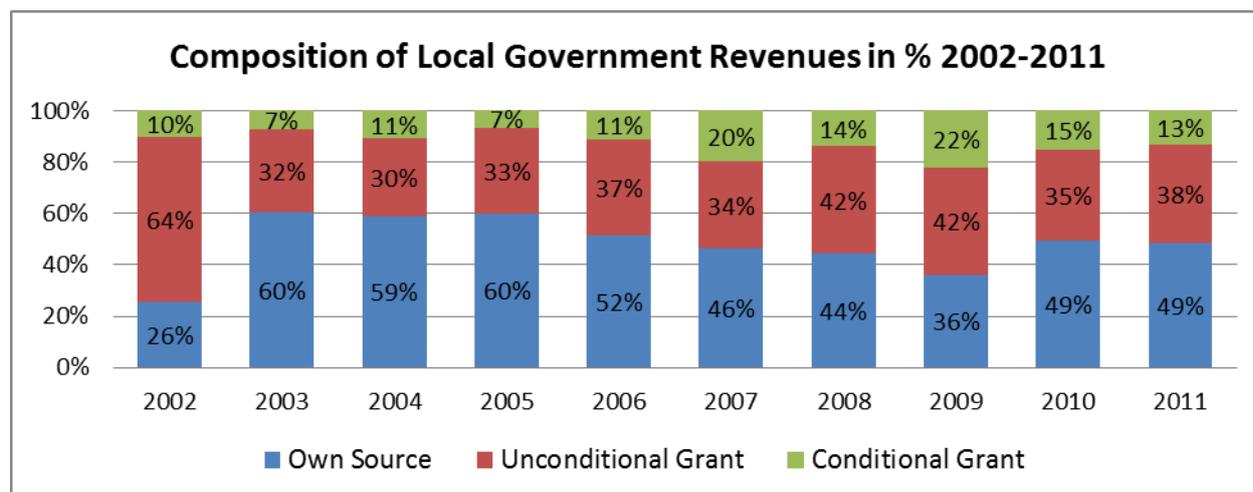


Figure 5.4 below provides the same information in percentage terms. Three aspects of these figures are worth noting. The first is simply that since 2009 there has been a palpable decline in total local government revenues. Second, this decline has occurred primarily because of a decline in grants and transfers, while own revenues have increased. This increase of own revenues however, is deceptive because in 2010 it includes almost 2 bln lek revenues carried over from 2009 (the corresponding figure for 2010 is about 1 bln lek. Indeed, since 2008 the national government has substantially reduced the tax powers of local governments by cutting the base of the Small Business Tax and lowering or capping the rates of other fees and taxes (see next section).

³² Again, there is some uncertainty whether all conditional grants are included in the data. For 2010 and 2011, conditional grants are determined as by adding own revenues and the unconditional grant together and then subtracting this figure from total expenditures.

Figure 5.4 Compositions of Local Government Revenues in % 2002-2011



And third, the share of conditional revenues in total revenues has increased from about 10% at the beginning of the decade to about 15% now. As a result, local governments are getting less revenue now than they were, but they are somewhat more dependent on the national government than before. Equally importantly, changes in national government policy have made all three of their major revenues increasingly unpredictable over time.

5.2.2 The Composition of Local Government Own Revenues

The most important local government own-revenues are regulated by the LOFLG and the LLTS, which has been amended repeatedly since its initial passage in 2002. These include the:

- Small Business Tax (SBT)
- Tax on impact on infrastructure for new constructions
- Recurrent Property Tax on Agricultural Land
- Recurrent Property Tax on Buildings
- (Shared) Tax on the Transfer of Immovable Property tax
- (Shared) Tax on Vehicles
- Tax (Fee) for the occupation of public space
- Tax (Fee) on billboard
- Temporary taxes
- Fees for services (most importantly the so-called Greenery fee)

As we have already indicated, the two pieces of legislation are not entirely consistent particularly with regards to what should be considered a fee and what should be considered a tax. They also include as local government own source revenues some revenue that should be considered shared taxes (the Transfer Tax and the Vehicle Registration Tax).

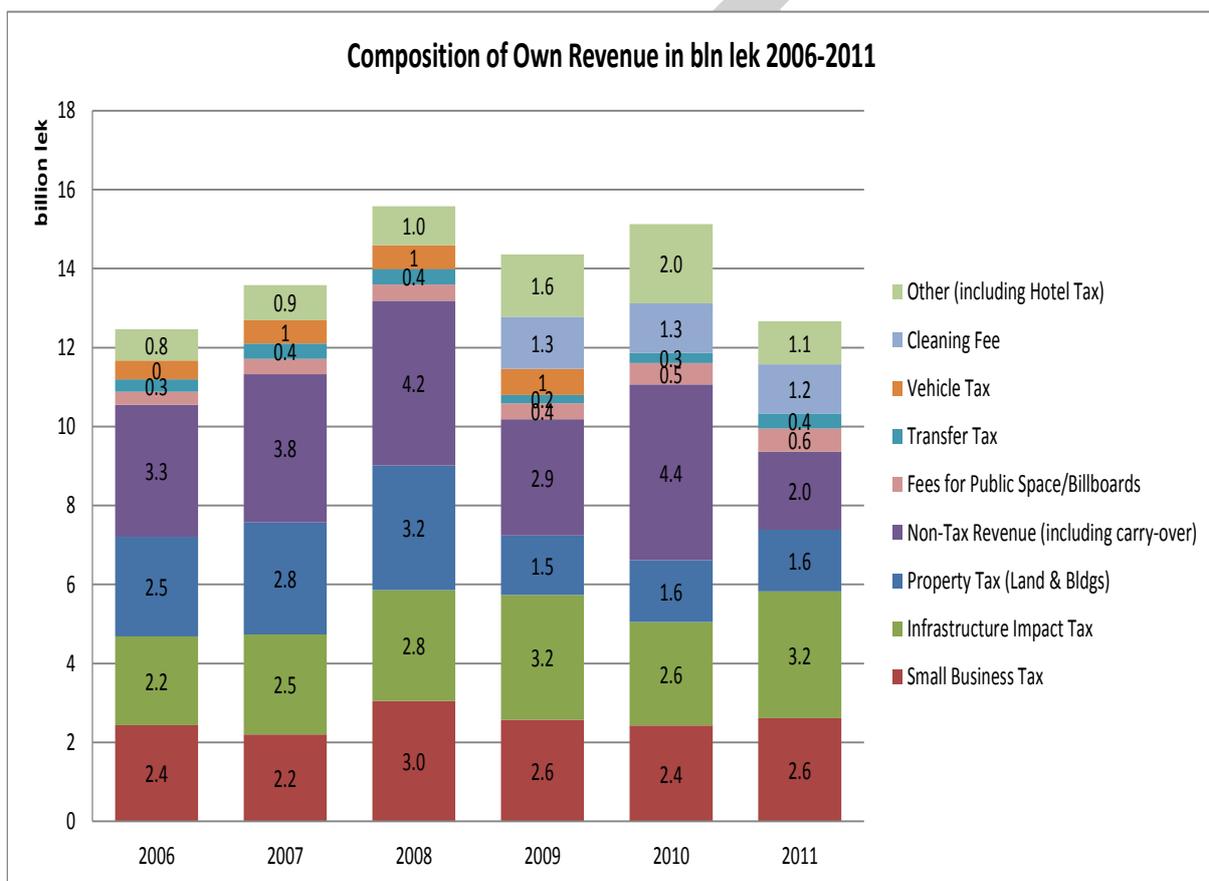
As with the general data on local government revenues, there are problems with the data on local government own revenues³³. Figure 5.5 below presents the composition of local government own revenues between 2006 and 2011 in billion lek. Figure 5.6 presents the same information in percentage terms. As can be seen from the tables the five most important sources of local government

³³ We have one set of files for 2002-2008 that contains a column clearly labeled “capital revenues”. We have another file in which there is no column for “capital revenues” but in which the subtraction of all “own operating revenues” from “total own-revenue” yields values of a similar magnitude to those contained in the first file for the years 2008-2011, suggesting that these are also capital or asset revenues. Unfortunately, it is very unlikely that these are capital revenues because a) local governments own very little property and b) if they sell what they do own the revenues go to the national government.

own revenues are the Infrastructure Impact Tax, the Small Business Tax, the Property Tax; Non-tax revenues (including carry over from the previous year; ; and more recently the cleaning fee.

The Small Business Tax (SBT): The base of the SBT is defined in a schedule contained in an Annex to the LLTS³⁴. Originally, local governments were free to set their rates up to 30% above or below those specified in the schedule, but this was lowered to 20% in 2009. Similarly, local governments were initially allowed to impose the SBT on all firms whose annual turnover was less than 8 million lek. In 2009, however, this threshold was lowered to 5 million lek, and then again to 2 million lek in 2010. These amendments brought the threshold for the SBT in line with the threshold used to determine whether a business should be included in the VAT system. As can be seen from the figure below, the yield of this tax peaked in 2008 at 3 billion lek, and then fell to 2.4 million lek by 2011. It still, however, accounts for about 20% of all local government own-revenue.

Figure 5.5 Composition of Own Revenue in bln lek 2006-2011



The lowering of the VAT threshold has encouraged small business to understate their turnover in order to stay out of the VAT system. This has not only lowered the yield of the tax for local governments, but has led to conflicts and confusions between the tax administration of the national government and those of local governments about which agency is really responsible for controlling small business tax compliance. The extension of the Profit Tax to small businesses has created similar problems. Like individuals and large firms, small businesses are now required to pay a 10% Profit or Income tax to the national government. To avoid double taxation, however, they are allowed to deduct what they pay in the SBT to local governments from their national taxes. This has complicated life for small businesses while also creating conflicts between national and local tax authorities over who is responsible for verifying the calculations.

34 The schedule defines different base rates for three different categories of local governments (Tirana and Dures; other big cities; and communes); six different types of small businesses (retail, wholesale, manufacturing, services, free professions, and street vendors) and seven different increments of turnover (below 2 million lek; between 2 and 3 million lek, etc).

Both the extension of the VAT system and the introduction of the Profit Tax raise questions about whether the SBT should remain as a separate, local government tax, especially since the literature on public finance generally argues against giving local governments the power to tax businesses. One possibility for reform here is to phase out the SBT while introducing into the system the sharing of PIT.

The PIT can be shared on the basis of the origin of the taxpayer (residence) or a per capita basis. Both methods are used in European countries. An analysis of the PIT collection distribution shows that for 2011, Tirana collected 70% of the PIT amount. This would indicate that a sharing of PIT on an origin basis would produce a substantial increase for Tirana, but have very little impact on the other LGUs. It would also distort the transfer system as a large amount of funds would be needed to equalize across the LGUs. In addition, at the present time there is no identification of the PIT taxpayer directly to a local government so that the transfer share can be allocated on an origin basis. Until this is possible, a per capita allocation, which is used in most European countries may be the only alternative.

Presently, the LGUs are receiving on a shared 18% basis the motor vehicle tax. This has been initiated in late 2011 and there is not complete data on the collection amounts for the LGUs. However, from some preliminary data this appears to be a substantial amount of LGU revenue, but may be concentrated in the larger municipalities, such as Tirana and Durres, and rather smaller amounts for the other local governments.

A mining royalty is also being provided on a shared revenue basis with local government units, but it has yet to be determined whether this will produce any modest to significant increase in local government revenues.

There are advantages and disadvantages to utilizing a shared tax approach to improving the local government finances. The transition countries have tended to use tax sharing for a number of reasons. The advantages for the most part are (1) provides efficiency in tax collection efforts with the national level collecting the tax, (2) broadens the tax base for local governments, (3) may promote economic policy incentives to increase the tax base at the local level, (4) can promote equalization of fiscal resources depending on the tax sharing arrangements and the transfer formulas, and (5) provides more expenditure decision authority to local governments if transferred as an unconditional grant.

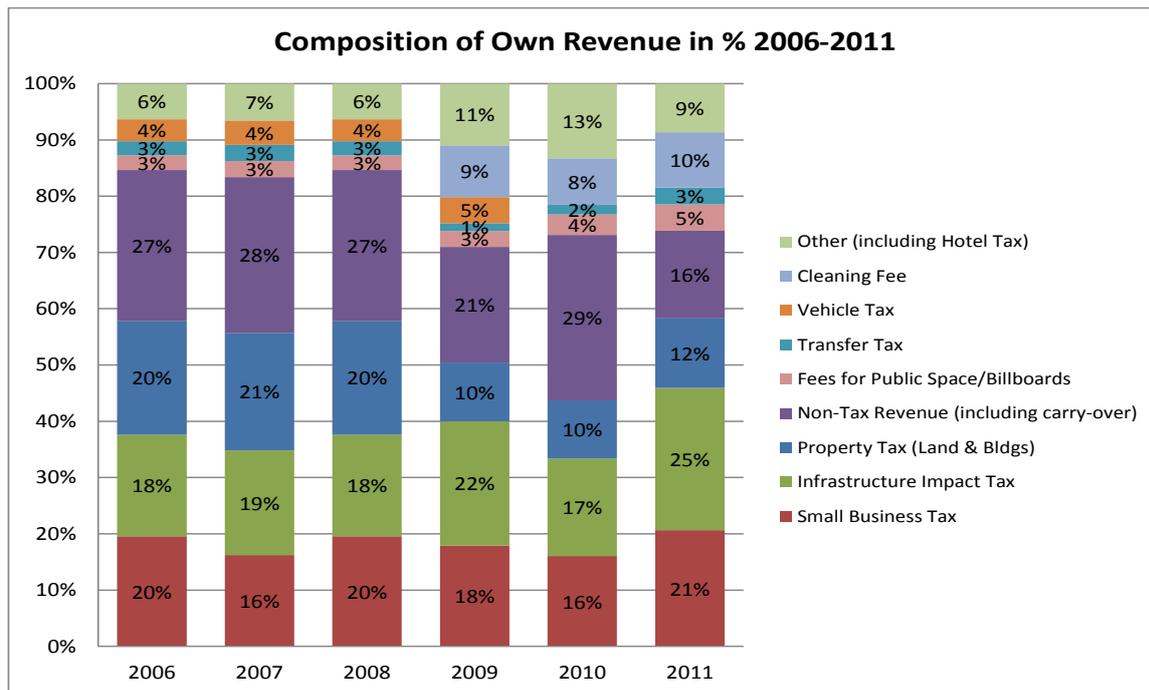
However, there are some disadvantages as well for utilizing tax sharing. These include: (1) is subject to changes in national level tax policies that may change from year-to-year, (2) lessens the accountability of local governments to their citizens for revenue raising decisions, (3) may make the central government focus on collecting other taxes, rather than the shared taxes, (4) may influence migration and job mobility depending on the level of tax sharing rates across the local governments, and (5) can require substantial levels of funding to provide equalization transfers across the local governments if there is wide disparity in the shared revenue sources.

These advantages and disadvantages need to be considered in determining the taxes to be shared, the tax sharing rates, and the amount of the transfer pool that is needed to improve the local government revenue situation.

This situation of shared taxes argues for providing the LGUs with the possibility of applying a surtax to the PIT as an own source revenue. This is utilized by some countries in the region, such as Croatia, and would provide the LGUs with some greater control over their revenue situation. It would promote fiscal decentralization as well since it would enable local governments to be more accountable to their citizens for the level of taxes that they must pay.

Tax on the Impact on Infrastructure for new Constructions: The Infrastructure Impact Tax was introduced in 2002 with the LLTS (Articles 9 and 27) and is a one-time charge that local governments can impose new private construction. The purpose of this tax –often called the Land Development Fee in other parts of the region—is to help local governments fund the public infrastructure necessary to serve private growth. The base of the tax is the value of the investment as stated in an investor’s construction permit and local governments can set the tax rate at between 1 and 3% of this value (2-4% in Tirana). As can be seen from figures presented, the Infrastructure Impact Tax has replaced the SBT as the single most important source of local government own revenue and in 2011 generated 3.2 billion lek or 25% of all own-income.

Figure 5.6 Composition of Own Revenue in % 2006-2011



Unlike elsewhere in the region, however, the yield of this tax is not legally earmarked for investment in public infrastructure. As result, local governments can –and apparently do—use the proceeds of the tax to fund their operating costs, undermining the purpose of the levy. For this reason, it would probably be desirable to legally require the yield of the tax to be dedicated to the construction of new public infrastructure. Indeed, for accounting purposes the tax should probably be considered a capital revenue because the tax is paid only once and because its yield is volatile and heavily dependent both on the construction permitting process and this real estate market³⁵.

Betterment charges (development fees, improvement fees/contributions) are a distribution of the public works costs among the landowners in the area surrounding the development. The increase on land value as result of the public works may be higher than the cost of the public works. Thus the betterment charge will only cover the cost and not the incremental value of land. It is paid by the landowner or the land user (the developer). The final payment goes to the government, but depending on who pays (owner or developer) has a certain effect on the land market. The advantage of using it is that the amount is directly linked to a specific public work costs, not to increased value of land, and thus it is usually lower than the tax on land value increment. It is also a good instrument to prevent speculation on land price as landowners pay for the cost (value deducted from the price of selling the land). However, as it is assigned to a limited area and not the whole city, it may often raise the

³⁵ This is important primarily to ensure prudent borrowing: Only true operating revenues should be taken into consideration by the national government (and private investors) when assessing the debt carrying capacity of a local government.

question of the final border. Thus what is the limit of the area paying this fee? Definitely the area includes the buildings facing the public infrastructure, maybe also the second line. However, for the rest of the households/landowners estimations need to be done. Good land use participatory planning and good planning of infrastructure investments (with proper feasibility studies and calculation of catchment areas) is of benefit to a fair process of fee value and cover area calculation.

Albania already implements some sort of betterment fee (it can also be considered as a sale of development right – see below) through the so-called *tax on impact on infrastructure*. The developer to the local government pays it and it is reflected in the price that the developer is willing to pay for the land, or the share of the investment profit that he is willing/ready to pay to the landowner. It is so far one of the most important ways to increase local revenues, and it is calculated as a rate of the total value of the development cost. It is almost a flat rate (has a ceiling which is very low, thus local governments do not tend to go down this ceiling) and it does not reflect the whole impact of the development on the public infrastructures.

Property Taxes on Buildings and Agriculture Land. These taxes were introduced by LLTS in 2002 (Articles 20-25). The Law defines the base of the tax for buildings through a schedule of base, square meter charges for residential and commercial properties. The schedule sets different base rates for three different groups of local governments, and local governments can establish different zones for property tax purposes within their jurisdictions³⁶. Until the 2009 amendments to the LLTS, local governments were allowed to set their rates 30% above or below the indicative levels contained in the schedule.

The base rates for agricultural land are set on a per hectare basis and adjusted according to seven categories of land quality and four groups of municipalities with no distinction between legal and physical persons. At the moment, there is no property tax on unbuilt urban land, though the government is planning to introduce this. Local governments have limited powers to issues exemptions and abatements and the base of the Property Tax is simple and straightforward.

As in Albania there is not yet a value based land tax and the last argument would be on the need to have it. The current fiscal legislation has a tax on agriculture land and a tax on urban buildings. For both of them, there have been extreme cases of discrepancies in tax collection rate. There is a draft of the Ministry of Finances proposing to add an area-based tax on urban land. While the intention of including the tax on urban land is very positive (it is a huge potential for increasing local revenues), the base of it being the area, will not guarantee the financial benefits that derive from the use of the land tax for financing infrastructure. This is because the area does not reflect the value of the land that increases as a result of public investments made on it; neither guarantees that costs of such investments are shared equally in the society.

One of the early recommendations of the World Bank has been to initially set an area-based property tax, then establish a proper database of buildings and land, create a methodology for tax calculation and assessment of land values and then finally jump to a value based property tax. The process for establishing the database and the methodology is yet far from being accomplished. However, for more than 3 years, the Government of Albania (Ministry of Justice) has revised the map of land and building values, which is being used as a reference in property transactions and in the building industry. Thus, even though the practice of calculating land values might not be well consolidated, it already exists. In fact, the problem still remains with the proper calculations of the size of parcels and construction areas in the buildings. Thus, whether applying an area-based or a value-based land/property tax, the problem is the same – proper registration of plots and buildings.

Last, but not least, another argument for establishing a value based property tax as the instrument that guarantees real local autonomy, is that it creates good conditions for applying also other land value

36 Annex 1. The three groups are Tirana and Duress; Other municipalities; Communes.

capture instruments. We can mention three most applied ones that could also be explored in Albania: betterment charges/fees; tax on the increment on the value of land; tradable development rights. For all three of them in Albania, a substantial revision in the fiscal/public finances legislation is needed. Given the strong relationship of these instruments with planning and land development, they can also be included in the planning legislation. However, as Albanian planning legislation is still in a controversial atmosphere, and efforts to revise the financial legislation are present, it would be better if value capture instruments were included in the latter. To conclude with the legal part, the Constitution of Albania, the Civil Code, the law on organization and functioning of the local governments, the expropriation law and the territorial planning law, all provide clear space for introducing value capture instruments. The latter are also in line with EU practices and the EU legislation on human rights.

As can be seen from the above figures, property taxes accounted for about 20% of local government own revenue between 2006 and 2008 (2.4 to 3 billion lek). In 2009, however, collection of property taxes seems to have declined sharply, and now account for only 10% of local government own revenue (c. 1.5 billion lek). It is not absolutely clear what accounts for this decline or whether there are again problems with the data. As in other countries in the region the property tax is extremely unpopular politically and –as in Albania-- local governments often focus their collection efforts on firms (who don't vote) instead of on individuals (who do.) Moreover, rates for businesses are typically an order of magnitude higher than for households.

Improving the collection of the property tax in Albania is clearly one of the major challenges facing both national and local policy makers over the coming years. This will require improving local government billing systems as well as the flow of information between agencies of the national government (cadaster, the courts) and local governments about the transfer and registration of properties. It would be also be useful if codes were introduced into the chart of accounts that distinguished the yield of the tax coming from legal and physical persons so that national and local government policy makers had a better idea of who is really paying.

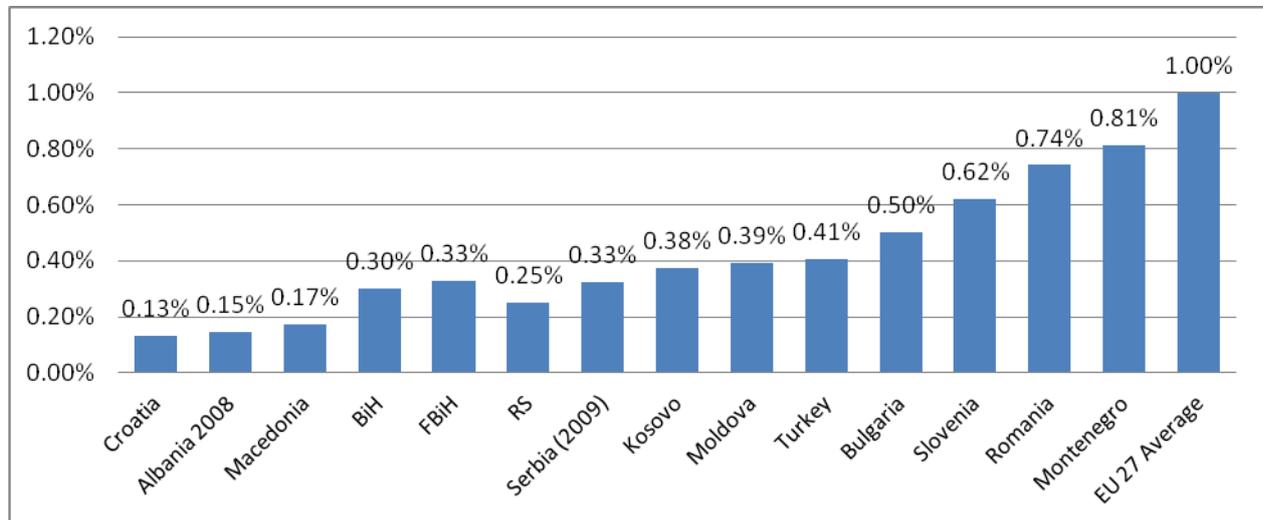
More importantly, efforts should be intensified to complete a legal cadastre and to link it to local fiscal cadastres. Finally, and most challenging, local governments will need to be encouraged to be more aggressive and effective in collecting the tax. Linking elements of the conditional or unconditional grant system to property tax collection could do this. For example, local governments who failed to improve their collection of the tax (from households) might be made ineligible for competitive grants, while local governments who significantly improved collection might receive additional transfers. Similarly, the national government could work with donors and local governments to create a public relations campaign that focuses attention on why this tax needs to be paid if people want better local services.

National government policy makers however, should be wary of expecting too much from the property tax. In Anglo-Saxon countries with long histories of well-developed property markets (and mortgage systems), the property tax does indeed yield very significant amount of revenue to local governments. Indeed, in America, Canada, Australia, Hong-Kong and Great Brittan, the ad valorem property tax is the single most of important source of own revenue for local governments and typically yields income equal to between 3 and 5% of the GDP.

But looked at globally, this is exceptional, and elsewhere the property tax has proved a much less robust source of local government revenue. This can be seen from Table 8 below which shows the yield of the property tax as percentage of the GDP in Albania, in other countries in South-East Europe, as well as in EU as a whole. As can be seen from the table, the property taxes in Albania (in their peak year of collection) account --after Croatia-- (where the tax is administered by the national government) for a smaller share of GDP than anywhere else in the region. At the same time however, in no country in the region does property tax collection obtain the average level for the EU. Moreover, the EU level –at 1% of the GDP-- is low. Indeed, if –on average— total local government revenues in the EU are equal to about 14% of GDP (see Figure 5.7) and property tax revenue 1% of GDP, than

property taxes in the EU can be said to account for about 7% of total local government income, while in Albania in 2011, this figure was 4%. In short, while there is no question that it is necessary to improve property tax collection in Albania today, it should also be clear that improvement in this area alone is unlikely to resolve local governments' larger problems with underfunding.

Figure 5.7 Property Taxes as % of GDP in 2009



–Non-Tax Revenues and Carry Over from the Previous Year: As we have indicated earlier there is much confusion in Albanian legislation about what constitutes a local fee and what constitutes a local tax. As a result, it is difficult to determine what this category contains, especially since there are separate categories for fees from the use of public space and (since 2009) for cleaning. Presumably, much of the revenue in this category comes from fees for solid waste collection and fees for processing civil documents. It also contains revenue from income carried over from the previous year, which in a number of years for which we have data is very significant. (In 2008 and 2009 it was over 2 billion lek, while in 2010 it was close to a billion lek.) Finally, this category should also include revenues from the sale and rental of municipal assets. Unfortunately, it is impossible to determine how much is coming from this source, though as we discuss below, the answer is probably not much.

With the passage of the LOFLG, local governments were made juridical persons and acquired the right to own land and buildings (Articles 4 and 8) and over the last decade the national government has transferred to them control over some public property. This process, however, has been slow and incomplete. Equally importantly, local governments have not really been endowed with the right to freely dispose of property they own. Indeed, according to the Law No. 9967, dated 24.07.2008 “For privatization and use of the public properties, etc...” not only does the national government have the right to privatize locally owned assets, but also proceeds from the sale of these assets go only to the national budgets. Local governments do however have the right to rent or lease municipal properties, but unfortunately the data does not allow us to see clearly what sort of revenues these practices might be yielding. Going forward, it would be desirable to accelerate the transfer of publicly owned property to local governments; to expand their real ownership rights; and to make sure that the proceeds from the privatization of municipal land and buildings (sold through public auctions) are considered municipal (capital) revenues and accrue (solely or primarily) to municipal budgets.

The transfer process is relatively long and complicated. It is almost impossible for the municipalities to keep the inventory list under control and updated of information that should normally be provided by other agencies dealing with property titles. It means that while municipalities go through the different stages of inventorying and developing of the final list, central agencies keep disposing the public property in different ways (privatization, leasing, concessions etc.). If not concluded soon, this process may result in LGUs receiving public properties that can be strictly used for public functions such as roads, administrative buildings, parks and infrastructure services. These are basically

properties already used and taken care of in daily activities by local authorities and getting the title deeds of them is of no additional value to local governments. In addition, there are cases when it takes several months for the Central Government to approve the request submitted by LGUs and issue the final transfer Decision of Council of Ministers (DCM). In few cases this is also affected by political considerations. To conclude, it is important for Central Government to re-establish and enforce legally required deadlines of both inventorying and transfer.

LGUs cannot always afford the costs of registration of the transferred assets. To this extent, it is expected that local governments with limited financial capacities will show no motivation on covering registration costs for public; especially for those that generate no revenues. It is also true that an LGU that will receive valuable and tradable state properties such as land and buildings will be more aggressive to speed up the transfer and, secondly, they will be eager to register the transferred assets on their own costs. The Central Government should be able to provide some coverage of the registration costs. From the legal point of view, the transaction between the CG and the LGUs, completed through the transfer DCM, which in this case is the property title, is no different from any other property transaction. In accordance to the Albanian legislation, real property transactions can only be completed for properties that are registered. The documents required are the Property Title (in our case the DCM) and the Ownership Certificate. It is obvious that the Central Government is missing the second. Therefore, CG should take the responsibility of at least sharing with LGUs the registration costs, which should have been covered by the CG prior to the transfer.

While public assets inventorying and transfer is a very important step to be completed, LGUs that have finalized or are finalizing the transfer and provided the necessary funding for registration are facing difficulties to properly manage the assets received. The actual applicable legislation besides being complicated and sometimes conflicting is also lacking the LGUs' perspective. Disposal options for different types of properties, including leasing, selling and especially PPP-s, are confusing and LGUs need strong legal expertise to identify "what it is not forbidden" in the legislation and further, produce processes that do not violate the legal requirements while protecting the best interest of both the LGU and the community. It is necessary to develop comprehensive regulations and guidelines to which LGUs can be referred. These regulations and guidelines can both combine and improve the existing applicable legislation.

Fees for the use of public space and for cleaning- As we have already indicated the LOFLG and the LLTS gave local governments the right to impose fees for the delivery of public service, though the LLTS unfortunately labeled some of these fees as taxes, compounding the not infrequent confusion that exists in practice between these two different revenue categories. According to the data that we have above, the two most important fees that local governments collect are cleaning fees and fees for the use of public space, including billboards. As we have mentioned above, fees for the collection of solid waste are most probably included in the category of non-fiscal revenues, as are fees for the processing or copying of official documents like marriage and birth certificates. As can be seen from the data, local governments have been deriving a significant amount of revenue from so-called Greenery Fees since at least 2008 when the Ministry began recording income from this source as a separate category. In some places, local governments have been bundling charges for general street cleaning, park maintenance, and green space development together with user charges for the collection and disposal of solid waste. As such, these "Greenery Fees" combine what should be distinct user charges based on some measure of the amount of trash households and businesses actually produce with what are really general purpose taxes for services that are provided for everybody (e.g. street cleaning), and whose use cannot be attributed to individuals or firms. Indeed, some local governments have justified the use of greenery fees to fund what are really capital investment programs³⁷. Moreover, throughout Albania—as in the rest of the region—there is a strong tendency for local governments to set fees and user charges for business at rates much higher than for

37 In Tirana, for example, the city bundled together fees for the collection of solid waste with charges not only for street cleaning and park maintenance, but with an entire capital improvement program designed to plant trees throughout the city.

households. For example, greenery fees for households typically run between 500 and 1500 lek per year, while those for businesses are often five to ten times higher³⁸.

Setting user fees and tariffs for public services whose consumption by households and firms is hard to measure (such as solid waste, or water use where meters have yet to be installed) is never easy. Nonetheless, reasonable proxy measures can and should be developed. Moreover these measures should prevent the gouging of the business community. Similarly, public services whose consumption cannot be attributed to individuals or firms –such as public lighting or street cleaning-- should probably be paid for from general taxes –like the property tax—and not from quasi taxes dressed up as user fees³⁹. As with the property tax, codes should be introduced into the chart of accounts that allow policy makers to distinguish fees coming from physical and legal persons.

Finally, it is worth noting that Article 33 of the LLTS allows local governments to create so-called Temporary Taxes, but says nothing about what these taxes might be for. As a result, it is hard to say what sort of taxes legislators had in mind, but interviews suggest that the real intent of this provision was to make it possible for local government to impose *seasonal fees* for things like the use or access to beach front property. Such fees should certainly be allowed, but that again they should not be confused with taxes. Instead, such special taxes should be called “Taxes for Special Purposes or Programs” and should require special procedures to be enacted. For example, these taxes should have to be clearly tied to the realization of specific investments; have clearly defined bases; and should require super majorities of the local government council to be imposed.

5.3 THE EQUITY OF THE INTERGOVERNMENTAL FINANCE SYSTEM

As indicated, it seems that there is strong evidence that in general local governments in Albania are seriously underfunded. A separate but related question is whether the total resources available to local governments is equitably distributed across them, so that all local governments have a reasonable chance of delivering the public services they have been assigned, and of slowly alleviating the infrastructure deficits they have inherited. Here, in other words we are looking at the horizontal equity of the system, and how much or how little equalization of local revenues is being achieved through the allocation of unconditional and conditional grants.

5.3.1 Allocation of the General Grant

The main instrument for equalization in Albania is the rules governing of the allocation of the general grant. These rules are defined in an annex to the Annual Budget of the national government and have changed from year to year, as has the amount of money earmarked for the funding of the general grant. The rules for 2011 state:

- 1) That size of the unconditional transfer is 11.5 billion lek, of which 402 million lek will be allocated to local governments for the support of pre-university dormitories (in 30 odd individual municipalities and communities), and 40,000 to the Social Care Centers of Berat and Ballash.
- 2) After subtracting the funds for dormitories and social care centers, the remainder (c 11.1 billion lek) is divided into two parts with 91.5% earmarked for local governments, and 8.5% earmarked for Regions (Qarks)⁴⁰. (10.1 billion for local governments)
- 3) 70% of the pool is then allocated to local governments on the basis of their population in accordance with data obtained by the General Department of Civil Registry⁴¹. (7.1 billion lek)

38 In one jurisdiction, authorities were charging small business greenery fees of 7,000 lek per year and certain classes of big businesses as much as 70,000 lek per year.

39 For more on these issues see Levitas, op cit.

40 In the remainder of this exposition we do not analyze the allocation formula for Qarks.

41 It should be noted that the population figures used from year to year have shifted and as we have discussed elsewhere in this report there are highly contentious.

- 4) 15% of the pool is then allocated to communes on the basis for their area in square kilometers (1.5 billion lek)⁴². (Four mountainous communities the area of the communes is multiplied four times).
- 5) 15% of the pool is then allocated on a per capita basis to all *municipalities* on the grounds that these jurisdictions have higher costs because they are providing more urban services (1.5 billion lek). (For mountainous municipalities the population numbers used for the calculation are multiplied four times)
- 6) Once these calculations have carried out, another set of calculations are made for the purposes of greater equalization: Local governments whose per capita revenues from the vehicle registration tax and the SBT are higher than the national average have 25% of the whatever they earn above the national average taken away, and then these monies are then distributed to local governments whose per capita revenues from these same source are less than 25% of the national average (1.2 billion lek).
- 7) A variety of other calculations are made to ensure a minimum per capita revenue of all municipalities and that no local government sees its revenues from the equalization component of the formula increase by more than 20% over the previous year.

There are a number of problems with these rules. The first is simply that it is completely unclear why what should be earmarked grants for dormitories in 30 particular municipalities and communes, and for social service centers in two municipalities are being allocated through an unconditional grant mechanism. This mixes apples with oranges and makes the whole system less transparent than it should be. Indeed, other rules in the Budget Law are further undermining the very notion of an unconditional grant by requiring that based on population number only a percentage of the grant is spent on wages and administrative costs

Second, while it is perfectly legitimate to allocate a percentage of the grant on the basis of the area of local governments on the grounds that those with large areas have to incur additional costs to serve sparsely populated areas, it is unclear why this allocation should be limited only to communes. After all, there are municipalities that have large areas and thus also incur the additional costs of providing services to dispersed populations.

Third, and conversely it is unclear why an administrative distinction should be used to allocate funds for urban services when there many communes that have significantly higher populations and population densities than some of their municipal counterparts. Here in other words, it would make more sense to allocate this money to local governments whose main settlements are over a certain population density.

Fourth, it should be noted that the equalization calculation means that richer local governments are essentially being taxed to help improve the financial position of poorer ones. These costs are substantial, and in 2011 amounted to 1.2 billion lek, most of which came from the budgets of Tirana and Durres. This is a perfectly legitimate way to finance horizontal equalization and many countries do similar things. But what it means in practice is that national government is playing no role in financing this important function and that more than 10% of the unconditional transfer is coming not from the national budget but from the budgets of Tirana and Durres. It is also likely that the high multipliers for mountainous communes (4 times their area) and mountainous municipalities (4 time their population) are combining with the equalization provisions to overfund certain communities.

Table 5.1 Changes in the Rules Governing the Allocation of the General Grant
Coefficients for municipalities and communes for 2002-2012

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
--	------	------	------	------	------	------	------	------	------	------	------

⁴² The boundaries of many communes and municipalities have never been official drawn so the figures used here are also both uncertain and contentious.

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Fixed amount	3.5 %	3.5 %	4 %	0	0	0	0	0	0	0	0
Population	62.5 %	62.5 %	62.5 %	73 %	70 %	70 %	70 %	70 %	70%	70%	70%
Surface of communes	4 %	4 %	9 %	12 %	15 %	15 %	15 %	15%	15%	15%	15%
Urban services	20.5 %	20.5 %	18 %	15 %	15 %	15 %	15 %	15%	15%	15%	15%
Urban services Tirana	9.5 %	9.5 %	6.5 %	0	0	0	0	0	0	0	0
Equalization	-	35 %	35 %	35 %	30 %	25%	25%	25%	25%	25%	25%
Further adjustments	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Finally, and most importantly, both the size of the unconditional grant and the rules governing its allocation has changed significantly from year to year. As we have seen in earlier figures, the size of the general grant (for municipalities and communes) has gone up and down over the last ten years, peaking at 12 billion lek in 2009 (an election year) and falling to 10 billion by 2011. Further complicating the situation is the changes in the rules governing the allocation of the unconditional grant, which are shown in Table 5.1.

As can be seen from the Table, there has been continual adjustment of the rules governing the allocation of the unconditional grant over the course of the last decade. Moreover, these adjustments have by and large been made without serious discussion of their consequences with representatives of local governments. It is beyond the scope of this analysis to discuss how these changes in the rules of the game have affected the budgets of individual local governments. But one thing should be clear; they have essentially made a major source of local government revenue essentially unpredictable from year to year.

Competitive grants constitute another instrument for equalization in the Albanian system, though at least in theory these grants are supposed to be allocated less on the basis of the relative wealth of jurisdictions, than on how well they have prepared their grant applications and on the relative importance of their investment priorities to the needs of the country as a whole. In practice however, a very high proportion of the grants have gone to support the construction of roads because these sorts of projects are easiest to prepare, the easiest to contract out; the easiest to adjust to the actual flow of funds; and the easiest to justify.

As with the unconditional grant, the total funding for competitive grants has varied quite substantially from year to year, peaking in 2009 at about 6 billion lek and since falling to about 4 billion lek. This fluctuation is somewhat less disturbing than the fluctuation in the size of the unconditional grant because capital investment is by nature both lumpy and discretionary. Nonetheless, the rising share of the conditional grants in total transfers is increasing the dependency of local governments on the national government. Equally importantly, the procedures for allocating conditional grants are non-transparent and by many accounts haphazard, meaning grants are allocated in the middle of the year; do not contain clear requirements for co-financing; and are not monitored for execution.

All this raises questions about the effectiveness and equity of the competitive grant program. On the one hand, it is necessary to preserve room in the Albanian intergovernmental finance system for the

national level to support priority capital investments at the local level. Moreover, it is entirely reasonable that higher shares of this support go to poorer jurisdictions. On the other hand, the scale of the program should not be allowed to crowd out unconditional transfers and it should be structured in such way that its rules and procedures are clear and transparent.

Here we see two basic possible lines of development. One is to call the Competitive Grants program what it really has turned out to be in practice –a Road Development Fund—but to introduce clear rules for the kinds of roads that will receive funding and a sliding scale that requires different levels of co-financing of from jurisdictions of different financial capacities. The other, more ambitious option would be to focus the program on areas of the highest national priority and in relationship to the skills and practices needed to absorb future EU funds. In this context, it would be logical that the program concentrates on the realization of major capital investment projects in the water and solid waste sectors, projects that necessarily require both serious technical preparation and inter-municipal cooperation. Here in other words, the program would be designed to support investments that necessarily require long preparation and construction times, and which might also help with reducing the fragmentation of Albania’s territorial arrangements.

The UNDP Integrated Support for Decentralization Project has examined the competitive grant process within the transformation to the now initiated Regional Development Fund. In the UNDP report a number of recommendations are made for improving the overall performance of these grants. These recommendations include improving the criteria for project selection, maintaining the level of funding at a constant ratio to GDP or national investment budget, and distribution of funds based on regional priorities. These are sound recommendations and should be implemented over the next budget cycle.

5.3.2 Per Capita Revenues and Horizontal Equity

The best way to assess how much horizontal equity is being achieved in any given country is to rank all local governments by their per capita own source revenues, divide them into four groups or quartiles from poorest to richest, and then look at the composition of their per capita revenues by type of revenue. Table 5.2 below presents this information for Albania in 2008, the last year we have reliable information on the line item revenues of all individual governments.

Table 5.2 Per Capita Revenues of Albanian Local Governments by Quartile in 2008

K & B	2008	Population	Own Source Revenues	Unconditional Grant	Conditional Grant	Total Revenue	Share of own source	Share of Unconditional Transfer	Share of Conditional transfer
94-0	1 st Quartile	379,455	284	4,088	1,476	5,849	5%	70%	25%
86-7	2 nd Quartile	600,985	833	3,115	1,429	5,377	15%	58%	27%
79-14	3 rd Quartile	771,959	1,561	2,818	1,314	5,693	27%	49%	23%
49-44	4 th Quartile	2,518,032	5,468	2,246	816	8,531	64%	26%	10%
308-65	All	4,270,431	3,649	2,636	1,051	7,336	50%	36%	14%
	Tirana	606437	9,049	1,466	117	10,632	85%	14%	1%

The first column in the table shows the number of communes and municipalities in each quartile. There are 94 local governments in the 1st Quartile and 93 in each of the rest. The 1st Quartile contains only communes; the 2nd Quartile, 88 communes and 5 municipalities, the 3rd, 80 communes and 13

municipalities, and the 4th, 48 communes and 45 municipalities. The second column shows the total population living in the local governments of each quartile. As can be seen from the table, the total population living in the 1st quartile is about half the size of the population living in the second quartile, and total population of the fourth quartile is equal to more the other three quartiles put together.

This is an expression of how fragmented the local government system in Albania is, and reflects the fact that there are a large number of very small and very poor local governments.

The third, fourth and fifth columns show the average per capita revenues that each quartile of local governments receives from the three main sources of local government revenues. As can be seen from the Table the 1st and 2nd quartiles derive very little revenue from own sources. The bad news here is that this is unlikely to change substantially in the immediate future. Meanwhile, the vast majority of own revenues in the system are coming from the 4th Quartile. Indeed, the average jurisdiction in the 4th quartile derives almost 20 times more revenues per capita from own sources than the average jurisdiction in the 1st quartile, and Tirana almost 32 times more.

Despite these dramatic differences in the per capita revenues of local governments from own sources, their total per capita revenues are extremely similar as can be seen from the sixth column. Indeed, the total per capita revenue of the 1st Quartile are higher than those of the 2nd and 3rd Quartile and only 30% less than those of the 4th Quartile. This is clearly because a disproportionate share of unconditional and conditional grants flowing to all local governments are flowing to local government with low own source revenues. In short, there is clearly a lot of horizontal equalization being achieved by the Albanian intergovernmental finance system.

Making judgments about whether this level of equalization is too much or too little is to one degree or another a question of political taste. Arguments can be made that too much equalization acts as a disincentive for own source revenue collection and more importantly deprives a country's more urban centers of the revenues they need to be growth poles for the economy as a whole. On the other hand, too little equalization clearly makes it impossible for balanced regional development. Worse, it is hard to come by good data that would put these sorts of judgments in comparative perspective.

Table 5.3 below, however, does this for Macedonia, Serbia and Albania for 2008 by comparing the ratio of the richest and poorest local governments in each country after equalization, as well as the ratio of the richest to the poorest quartile local governments in each country. As can be seen from the Table, Macedonia has by far the weakest equalization system of the three countries with the richest jurisdiction getting 14 times the total revenues of the poorest, and the 4th quartile getting the 3.7 times the amount of the first. Meanwhile, Albania has the strongest equalization system of the three, with the 4th Quartile getting only 1.5 times the amount of revenue of the 1st, and the Capital City getting only 4 times the amount of per capita revenue as the poorest jurisdiction. Indeed, rather exceptionally for the region, Tirana –as the capital—is not the richest jurisdiction in the country. Instead, in 2008 the jurisdiction with the highest per capita income in Albania was the commune Leskovik (pop. 1037). Indeed, the high per capita income of this commune (24,689) was almost entirely a product of the amount of conditional and unconditional grants it received.

Table 5.3⁴³ Ratio of Richest to Poorest local governments and Quartile of Local government in Albania, Serbia and Macedonia in 2008

	Macedonia	Serbia*	Albania
Ratio of the Richest to Poorest local government	14 to 1	6 to 1	9 to 1

43 The data for Serbian and Macedonia are drawn respectively from Levitas, The Effects of the Suspension of the Law on Local Government Finance on the Revenue and Expenditure Behavior of Local Governments in Serbia: 2007-2009 IDG Working Paper, Urban Institute, October 2010, pp 1-28 and Serbian Quarterly Economic Monitor, Winter 2010) and Local Government Finances in Macedonia Today: Possible Reforms for Tomorrow, IDG Working Paper, Urban Institute, May 2010, pp 1-39

Ratio of the Richest Quartile to the Poorest Quartile	3.7 to 1	2.1 to 1	1.5 to 1
Capital City to Poorest Local Government	14 to 1	6 to 1	4 to 1

*data for Serbia are for 2007

Again, it is difficult to make unilateral judgments about the whether there is too much or too little equalization going on in a particular country. But the data suggests that Albania system is over-equalizing and as such depriving its urban jurisdictions of the revenues they need to serve as growth poles for the economy as a whole. At a minimum, the equalization system should be comprehensively reviewed and above all stabilized by stabilizing the size of the unconditional grant and rules governing its allocation, and by reducing the role of and uncertainty around conditional grants.

5.4 RECOMMENDATIONS FOR IMPROVING THE INTERGOVERNMENTAL FINANCE SYSTEM

With respect to municipal finances we consider the following issues to be the most important.]

1. Local governments in Albania have suffered an overall decline in their funding sources and immediate steps need to be taken to improve their finances.
2. Efforts to support the more effective collection of user fees for water and solid waste, and of the property tax --*particularly from households*—must continue. But improvement in this area cannot be considered a substitute for putting more money into the transfer system.
3. Expanding the size of the unconditional grant should increase municipal revenues. The size of the pool of funds used to finance the unconditional grant should be defined in law as a percentage of the national budget (or the GDP) in order to make local government budgets predictable and to ensure that both national and local governments share equally in economic growth (or decline). It is suggested to approach 4.5 % of GDP by 2017.
4. The competitive grant system needs to be focused on areas of the highest regional priority and reconsidered in relationship to the skills and practices needed to absorb future EU funds. In this context, it would be logical to focus the program on the realization of major capital investment projects in the water and solid waste sectors, projects that necessarily require both serious technical preparation and inter-municipal cooperation.
5. The Ministry of Finance should provide all local governments with a budget circular in July or August of every year telling them what their expected revenues from all grants and transfers will be in the next fiscal year. The executed line item revenues and expenditures of all local governments for the previous fiscal year should be made available to the municipal associations and the public at large by the end of the first quarter of the current fiscal year.
6. Efforts should be made to clarify in both law and practice the difference between user fees and charges on the one hand, and general purpose taxes on the other. Taxes for the use of public space, and for billboards should be redefined as fees. More importantly, rules should be introduced to govern the calculation of fees for solid waste collection and disposal. Decisions also need to be made about whether fees can be imposed for (general) public goods like street cleaning, public lighting and park maintenance, and if so how they should be calculated. The Infrastructure Impact Tax should be earmarked for capital investments and considered for accounting purposes as a capital revenue to ensure prudent borrowing.
7. Over the medium term consideration should be given to introducing more effective taxation of urban land. Eventually, efforts may be made to move all property taxation towards market-based valuation. But for the foreseeable future it is much more important that local government fully register *and tax* all properties, and that the national government make the improvements in the cadastre and land registry systems that allow for the full registration of the base. Significantly raising property tax rates before 80 or 90% of taxpayers are in the system, and paying their taxes will likely do more to delegitimize the tax than increase revenues. It may be worth considering

incentivizing the allocation of competitive grants by making eligibility dependent on improved collection of fees and charges from households.

8. Over the medium term, the small business tax should probably be phased out because it is not generally considered good practice to give local governments the power to tax businesses; because the taxation of small business has proved politically contentious; and –most importantly-- because the tax has become “redundant” with the extension of the profit tax and VAT to virtually all economic agents.
9. The phasing-out of the small business tax should be accompanied by the phasing-in of the sharing of PIT (but not CIT). This however will require technical preparation by the Ministry of Finance to ensure that PIT is registered by the place of residence of employees and not their place of work (or the headquarters of the firm they work for). Preparation has to be made for registering PIT based on municipality and commune level as today it is kept only on district level. A deep analysis will be required for understanding the effect of sharing PIT to the revenues of LGUs as at present it is highly concentrated with Tirana collecting 70% of the PIT.
10. The introduction of PIT sharing will however require the development of a new equalization system. The system that has worked the best in most of post-communist Europe is to guarantee all local governments an equalization grant equal to the difference between their per capita PIT revenues and some percentage (70 to 90%) of the national average of PIT per capita, if their per capita PIT revenues are below this threshold.
11. The transfer of publicly owned land and buildings of local significance into the ownership of local governments should be accelerated. Local governments should be given the right to alienate these properties and to receive the proceeds from their sale.
12. A permanent intergovernmental finance commission should be established and obliged to monitor the operation and function of the intergovernmental finance system. This commission should be Chaired by the Ministry of Finance and composed in equal measure of representatives of the national government and of municipalities and communes in order to guarantee political consensus of this process.

5.5 NEXT STEPS

Near Term (within one year)

- Continue efforts to implement effective collection of property taxes with property registration data transferred to the LGUs.
- Define the level of transfer as percentage of total public revenues
- Clarify the definition of fees and taxes within the existing legislation
- Enact a Law on Local Finance
- Provide for a new transfer formula for unconditional transfers based on more transparent, simple and objective criteria
- Develop an analysis of the cost/benefit and efficiency of the collection of the small business tax and the property tax by the LGUs.
- Analyze the distributional impacts of the PIT sharing on LGUs and the national transfer levels
- Establish a Intergovernmental Finance Commission to provide national level policy on the development of local government revenues, expenditures and transfers

Medium Term (1-3 years)

- Eliminate the Small Business Tax
- Implement full system of property tax collection
- Increase the distribution of the motor vehicle tax to a 50-50 sharing between the central and local governments
- Establish a sharing of PIT with LGUs
- Transform the competitive grant on a more objective criteria and performance based eligibility to receive these grants with greater role of the regional councils in the decision process

Long Term (3-5 Years)

- Introduce a Law on Intergovernmental Transfers to stabilize the allocation formulas for the transfers, to define the size of local government expenditures as percentage of GDP approaching 4.5 % by 2017 and maintain local government fiscal capacity

DRAFT

6.0 LOCAL GOVERNMENT BORROWING

This section addresses the situation with regard to the utilization of borrowing by the local governments to finance capital investment and infrastructure projects. While there has been a Law on Local Borrowing enacted, subsequent central level actions through administrative regulations have effectively prevented the local governments from being able to borrow to finance projects. Some aspects of this public debt situation will be analyzed in this section and new possibilities explored that would enable local governments to meet their needs for additional financing.

Section Highlights

- 1. The legal framework has been provided, but highly restrictive for the possibility of LGUs to utilize borrowing.**
- 2. The national level policy of limiting public debt to 60% of GDP, combined with a high level of central level use of external and domestic debt, does not provide any space for LGUs to utilize borrowing within these constraints.**
- 3. LGUs have shown a high level of interest in utilizing borrowing for capital investments that cannot be met.**
- 4. The basic level of technical assistance for undertaking borrowing in a prudent manner has been provided by a USAID program.**
- 5 There is a need to review the current debt limitations and increase the level being allocated for local borrowing and reviewed by the Albania Development Fund and approved by the Ministry of Finance.**
- 6. Begin implementation of the transformation of the Albania Development Fund as a mechanism for providing LGUs with borrowing capacity through issuance of bonds by the Albania Development Fund for the LGUs.**
- 7. Innovative techniques for allowing LGUs to undertake borrowing should be examined and appropriate changes to allow these methods should be enacted.**

6.1 LAWS RELATING TO LOCAL GOVERNMENT BORROWING

The Law on Organization and Functioning of Local Governments of July 2000 recognizes the right of local governments to borrow (incur public debt) both as means to meet their public service responsibilities and to increase their financial autonomy. According to the above law, the rules and procedures governing local borrowing will be defined in separate law starting on January 1st, 2002.

However, it was not until 2008 that the Law on Local Borrowing (No. 9869) was enacted. The law defines that LGUs might borrow for cash flow and investment purposes from financial institutions and banks in both domestic and international markets. Local governments are entitled to both short-term and long-term loans. The securities for LGUs borrowing might include physical property as collateral based on local ownership (but it is limited to properties that are purely local public property such as schools, roads etc); pledged revenues; general securities payable from each and every revenue source of LGUs (debt for investment in water supply assets may be secured through water fees),

The short-term loans shall not exceed 10 % of total actual revenues of the LGUs from local taxes and fees, and shared taxes from previous fiscal year and does require the approval from the Ministry of Finance before the Mayor may submit the request to the banks after City Council's approval. While the long-term loans are restricted to be issued for investment (only for public purposes) in covering local functions such as own, shared and when necessary even the delegated functions.

The debt limitations defined in the law are:

- The annual debt service payments on all long term debt from LGUs cannot exceed:
 - 20 % of the average total actual revenues of the local government from the unconditional transfers, shared taxes, local taxes and fees of the last three fiscal years;
 - 71 % of operating surplus, which means that operating surplus⁴⁴ 1.4 times higher than debt service.
- Debt stock should not be higher than 130 % of the unconditional revenues (unconditional transfer + shared taxes + local taxes and fees)

Once the law was approved municipalities started negotiating the first loans mainly to finance the capital infrastructure's projects and the Ministry of Finance and domestic banks approved most of them.

In January 2010 Minister of Finance issued the Administrative Order Nr. 857, date 27.1.2010 that limited the local loans use during 2010 (for the local loans already approved) in 5 % of operating expenditures of 2009 and on December 2010 Minister of Finance issued another Administrative Order Nr. 17752, date 28.12.2010 by limiting even more to 2.5 % of operating expenditures of 2009 during 2011. Both orders have severely restricted municipalities' ability to incur debt over the last three years despite the passage of legislation that was designed to make debt financing more possible for local governments.

6.2 CURRENT SITUATION OF PUBLIC DEBT IN ALBANIA

The end of 2011 estimated the total public debt to be 58.9 % of GDP and worth 774,547 million ALL⁴⁵. The debt is composed of domestic debt calculated at 33.36 % of GDP and the external debt at 25.54 % of the GDP as it is shown in the Table 6.1 below. Debt services increased starting in 2009 (3.15 % of GDP), 3.55 % of GDP during 2011 and it is foreseen to reach 3.64 % of GDP on 2012 and 3.79 % of GDP in 2013. The instability of the international financial market affected the situation in Albania and increased the cost of financing the public debt.

As can be seen from the Table below, a considerable amount of the increase in external debt, compared to domestic debt, started after 2007 and was a consequence of pursuing a conscious policy to finance more of Albania's public needs from external sources in order to leave more room for the development of the domestic market⁴⁶. Another reason for this increase is related with the entrance into international markets and because of the issuance of Eurobond as part of the above strategy. As the new loans of financing were mainly for infrastructure projects came from international markets they have been borrowed with commercial interests showing an increasing external debt stock.

Table 6.1 Central Government Debt

44 The difference between the LGUs' revenues from unconditional transfers and own revenues and the expenditures from these sources is the operating surplus

45 Economic and Fiscal program 2012-2014 Albania, Government of Albania, February 2012

46 Public Debt Management and Strategy 2011-2013, Ministry of Finance

In million lek	2008	2009	2010	9 mos/11	P 2011
Debt Stock Total	595,786	682,404	715,328	767,876	774,548
Internal Debt Stock	400,456	415,028	407,372	437,652	438,727
External Debt Stock	195,330	267,376	307,956	330,224	335,821
GDP	1,089,293	1,151,020	1,238,094	1,314,702	1,314,702
Debt Stock Total/GDP	54.69 %	59.29 %	58.11 %	58.20 %	58.90 %
Internal Debt Stock/GDP	36.76 %	36.06 %	33.09 %	33.17 %	33.36 %
External Debt Stock/GDP	17.93 %	23.23 %	25.02 %	25.03 %	25.54 %

Source: Ministry of Finance

The composition of domestic stock debt reflects mostly short-term instruments debt and indicates difficulties of the internal market to accommodate the demands for borrowing the long-term instruments.

The policy of the GoA in the last years was focused in re-composition of the public debt portfolio by reducing the short-term instruments of the debt to the benefit of the growth of the long-term instruments. This is going to be the strategy for the next coming years too. Even the issuing of Eurobond made possible the decrease of issuing short term instruments such as treasury bills with 12-month maturity. But again the short-term instruments compose an important share in public debt portfolio. The Government has elaborated some policies for the next 3 years on the public debt reduction, which is considered to be too high by the IMF, World Bank and other international financial institutions for a developing country. Measures are suggested to focus on fiscal policies and public expenditures where certain negative impacts might go to LGUs too. A revision of fiscal policies and improvement in revenue collection (for example low efficiency of value added tax collection) as well as reduction in public expenditures is suggested.

6.3 USE OF BORROWING BY LOCAL GOVERNMENT

The public debt until the end of 2009 was composed only from the central government debt even though the law on local borrowing was adopted at the beginning of 2008. During 2010 it was noted for the first time the public debt being created by local governments borrowing which was estimated to be at the limits decided by the Ministry of Finance, 147 million ALL as local public debt stock which is counted to 0.01 percent of GDP for 2010 and a little more for 2011.

Table 6.2 Status of Country's Debt

In million lek	2009	2010	31.12.2011
Public Debt Stock	682,547	715,517	772,582
Central Government Debt Stock	682,547	715,370	772,364
Local Government Debt Stock	0	147	218

Source: Ministry of Finance

The total public debt is close to 60 % of GDP that is the limit of total public debt set in the Maastricht Treaty and the national government is trying to control the ceiling especially under the advice of International Monetary Fund and World Bank that raised the warning flag about this level. The recommendations are for getting the public debt at the level of 50 % of the GDP in the next coming years. Given Albania's relatively low level of income and potential vulnerability to adverse shocks, its debt ratio should not be higher than 41 % of the GDP⁴⁷. Furthermore, the European Commission⁴⁸ is pushing the Government of Albania to apply a revised definition of public debt that includes accrued loan interest payments and unfunded liabilities, which will aggravate the difficulty that the Government will countenance in meeting the target ratio of public debt to GDP.

It is evident that there is a strong interest of LGUs to utilize borrowing to finance infrastructure. Once the law was approved LGUs start negotiating the first loans mainly to finance the capital infrastructure projects and most of them were approved by the Ministry of Finance and was supported from domestic banks. In general the domestic banks are willing to expand their portfolios with local governments and consider the local debt mostly with same risk as the sovereign debt. The interest rates and maturity of the loans offered from the banks were generous to local governments. It is noted a sufficient liquidity of the supply side of municipal credit market although the demand side it is limited. The banks want to expand the mutual interest with local governments even in the other areas and are supportive to lend loans for their projects. During this period when private businesses are facing too many difficulties in paying obligations to the banks, LGUs are seen as a potential and a safe client to them (according to the law, Ministry of Finance will use the unconditional transfer if LGUs fail to pay the obligations to the banks, another guarantee for the banks compared with private sector).

The ten pilot cities included in USAID LGPA piloted municipal borrowing. LGPA provided the technical assistance and manual for local borrowing for implementing borrowing and there was a good reception by local governments for this.

During 2010, the Ministry of Finance approved the requests of 7 municipalities/communes in the total of 1,668 billion ALL, the biggest loan for the Municipality of Elbasan of 800 million ALL and the lowest one to the Commune of Petrele of 15 milion ALL. During 2010 there were 8 other requests submitted from municipalities and communes and only the Municipality of Polican got the approval from the Ministry of Finance. Recently there are only two LGUs, Municipality of Gjirokaster and Commune of Libofshe that have submitted the request to the Ministry of Finance for loans. But with the issuance of the administrative regulations because of the tight debt policy of Central Government the local government borrowing has been squeezed once it started to be implemented through issuance of Administrative Orders of the MoF.

All the local loans are taken from domestic banks; none of the LGUs approached any international bank besides Municipality of Tirana that negotiated with European Bank for Reconstruction and Development a municipal loan at the amount of 22 million Euros for financing the Outer Ring Road of the city. There are only 6 LGUs that took municipal loans from the banks and only 85 million ALL has been disbursed up to 31st of December 2011 as it is revealed in the table below:

Table 6.3. Local Borrowing Data for 2011

Municipality/Commune	Disbursements up to 30.12.2011	Payments up to 30.12.2011	Local Public Debt Stock 30.12.2011
Korçe	23,800,000	4,172,124	63,983,191

47 IMF Working Paper "Fiscal Objectives in the post IMF Program World: The Case of Albania" Jiri Jonas, March 2010

48 European Commission "Albania 2010-2011 Progress Report" Brussels, November 2010/October 2011

Pogradec	18,000,000	2,283,279	33,716,721
Vlore	0	4,477,689	55,224,859
Petrole	3,000,000	0	9,000,000
Elbasan	32,032,519	2,978,475.11	48,257,544.49
Lezhe	8,262,526.73	545,939.33	7,695,250.62
Total	85,095,046.33	14,457,506.44	217,877,566.11

Source: Debt Department, Ministry of Finance

Nowadays the local public debt stock is counted only for 218 million lek or 0.01 percent of GDP because of a highly restrictive borrowing policy for local governments due to debt policies. The law does not define the level of public debt that local governments are eligible to create, but leaves it as part of annual budget decisions.

According to Decentralization Strategy of April 2010 (not yet approved from the Albanian Government) borrowing is defined as a limited financial instrument for securing revenues from local governments. The reasons for such limitations as mentioned in the strategy are related mostly with inability of LGUs to pay and certain measures they should take for generating their own local taxes and fees and not with the real concerns that Central Government do have on controlling public debt in the coming years. Both administrative orders issued once the tight public debt policy started, have severely restricted municipalities' ability to incur debt over last three years despite the passage of legislation that was designed to make debt financing more possible for local governments.

In the Strategy it is also mentioned the attention of Central Government to LGUs for meeting the financial obligations towards the payment within deadline of the principal and the interests of the loans; but there is no evidence of any bad example as regards the correctness of LGUs so far.

According to the Economic and Fiscal Program 2012-2014 of the Government of Albania in respective of integration process in the European Union certain measures are expected to happen during next coming years such as:

- Public debt ceiling as a ratio to GDP is 60 % for each year 2012-2014 and promising to go down to 55 %;
- The annual deficit of the general government a ratio of the GDP is 3 % for 2012 and 2013 and 2.5 % for 2014;

It becomes clear that local governments will perceive the biggest burden of national policies on reducing the public debt. In the entire Economic and Fiscal Program 2012-2014 there is no stated policy on the strategy of the Government for local borrowing, on disbursements of the existing loans that have been blocked by administrative orders, and everything is left within the annual budget discussion. The expectation is that such limits will continue in the coming years and fewer possibilities for the situation to get better as the public debt is close to the ceiling.

6.4 RECOMMENDATIONS FOR IMPROVING LOCAL BORROWING

While the present public debt situation would seem to severely limit the possibility of LGUs accessing debt methods; there are a number of actions that should be examined to see if the situation could be

improved for LGUs to have some measure of debt to finance capital investments. These recommendations and actions are addressed in the next sections.

6.4.1 Provide for Increase in Debt Limitations

The present policy of limiting public debt to 60% of GDP does not provide any space for local government borrowing that can be allocated to LGUs. There is need to review this situation and determine if some allocation of debt can be provided to the LGUs with the Albania Development Fund reviewing all requests for borrowing purposes and final approval by the Ministry of Finance. This will allow for the use of the credit rating enjoyed by Albania to be utilized for borrowings that will finance many needed local government infrastructure projects and stimulate economic growth that will increase national and local level revenues. The possibility to revise the domestic debt limit should be examined to provide some possibility for the LGUs to access the credit from the banks that appear willing to provide this credit.

Administrative Orders Nr. 857, date 27.1.2010 that limited loan disbursement on 5 % of operating expenditures of 2009 and the other Administrative Order Nr. 17752, date 28.12.2010 that limited even more on 2.5 % of operating expenditures of 2009, should be examined and relaxed in their impact.

6.4.2 Need for Central and Local Government Dialogue

There is a need to initiate a dialogue and consultation among all stakeholders that concern local government borrowing. The USAID sponsored PLGP project can undertake this effort and continue the already substantial effort that USAID has committed to providing for local government borrowing possibilities. This dialogue could address the possible actions described.

A review of the situation necessitating the administrative orders limiting the local government borrowing should be initiated as part of the dialogue and consultation effort. This may lead to a modification or elimination of the two administrative orders issued from the Ministry of Finance that blocked the use of already approved loans and left their infrastructure projects in the middle of their implementation.

There is the possibility that the government should cooperate with international financial institutions on the establishment of a Local Development Fund as a mean of financing capital investment which will have the competence of exploring the local borrowing and assessing the capital investment projects. Such institution might have the authority of exploring the possibilities for local borrowing as well as assessing the capital investment projects.

6.4.3 Provide for Local Borrowing Through Separate LGU Entities with Authority to Borrow

Examine the existing authorities of the local governments that may allow for creation of special entities to undertake capital investment financing through use of administrative territorial units created for this purpose and means of financing through special funds. These seem feasible under existing laws as referenced here. The Law on Organization and Functioning of Local Governments allows for creation of organizational units within the local government structure as indicated in the box below.

Article 8 Rights of Local Governments

1. Each commune, municipality and region shall have the following rights:

I Right of governance

- a. Take any necessary measures for carrying out their functions and exercise their authority.
- b. Based on the Constitution, laws and normative acts, and to carry out their functions and exercise powers, they can issue directives, orders and ordinances, which are obligatory for all its entities within its jurisdiction.
- c. Local governments can create administrative structures to carry out their functions and exercise powers, in compliance with the laws in force.
- d. They can establish economic units and other institutions under their authority.
- e. Each local government may create committees, boards, and commissions, as it deems necessary for exercising specific functions.
- f. Each local government may create any administrative-territorial sub-division within its jurisdiction to perform its governing functions, in the manner as set forth in this Law.

The financing of these organizational entities for the capital investment purposes may be provided through Article 7 of the Law on Management of Budgetary System with reference to Special Funds. This article is presented below.

Article 7 Special Funds

Special fund of central or local government units is established by a special law, proposed by the minister responsible for finance, hereinafter called minister of finance, in the Council of Ministers. The local government special funds are proposed to the minister of finance from council of the local government units.

The law for the establishment of a central or local government special fund shall define:

- a. The scope of establishing the special fund
- b. the administrative unit of the special fund that may be a central or local government unit, independent or controlled by another unit.
- c. means of financing and balancing of the special fund
- d. means of consolidating with central or local government accounts
- e. duration and way of closing of the special fund.

Special fund includes all the revenues and expenditures of a special fund unit.

The procedures for the proposal and approval of the special fund budget of central or local government shall be the same as the State Budget Special funds of the central government units shall be presented to the National Assembly together with the state budget.

Special funds of the local government units shall be presented to the local government council together with the local budget.

No extra budgetary fund shall be created that is not a special fund.

The local government through these legal articles maybe able to create these organizational entities and funding source and provide a guarantee for the payment of borrowed funds as stated in the Law on Local Borrowing Article 4/3 quoted here: "A Local Government may issue a Guaranty of debt that

is issued by a separate legal entity controlled by the Local Government to finance capital investments that serve an essential local government function.”

The potential for using revenue associated loans for financing local services through loans provided from LGUs such as water supply and sewage systems should be considered; because of enterprise’ legal status, such loans are not calculated as public debt loan. Recently the Water Enterprise of Tirana received a loan of 15 million euro for an important investment to be carried out in the system, which is not calculated as the public debt because of shared-own company status. Most of the water and sewage enterprises under LGU’s administration might consider local borrowing for initiating investment that is much needed in the water sector. Different public-private partnership are carried out from LGUs for services such as garbage collections, land-fills, underground parking, etc where the private enterprise might apply lending schemes in improving such local services.

6.4.4 Innovative Methods Linking Development and Borrowing

Emphasize some innovative methods of funding capital investments through the use of inter municipal cooperation, public private partnerships, or financing methods, such as Tax Increment Financing, that may be authorized under the existing legal framework. A thorough review of these methods as part of the central-local-financial institutions dialogue may yield some possibilities for devising alternative debt mechanisms that would not break the current debt limitations.

The tax on the land value increment (planning gains tax, tax increment financing) is supposed to cover the costs of the territorial plan, given that the latter will affect the increase of the land value. In principle it is based on the full increment of the land value, but as the paying value may result very high, governments often tend to cover a percentage of the increment. In principle the landowner, whose property increases in value, pays it but the developer based on the business agreement between the landowner and the developer can also pay it. When the land value increment happens due to specific public investments, then it should fund the public infrastructure. As it is higher than the cost of the infrastructure, then the surplus goes for other public investments. However, if it is created by the land use plan then it is distributed to cover different public purposes, or even earmarked to a specific public expenditure, or public housing. In case the tax is created by the land use plan, it can be collected in three different moments: 1) when the plan is approved; 2) when the land is sold; 3) when a development permit is issued. In principle it is easier to collect the tax in the second or third case, and the risk of the plan being changed is much lower in the third case. In principle, this tax reduces the benefit of the landowner and it also reduces, or prevents speculation. It is not difficult to be calculated, but it requires a careful market study before and after a land use right is established.

Tradable development rights (purchase/selling of development rights, density fee/bonus, density ceiling, legal density platform) build on the concept that development rights are separate from the property rights. In Albania this is not explicitly spelled out in the laws. However, an interpretation of the Civil Code shows that it is possible. Further, as development rights are simply floor area ratio (FAR) rights (floor area ratio that is allowed or designated by the local government to an area) and Albanian territorial planning law defines development rights as such, it means it is possible to divide property rights from development rights. Tradable development rights are a very practical and simple way to collect the full value of using land for urban purposes (density bonus could be one of the most handy ones). As the use on land is designated by the local government (deciding also for an increase in value), the latter has the right to also get back the value of creating this use. The local government sells the right and the landowner or the developer of the respective land purchases it. The money goes for financing public infrastructure – preferably in the area where the development is taking place, but not only (it can be applied to social housing as well). To apply it, it is first needed to have plan, define the development right and set a unit for it, define the base for applying the purchase/selling and then sell the rights in the market – preferably through an auctioning process. It is also very important to register the process, either in the property registration system or in a separate Registry.

6.4.5 Examine Alternatives for Borrowing

Other actions that should be considered and based on experience could include the provision for the following:

Development Credit Authority

USAID Development Credit Authority might be developed as a credit guaranty facility through USAID project and different municipalities can go through this process of borrowing (such as was used in Macedonia). The previous project of USAID was very active in promoting local borrowing and has supported the ten pilot municipalities for preparing the documentation and the development of local government borrowing with financial institutions. Ten cities received loans from domestic banks.

Albania Development Fund

The Law creating the Albania Development Fund (ADF) in 2009 provided for promoting economical development in regional and local level in support of national policies. It is financed from central government, donors, loans, etc, and implements most of the projects that comes from mutual cooperation of the government with international institutions on regional and local level. Two main authorities of ADF are the Leading Council and Executive Director. The Leading Council is the main decision making body of ADF that appoints the Executive Director with 2/3 of the votes. The Leading Council is chaired from Deputy Prime Minister and is composed of 11 member, five from Central Government and 6 from three LGUs's Associations. As a State Funded Development Institution, ADF has supported LGUs in different projects through implementation of World Bank projects, Bank of Council of Europe's projects and other international institutions. The last project of the World Bank on improving secondary and local roads has been implemented from ADF by providing also supervision and project sustainability. ADF is eligible to provide financial support to LGUs as grant, loans, guarantee etc.

ADF might be an institution that can continue to support LGUs in providing local loans with lower interest than commercial banks and it should explore the possibilities of transforming it into a Municipal Development Fund or Local Development Fund/Bank.

EC Funded Projects

Borrowing for EC funded Projects, which will come from the integration process of Albania in European Union, may be a possibility as it provides different incentives such as exclusion from debt threshold of the debt taken to provide local contribution. The Central Government might guarantee the local loans or regional water and sewage company loans related to EU- funded projects; and Central Government provides local government with interest free loans to meet needs.

Bridge Financing Mechanism

Use of Bridge Financing Mechanism as a special type of short term loan where financing for a capital investment project in a transitory period until the long term financing is obtained. Municipalities in Bulgaria are assisted from such a Fund. The Municipality of Mezdra received bridge credit for implementation of the project for reconstruction of 6.7 km municipal road while it was finalizing the procedures for a long-term loan.

6.5 NEXT STEPS

Near Term (1-3 Years)

- Establish dialogue of main stakeholders from central, local and financial organizations to review existing legal framework and identify new approaches to borrowing
- Review debt limit and allocate some debt to the LGUs for borrowing through the Albania Development Fund
- Provide for use of separate entities to undertake LGU borrowing

Medium Term (1-3 Years)

- Provide authority for innovative methods of local borrowing linking land and infrastructure to special funding authorities; such as special assessments, impact fees dedicated to improvements, and tax increment financing

Long Term (3-5 Years)

- Provide for Albania Development Fund to issue bonds to pool needs from local government for borrowing

DRAFT

7.0 SUMMARY AND CONCLUSIONS

The above sections have presented the full scope of issues to be addressed in moving fiscal decentralization forward in Albania. It is clear that there are many issues and they are clearly connected across all these issue areas. In order to determine the possible path forward there needs to be a clear identification of the priorities and processes that need to be implemented in the coming months and years. Within each of these sections a number of recommendations are made and a timeframe for addressing these issues is provided. The challenge of identifying and prioritizing these issues is presented in the following sections.

7.1 REFORM PATH

The following table provides a brief summary of the key reforms that need to be undertaken on a comprehensive and integrated policy development approach over the coming months. It attempts to assign to specific areas of reform priorities a comprehensive list of the key changes that need to be addressed through a central/local dialogue that will yield the political will to bring forth the important legal and regulatory frameworks that will achieve the goal of a more decentralized democratic system.

Table 7.1 Reform priorities for fiscal decentralization in Albania

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central gov't institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector	Update Decentralization Strategy	Adopt National Decentralization Strategy	Improve National Level Institutions		Promote Monitoring Process for Fiscal Decentralization
(2) Functional and expenditure assignment	Clarify Shared Functions Role of Regions		Implement administrative and territorial reform	Improve budget process at community level	Improve community involvement in budget process
(3) Assignment of revenue sources	Define Shared Taxes	Law on Local Government Finance			Enhance citizen commitment to pay taxes

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central gov't institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(4) Intergov. Fiscal transfers incl. the scope of unfunded mandate	Objective and Transparent Transfer Formulas Mix of Conditional and Unconditional Transfers Stability of the Transfers to LGUs	Law on Intergovernmental Fiscal Relations	Normative act needed and Implementing Action Plan		
(5) LG borrowing and infrastructure dev			Define Levels of National and Sub national Borrowing	Improve capacity of LGUs to borrow with CIP and financial resources for debt borrowing	Community Involvement in CIP decisions

7.2 PRIORITY AREAS FOR IMPROVING FISCAL DECENTRALIZATION

7.2.1 Areas of Consensus

With such a complex set of policy issues and options there is a need to identify the national priorities and consensus areas in which there is the possibility of achieving some improvements in the fiscal decentralization system.

In order to determine the basis for further central/local level dialogue and achievement of some consensus; a survey of 11 of the 14 local governments participating in the PLGP was undertaken. A set of questions was presented asking for a ranking of the various issues and possible areas that need improvement within the local government system. The results of this questionnaire are presented here as a basis for beginning this consensus dialogue and further discussion.

The first question posed focused on the main areas of fiscal decentralization and how these should be identified on a priority ranking for central/local policy development. The priority areas and the results of the survey are presented below.

Priority Areas for Improvement

Of the following areas, indicate which you feel are most important to change in the next two years (rank in order of importance with 1 being of highest importance)

- 1 Changes to the Legal Framework
- 3 Clarify Expenditure Assignments of the LGUs
- 5 Improving the Revenue Capacity of LGUs
- 3 Improving the basis of the intergovernmental transfers
- Supporting LGUs to use debt and borrowings
- (Other)

One LGU indicated multiple priorities of the issue areas. Based on the above the main priority area for the LGUs is the improvement of the revenue capacity, with other areas closely following in the prioritization.

Improve the Legal Framework

The survey then asked for rankings of issues within the policy areas identified above. The first area was the importance of making changes to the legal framework. The results of this question are presented below.

- 3 Amend Law on Organization and Functioning of Local Governments
- Amend Law on Management of Budgetary System
- Amend Law on Local Borrowing
- 7 Develop Law on Local Government Finance
- 2 Develop Law on Intergovernmental Fiscal Relations
- (Other)

There is a clear consensus that there is a need to develop a law on local government finance within the issue areas of changing the legal framework.

Improve Expenditure Assignments

Following the issue of changing the legal framework, the surveyed LGUs were asked to prioritize the areas in which improvements in the expenditure assignments should be made. The results are presented here.

- Clarify assignments of regions
- 4 Clarify assignments of shared functions
- 3 Provide for administrative territorial restructuring

4 Provide for assignments based on size of LGUs

(Other)

While there is some consensus among the LGUs for making the expenditure assignments based on population size of the LGUs, the issues of administrative territorial restructuring and clarifying the shared functions are very closely ranked as well.

Improve Revenue Capacity

The next area for prioritization was the means to improve the revenue capacity of the LGUs and what particular approaches should be implemented. The results of this survey questionnaire are provided here.

7 More authority for LGUs to establish rate and base of taxes

 Remove restrictions on the use of the Small Business Tax

 Provide authority for additional revenue sources

2 Utilize Shared Taxes to LGUs

2 Improve Property Tax Collection

 Improve Collection of Other Taxes

(Other)

By an overwhelming consensus the LGUs surveyed indicated that more authority for the LGUs to establish the rates and base of taxes is the most critical priority area.

Improve the Intergovernmental Transfer System

Another priority area for attention is the improvement of the intergovernmental transfers from the central to the local level. The opinions of the LGUs with regard to this issue are shown below.

3 Improve the stability of the transfer allocations from year to year

3 Define the amount of the grants as percentage of GDP or Total Revenues

4 Provide for more objective and transparent allocation formulas for all transfers

1 Improve the competitive grants with more relevant criteria

1 Eliminate the competitive grant and apply funding to unconditional grant

1 Improve the horizontal equity of the transfers across all LGUs

2 Utilize a population classification to provide for different levels of grant

(Other)

One LGU provided multiple choice for the prioritization, but the main area of consensus was the improvement of the transfer allocations on a more objective and transparent formula. This was closely followed with the stability of the transfer allocations and defining the transfer pool based on taking a percentage of GDP or total revenues.

Local Government Borrowing

The final area examined in the questionnaire was the prioritization of possible improvements for local governments to use borrowing to finance capital investments. The findings of the survey are presented here.

- 8 Make borrowing less restrictive under existing law
- 2 Allocate part of the debt capacity available between the national and local governments to utilize
- 1 Improve LGUs capacity to plan capital improvements and utilize debt for these purposes
- 1 Improve community participation in capital investment planning
- Create bond bank or other credit mechanism for LGUs to access credit markets

The overwhelming consensus is to make borrowing less restrictive under the existing law and administrative regulations.

7.2.2 Sequencing of Fiscal Decentralization Actions

While this White Paper has defined a comprehensive and complex set of recommendations and timeframe for implementation it not realistically possible to achieve all of these in a simultaneous set of actions. Many of these actions will require further analysis of possible impacts and the changes in the legal framework and administrative territorial restructuring will require time and opportunity for public debate before a consensus can be achieved. Therefore, it is important that some consideration be given to determining those actions that can be achieved in an expeditious manner and without considerable delay.

Some of the recommendations can begin without much further delay. These include:

1. Reactivate the revision and updating of the National Decentralization Strategy
2. Finalize the existing Draft Law on Local Finance
3. Reconcile the census and civil registry data
4. Accelerate the property registration process with transfer of property record information to the LGUs
5. Initiate better distribution of the motor vehicle tax with more going to the LGUs

The other recommendations that would require additional time and consideration include:

1. Redefine the administrative territorial structures following a period of voluntary structuring and then compulsory amalgamation
2. Transfer the shared functions to LGUs based on willingness and capacity
3. Initiate shared taxes on PIT once the technical problems of implementation are resolved
4. Define the role and responsibilities of the regions

The above enumeration of actions is only intended to highlight that it is important to take into account the timeframe and sequencing of fiscal decentralization actions in order that it can be done in an orderly and systematic manner without any significant disruptions to the present operations and functioning of the local governments

An important consideration, particularly with respect to changing the expenditure assignments and the transfer formulas is whether to proceed with these before or after the completion of the administrative territorial restructuring.

7.2.3 With Territorial Restructuring

The ideal situation, from a theoretical perspective, is to complete the administrative territorial restructuring in order that the expenditure assignments and transfer formulas can be based on a more realistic set of conditions within the local government system. This would allow for better expenditure assignments based on population size, some capacity considerations, and efficiency of the services to be assigned and delivered either at the local level or by regional or central levels.

This does not generally occur in practice when there is substantial time needed, especially if there is to be voluntary amalgamation, for the territorial restructuring to occur. Also, without a consistent set of criteria and specifying the minimum level of the LGUs size, there may be amalgamation that still does not provide for LGUs with the revenue or service delivery capacity.

Consequently, if Albania is to wait until there is some resolution of the administrative territorial restructuring, it is likely that no significant changes at least in the expenditure assignments or transfer formulas would be realistically possible within the next several years.

7.2.4 Without Territorial Restructuring

It is necessary to consider what could be accomplished as far as promoting fiscal decentralization without having the territorial restructuring in place for several more years. There are a number of actions that could realistically be taken to improve the process of fiscal decentralization and these are primarily focused on the revenue side of the fiscal decentralization effort.

There is no reason not to continue to provide to the LGUs some additional revenue sources, whether tax sharing or own source revenues. Some changes to the legal framework allowing for additional tax sources, clarifying the tax sharing arrangements of the PIT, or allowing for LGUs the authority to establish the rate and base on some surtaxes would promote the overall fiscal capacity of the LGUs and prepare them to assume more of the expenditure responsibilities. Therefore, it is suggested that these efforts be continued and accelerated over the next two years pending any changes in the administrative territorial restructuring.

U.S. Agency for International Development
Planning and Local Governance Project in Albania
St. Dervish Hima
3 Towers near Qemal Stafa Stadium
Tower No. 1, Apt. 91, Tenth Floor
Tirana, Albania
Tel: + 355-04-450-4150
Fax: + 355-04-450-4149
www.usaid.gov