

Albania: Fiscal Decentralization Study

EXECUTIVE SUMMARY

(Revised-June 26, 2003)

I—BACKGROUND AND ISSUES

After almost half a century of an extremely centralized government, Albania started on a path of political decentralization with the first local democratic elections held in 1992. Despite the significance of this initial political move towards increased democratic representation, the local administrative and fiscal autonomy remained very weak. However, the decentralization process received a second boost in the late 1990s. In 1998 the country formally subscribed to the Council of Europe's Charter of Local Self-Government—incorporating its key principles into the new Constitution—and in 2000 it passed legal reforms for local governments.

The adoption of the local self-government principles explicitly in the Constitution consolidated the political decision for a decentralized government structure, under the laws of Albania as a unitary country. The new organic laws on the “Organization and Functioning of the Local Governments” (Law # 8652/00) and on the “Administrative-Territorial Division” (Law # 8653/00) discontinued the old District Councils, reducing the state's direct political influence over the local governments' businesses. This clearly established a solid legal framework that would allow for functional decentralized administrative and fiscal structures, which would include the self-governing regions, municipalities, and communes.

Although Albania is far from completing the design of political, administrative and fiscal decentralization that would be able to satisfactorily improve service delivery, governance and accountability, it needs to be acknowledged that considerable progress has been made in establishing the basic institutions and legal framework, as well as in implementing policies towards decentralization. Since 2000, important institutional arrangements have been put in place, regulations have been adopted, and initial policy reforms have been implemented on several fronts. These actions have included: (i) the establishment of the (inter-ministerial) National Committee on Decentralization (NCD), supported by the Technical Group of Experts on Decentralization (GED) with international expertise; (ii) the adoption by the NCD of the Strategy of Decentralization and Local Autonomy; (iii) the approval of a new law on the role of Prefects and their relationship to the local authorities; (iv) the approval of the Law on Immovable State Properties, the Law on the Transfer of State Properties to the Local Authorities, and the creation of the Agency for Inventory and Transfer of Public Properties; (v) the transfer of several key exclusive functions to local authorities (including some minor functions transferred to the regions) as defined by the law on local governments; (vi) the establishment of a formula-based unconditional grant mechanism (partially replacing conditional, earmarked transfers); and (vii) the adoption of a critical package of fiscal reforms in 2002 (including the local small business tax, the simplified profit tax, property taxes, and a system of local fees and charges) which expanded local government revenue autonomy.

Although the country has taken a political decision to decentralize fiscal and administrative decisions, and for that end can now count on a minimum institutional base and a reasonably strong legal framework, it should be noted that Albania is at a crossroads. The implementation of policy reforms has been uneven and is lagging behind schedule. This has been partially due to weak implementation capacity, to institutional and structural constraints, and to political and bureaucratic stumbling blocks in the reform process. Actually, while in some areas progress has been substantial (as noted in the previous paragraph), in other areas reforms that would facilitate decentralization have met with difficulties or resistance. For example, the specific competencies of regions, municipalities and communes, as well as the drafting of the new Law on Local Budget and the new Law on Local Finance (including the badly needed national tax sharing arrangement) are still undecided. Overall, for Albania to successfully implement a sustainable intergovernmental fiscal relations system, it still must address certain critical challenges, including the following:

1. ***The lack of implementation capacity and weak institutions***,¹ has delayed the adoption of decentralization measures, since there is a fear that this may disrupt the delivery of local public services and/or may have an unfavorable impact on fiscal accountability.
2. ***The fragmentation of local government units and the undefined role of the regions***, which could complicate a uniform attribution of responsibilities and could affect local public service delivery efficiency, fiscal transparency and fiduciary accountability.
3. ***The lack of a clear definition of specific responsibilities*** and decision-making powers, especially for shared functions, which has led to inefficiencies, because of duplication or under-provision of services.
4. ***The insufficient local revenue autonomy***, which has negatively affected fiscal and political accountability of local authorities directly to citizens.
5. ***The inefficient transfer/grant system***, which renders the local government financing system unpredictable (and which still reflects the old “gap-fill” approach), since it remains dependent on undesirable political and bureaucratic maneuvers.

This “Albania-Fiscal Decentralization Study” report provides: (i) a stocktaking of the decentralization process in Albania; (ii) a discussion of the conditions for sustainable intergovernmental fiscal relations under a certain degree of local fiscal autonomy; and (iii) a roadmap on how to proceed in critical cross-cutting intergovernmental finance matters. The study is intended to support the development of a consistent decentralization strategy in Albania and provide inputs to Bank’s operational interventions (including the CAS, the PRSC, and sector operations).

The following sections of this Executive Summary specify the strategic directions for reform and cover the above identified main issues under the headings: II, Strategic Directions; III, Implementation Capacity and Institutions; IV, Territorial Division and the Role of the Regions; V, Assignment of Responsibilities; VI, Revenue Autonomy and Accountability; and VII, Fiscal Imbalances and the System of Transfers. Section VIII provides suggestions towards a road map for reforms.

¹ Including the absence of central coordination and the reluctance of the central bureaucracy to relinquish decision-making power on micro-managing local public services.

II—STRATEGIC DIRECTIONS

In order to implement a sustainable decentralized administrative and fiscal system, the Government of Albania must publicly spell out a feasible reform agenda that it intends to implement in the near future. One option is for the Government to review its current decentralization implementation program, make it consistent with its National Strategy for Social and Economic Development (NSSED), and focus the reform agenda (see the next sections of this Executive Summary) on the following general strategic directions:

1. ***Boosting the credibility of the government’s decentralization strategy*** by maintaining the momentum of its reform implementation agenda and definitively consolidating in practice the legally adopted three-tier public administration structure.
2. ***Defining and attributing the specific responsibilities of local governing units asymmetrically,***² on the basis of pre-established objective criteria of eligibility. This would imply empowering local managers and authorities with sufficient capacity, incentives and autonomy, and ensuring their commitment to policy outcomes through enforceable meaningful legal instruments.
3. ***Creating the conditions for the improvement of local government accountability to the citizens,*** by promoting local fiscal autonomy on the basis of the appropriate, efficient and fair assignment of local revenue sources.
4. ***Using the transfer system as an effective policy instrument*** to compensate for regional economic disparities and fiscal imbalances, and to achieve nationwide and local objectives (in terms of public expenditure priorities and service provision, in quantity, quality and accessibility), in a transparent, congruent and efficient manner.

These general decentralization strategic directions are consistent with the NSSED,³ which establishes that “by the end of the 2003-2006 period, the Government will have completed the decentralization process ...” including the “...transfer of assets and the total transfer of financial and fiscal competencies ...,” the definition of the shared functions and the clarification of the position of the local government ... (in education, health service, social assistance, civil defense, etc.), ... the reform of the administrative-territorial division, ...and the strengthening of the municipalities and communes ... aiming at enhancing inter-communal cooperation with the District Councils.”⁴

III—IMPLEMENTATION CAPACITY AND INSTITUTIONS

Policy implementation capacity and intergovernmental and donor cooperation in Albania are weak. Therefore, improving implementation capacity, especially at the local level, is a necessary condition for proceeding successfully with decentralization. Too rapid decentralization without the proper capacity and institution building (including improved

² That is, in accordance with their respective implementation capacity.

³ *NSSED: Progress Report for Implementation 2002—Objectives and Long-Term Vision of the NSSED, Priority Action Plan 2003*, Council of Ministers, Republic of Albania, Tirana, May 8, 2003.

⁴ See Road Map Section of this Executive Summary.

intergovernmental and donor cooperation) could jeopardize governance and exacerbate the disruption of local public services delivery (in both quantity and quality). Such an outcome would run counter to the very objectives of decentralization. Therefore, a well designed government decentralization implementation strategy is necessary—one that factors in capacity and institution building accordingly.

One problem affecting capacity—and this has been exacerbated by the recent migration outflows of population—is that the administrations of small municipalities and communes have found it difficult to retain young, talented professionals, who are leaving in search of better employment opportunities, wages and living conditions. This migration has constituted a major challenge for those communities in the northern and southern regions, where migration to the central regions and abroad takes place. This challenge is particularly important in view of the absence of a national capacity/institution building program at the local level. Institutional weaknesses are particularly acute in the area of budgeting, where accounting procedures are de facto not uniform, where planned and executed budgets usually diverge, where auditing (if any) is not regular, and where monitoring and evaluation are practically nonexistent.

In addition, some central ministries are reluctant to decentralize functions. Partly since their new role would essentially involve relinquishing some of their current decision-making power in almost every aspect of local public service delivery, and taking on the more essential new central functions of planning, regulating, coordinating, and overseeing responsibilities such as policy formulation, the setting of standards and regulations, and monitoring, control and evaluation.

Moreover, the old paradigm under which the central government and some of the donors still operate tends to alienate local authorities' and the civil society's inputs in the prioritization of local resource allocation. Some times donors have conducted the negotiations for locally implemented assistance projects/programs at the ministerial level, without sufficient direct involvement on the part of local governments, NGOs and the civil society. Under such a paradigm, donor assistance may end up obstructing, instead of assisting, the sustainable implementation of the Government's decentralization strategy.

The report suggests that the Government may want to consider addressing the above issues regarding implementation capacity and institutions by adopting a set of complementary institutional reforms that can remove the remaining hurdles that are impeding or delaying the implementation of the degree of administrative and fiscal decentralization that could be sustainable. Such a set of reforms should include the following:

Shifting the paradigm of central government institutions from managing local service delivery towards policy formulation, setting up standards and regulations, and exercising monitoring, controlling and evaluation more effectively. The implementation of this reform approach is a sine qua non for the continuation of decentralization in Albania. The Government may consider

implementing this reform approach *immediately*,⁵ although the results may be expected to be fully effective in the medium term.

Strengthening governance institutions, including building capacity, is a sine qua non to effect the decentralization reform measures. This can be achieved by:

- (i) reviewing the Organic Budget Law and making budgetary procedures and processes uniform at all government levels;
- (ii) empowering local authorities and managers with clear specific competencies on expenditures and revenues, and making them personally accountable before the law and the local citizens;
- (iii) designing and implementing a Law on Local Government Finance, which clearly regulates all intergovernmental relations, including tax sharing and access to borrowing; and
- (iv) adopting a national training program (for central and especially local authorities, officials and staff—on public finance, including budgeting, accounting, and fiscal and debt management) in collaboration with the Training Institute of Public Administration/DOPA. The adoption of policy measures in all these areas of reform is desirable and feasible in the *short term*.

Strengthening downstream coordination by setting up an “Intergovernmental Committee for Coordination of Decentralization Implementation (ICDI)” to support the GED and the NCD in effecting the government’s decentralization agenda. The ICDI should be designed to promote vertical and horizontal intergovernmental dialogue and cooperation, by increasing communication, capacity building and management of information, and by disseminating best practices across local government administrations and serving as a cushion to accommodate divergent interests and as a first point for conflict resolution. Moreover, the ICDI would feed back the work of the GED and NCD with critical elements for periodic policy adjustments. This is a critical institutional reform measure that the Government may consider adopting in the *short term*, owing to the urgent need for implementation coordination.

Promoting an increasing role for the private sector (including local NGOs and civil society organizations) in the financing and the delivery of local public services. The more direct involvement of the private sector should be aimed at rationalizing the use of public resources, reducing waste and ensuring a sustainable supply of services (including utilities). Given the present conditions in Albania, and in order to avoid disruptions in service delivery, this should be considered an objective to be achieved in the *long term*.

IV—TERRITORIAL DIVISION AND THE ROLE OF THE REGIONS

The current territorial division and the role of the regions have raised issues on both efficiency and political grounds, that is, on the grounds of whether the local administrative units (especially the communes) are not too numerous and of too small a size, and whether the

⁵ In this report, policy reforms have the following time dimensions with regard to their desirable implementation: *immediate*, in the next three months; *short term*, in the year ahead; *medium term*, in the next two years; *long term*, when the necessary conditions are in place.

Regional Councils have the legitimacy to play a relevant governmental role in Albania. The main arguments are as follows.

Although Albania is a small country (about the size of the state of Maryland and with only about 3 million inhabitants), its territory is formally divided into 374 first level local self-government units (65 municipalities and 309 communes). This entails a situation in which 48 percent of these self-governing units, representing 17 percent of the country's population, are made up of communities of less than 5,000 inhabitants—or 54 percent and 30 percent, respectively, in the case of the communes. As with many other European countries in transition, this fragmentation raises concerns that go beyond economic efficiency arguments (e.g., economies of scale and externality spillovers) to include considerations of a political and an administrative nature. On the one hand, fragmentation means that the decision-makers are closer to the voters, which increases democratic representation, and, depending on the design of the decentralization of powers and incentives, may increase fiduciary and political accountability. On the other hand, excessive fragmentation tends to leave the smaller communities short of the administrative and technical capacities necessary to implement policies effectively and operate public services efficiently—an argument which runs against decentralization.

The discontinuation of the old Districts and their replacement by a second level of local self-government (i.e., the Regional Councils) constituted an innovative facet of the 2000 territorial-administrative reform. To the Regional Councils the law assigned the exclusive functions of planning and coordinating actions of regional interest and of delivering public services which could be delegated to them by the central government or the constituent municipalities or communes. In practice, however, the local regional government concept has as yet been perceived as an “empty box,” since the functions of the Regional Councils are still poorly defined, the Councils can count on no fiscal autonomy, and the central government and first level local governments are reluctant to delegate functions to the Councils. In fact, as the Regional Council members are not directly elected by all of the citizens in the region, they tend to lack accountability, and both Prefects and local Mayors (who are, respectively, appointed by the central government and directly elected by municipalities and communes) have questioned the legitimacy of the regional authorities on this basis. Mayors of larger municipalities, in particular, are unwilling to accept regional guidance, or intermediation in their dialogue with the central authorities, since they are usually capable of gathering a large enough audience of their own. In addition, central and line ministers are accustomed to operating locally under the old paradigm of de-concentrated services in the territory and seemingly prefer to continue doing so.

Overcoming the administrative fragmentation of local governing units is possible either by implementing the compulsory amalgamation of the smallest units (especially the communes), or by promoting incentives (including financial incentives) which encourage various forms of voluntary associations among the local governments. The former approach may have the advantage of being more effective and simple to operate from the center, but it runs the risk of confronting local traditions and may also create political turmoil, since it may be perceived as imposed from the top down. The latter approach, by definition, is more efficient since it respects local traditions and preferences, but tends to take longer to complete (if it is implemented at all) and is more complex to monitor centrally. Given the political sensitivity of the issue, the

Government of Albania may consider taking a flexible approach (considering conditions and timing) by:

- (i) assigning responsibilities (and the corresponding resources) to local self-governments asymmetrically, that is, according to their respective capacity of delivering the specific local public service efficiently; and
- (ii) articulating incentive instruments (including direct technical support, training, and financial/fiscal support) in such a way that eligible jurisdictions could easily realize that amalgamation/association could increase efficiency and make them better-off permanently, as well as improving their chances to access EU concessions later on.

Establishing the regions as effective governing authorities will require a clearer assignment of their responsibilities and a commensurate degree of fiscal autonomy in order to ensure greater efficiency and accountability. To this effect, complementary measures should be implemented in the medium term in order to clarify the role of the regions by:

- (i) re-examining the advantages/disadvantages of the indirectly elected Regional Council members—for example, whether the current *local* regional governments (i.e., a kind of local government association) could be as effective as a truly self-governing regional government (i.e., a directly elected *intermediate* level of government);
- (ii) submitting, de facto, the role of the Prefects to the requirements of the new Law # 8927/2002, and discontinuing the traditional prevalence of the Prefects in matters of local interest;
- (iii) considering adopting the compilation of statistical information in conformity with EU's Nomenclature for Statistical Territorial Units (NUTS); and
- (iv) evaluating any current and prospective regional semi-autonomous agencies (e.g., Tirana Region Health Authority-TRHA) for consistency and proper coordination with the decentralization reforms.

V—ASSIGNMENT OF RESPONSIBILITIES

The provision of public services in Albania is in a transitional phase, from a highly centralized, hierarchically de-concentrated system inherited from the previous regime to a decentralized decision-making structure formalized by the 2000 legal reform. This legal reform represented a turning point in intergovernmental fiscal relations, which, inter alia, broadly assigned responsibilities to local governments. Although considerable efforts have been made in this direction and some progress has been observed in the years following the reform, political difficulties and bureaucratic stumbling blocks do exist, and thus there is still a long way to go to bring the basic legal reforms into satisfactory practical implementation.

By and large, the new organic local government law associates responsibilities with the theoretical concept of benefit areas, and it is broadly consistent with the practical principle of subsidiarity adopted by the European Union (i.e., local governments are assigned responsibilities for services that benefit the local jurisdiction, so that authorities will be accountable to their own local constituents). However, the law assigns only generic responsibilities to local governments according to three categories of public functions: exclusive, shared, and delegated functions.

Exclusive functions are those in which the local jurisdiction is the main beneficiary of the public services. These include mainly local infrastructures and public utilities, but also some areas of social services, housing, recreation, sports and cultural activities, as well as local traffic regulation, public transportation, public sanitation, civil security, and local development planning. Shared functions are understood as those in which major externalities may occur in the provision of the public service (i.e., the benefit area is likely to extend beyond the local jurisdiction that provides the service). The following are broadly defined as shared functions by the organic law: pre-school and pre-tertiary education, emergency/primary health care, public health protection, social assistance and poverty alleviation, public order and civil protection, and environmental protection. Nevertheless, the precise definition of competences to be attributed to local authorities is still pending further specific regulation. Finally, delegated functions are those for which the state (the principal) can attribute, by means of law or agreement, to the local authorities certain competences (e.g., delivery of services, payment of benefits) according to prescribed standards, in which case the local government essentially acts as an agent in the delivery of the specified services.

Although the organic local government law has established a sound foundation for the assignment of expenditure responsibilities, Albania stands as an example of a difficult implementation process, typical of European countries in transition, where political and bureaucratic issues interweave with a difficult social situation on the ground. In Albania this is aggravated by the fact that the initiative for further specifying responsibilities and powers has essentially been left to the decisions of the line ministries, an approach that may not augur well because of the obvious vested interests involved.

The main issues in the assignment of responsibilities identified by the report include the following: (i) lack of clarity and specificity in the assignment of responsibilities; (ii) de facto insufficient expenditure autonomy for local governments; (iii) inefficient delivery of local public services; (iv) inconsistent separation in the assignment of responsibilities for capital expenditures; and (v) substantial disparities in per capita expenditures across local self-governing units.

The lack of clarity in the assignment of responsibilities for specific competences (to both the regions and the municipalities and communes), especially with respect to shared functions, may lead to concurrent authority, with duplication or under-provision of essential services. Confusion regarding powers may become an excuse for unfunded mandates and may serve as a perverse incentive for local governments to trigger a bailout which may soon turn into a source of soft budget constraints. As long as the specification of competences is not properly defined, distortions will tend to build up and the service delivery system will become increasingly inefficient, further complicating the implementation of the Government's decentralization agenda.

The insufficient de facto autonomy of local governments with regard to local expenditure (because of the excessive ascendancy and power of Prefects and central regulating agencies, which are supported by the central authorities) has in practice limited the ability of local administrations to prioritize resource allocation in accordance with the citizens' interest.

The *inefficient delivery of local public services* has recently been aggravated by two main factors. The first of these factors is the weak prioritization of resource allocation, revealed by an inadequate mix of factor inputs at the local level, reflected in the low O&M/wage expenditure ratio, which may indicate insufficient complementary resources per local public worker (including training and equipment). Low maintenance expenditures for existing equipment and facilities have led to inefficiencies, to the high cost of local service provision, and to the too rapid deterioration of the capital stock. The other factor is the intense migratory movements, mainly from small rural communities in the north and the south toward larger urban centers in the middle of the country that have exacerbated the structural imbalances of the territorial administration, which comprises, on the one hand, fragmented administrative units operating with high fixed costs and, at times, “idle” capacity, and, on the other hand, a few bloated urban centers with overcrowded infrastructures and social service facilities.

The *inconsistent separation in the assignment of responsibilities of capital expenditures* (investment and maintenance) has led to sub-optimal spending on the maintenance of facilities and equipment, since it represents a perverse incentive policy which tends to lead to more rapid depletion of the capital stock than would otherwise occur, including in the social sectors.

The *substantial disparities in per capita expenditures across local self-governing units* may increase with the decentralization of tax revenues on a derivation basis, thereby threatening equity principles, and, in the medium and long terms, may jeopardize the country’s social and political stability, colliding with the EU cohesion objectives.

Conflicts between emerging sectoral strategies and the Government’s decentralization agenda may indicate a disconnect and a lack of central coordination, which would tend to create confusion and uncertainty in local planning and budgeting, and would run the risk of alienating the local authorities. A disconnect also seems to persist between the decentralization strategy and the privatization policy (including utility services). In the matter of this disconnect, a clear policy sequencing (i.e., whether privatization of public assets would precede or follow decentralization, and under what conditions) may still need to be established.

In parallel to the required institutional and capacity building arrangements referred to in the previous section, the Government might consider addressing the above issues by:

Effecting the implementation of exclusive functions by clarifying specified functions and competences, defining the unconditional financing sources, and accelerating transfers of public properties to local governments. This could be achieved by: (i) establishing explicit implementation programs to complete the shifting of responsibilities (either to Regional Councils or to municipalities and communes), including civil defense, urban planning, land management, housing, protection of the local environment, and utilities (e.g., water and sewerage); and (ii) resolving the pending issue on the assignment of responsibilities for capital expenditures (where currently the central government is basically responsible for capital investment while local governments are responsible for O&M) by establishing a long-term program to phase in local government responsibilities for local investment and, to the extent possible, to open this opportunity to private sector participation as well.

Defining specific competences on shared functions for local governments in accordance with Law # 8652/2000. This is critically urgent to resolve the pending inconsistencies in the legislation and to avoid increasing inefficiency and disruptions in social service delivery (including education, health, and the environment). In addition, *national criteria, service standards, and funding sources for shared functions* should be agreed upon, in congruence with the national strategies for the respective sectors and in consultation with local governments. In this regard, a feasible, binding timeline for the transfer of assigned responsibilities to local governments, including capital expenditures, should be approved and implementation should begin soon. Moreover, the Government may consider whether some specific competences of “veterinary services” (e.g., animal disease control, agricultural research, and rural extension services) and “health care” (e.g., the campaign to combat contagious diseases, HIV) should be re-assigned from *shared* to *delegated* competences, in accordance with the argument that the benefit area is actually the entire national territory.

Reviewing and re-assigning delegated functions by considering (i) amending the organic law by re-assigning those functions of evident national benefit area, such as veterinary services, some national health care services, and social assistance to the poor (i.e., *ndihma ekonomike*), from the *shared* to the *delegated* category; and (ii) defining the specific competences of local governments in education and health (including operations and maintenance of facilities) and re-assigning them from (the currently interim) *delegated* functions to *shared* functions definitively, as authorized by the organic law.

Assigning capital expenditure responsibilities consistently by envisaging a medium- to long-term strategy of gradually transferring to the local governments the responsibilities for capital investment *and* maintenance on exclusive and shared functions.⁶ Although in the short term the Government may still have to provide substantial capital transfers and loans to the weaker local governments, the proposed medium- to long-term strategy would not only help the system converge to a more efficient allocation of capital expenditures (thereby minimizing the waste of scarce resources) but would also be consistent macroeconomically, since it would alleviate pressures on the state budget by tapping resources for essential local capital investments (including infrastructure reconstruction and expansion) from alternative financing sources.

Assigning meaningful responsibilities to the regions while addressing the fragmentation problem of the communes and municipalities by identifying and shifting functions whose expanded benefit areas can increase efficiency in service delivery. In this regard, some of the problems associated with economies of scale and externalities at the local level could probably be solved at the regional level, or by voluntary associations of municipalities/communes, service outsourcing, and the direct participation of the private sector. Probably some education competences (e.g., secondary and vocational education), some health care competences (e.g., primary health care, including ambulance services and regional hospitals), some civil security competences (e.g., firefighting), transportation and telecommunications (e.g., intercity transport services and regulations), and utilities (e.g., water supply, irrigation, solid waste collection and management) may fall into this category of services. Although the Government may consider delegating some of these functions and competences to the regions and introducing incentives for

⁶ The assurance of fiscal transparency and hard budget constraints is critical for such an approach to work well. Albania may still need considerable reforms in the financial sector for the necessary conditions to be in place.

the municipalities and communities to do the same (or to associate, or outsource), caution should be exercised to avoid inter-jurisdictional conflicts regarding power, unfunded mandates, and soft budget constraints.

Increasing the efficiency of public service delivery by implementing structural reforms that would account for an increase in the O&M/wage ratio and would resolve the regional imbalances provoked by the migratory movements of recent years. In this regard, the Government may consider the following:

- (i) Extending the civil service reform to cover local administrations, and better prioritizing local resources during the budget formulation phase (including adopting a cautious use of expenditure “norms” to avoid maintaining local oversized or idle institutions).
- (ii) Carrying out sectoral and administrative reforms to rationalize the existing facilities, infrastructures, and personnel. These reforms would, on the one hand, probably require the closing of many idle facilities in the depressed areas of the country and the re-deployment of (de-concentrated) personnel across jurisdictions. On the other hand, they would also require increased investments in the immigration areas in order to alleviate the excessive pressure on the insufficient local infrastructures.

Strengthening coordination between sectoral and decentralization strategies by empowering the GED and the proposed ICDI with enforceable monitoring and control instruments to ensure policy consistency at the formulation and implementation phases, respectively. Strengthening coordination in policy formulation is essential to avoid the current disconnect between the emerging sectoral strategies and the Government’s decentralization agenda. A tight follow-up approach should be maintained to guarantee that a consistent and comprehensive decentralization strategy is implemented in congruence with the central and line ministries, without alienating the local governments and the private sector in the process.

VI—REVENUE AUTONOMY AND ACCOUNTABILITY

In fiscally decentralized systems, revenue autonomy—apart from expenditure autonomy—provided by meaningful and predictable own sources of revenues is a prerequisite incentive mechanism for local accountability. Citizens can easily associate the costs with the benefits of the public services they demand and with the local authorities that are responsible for taking decisions. In addition, an adequate degree of revenue autonomy provides local authorities with the necessary instruments to reduce fiscal vertical imbalances, by predicting, forecasting and planning their budgetary priorities accordingly.

The system of revenue assignment in Albania is experiencing a major overhaul, which started with the introduction of new local tax, charges and fees legislation in December 2002. This fiscal reform is aimed at strengthening the local tax regime and developing a sound revenue base for local governments. It represents a rupture with the past local government financing structure, which was characterized by an extreme degree of centralization in fiscal decision-making. The fiscal reform package of December 2002 reorganized the assignment of revenue

sources by redefining some previously national taxes as local taxes (property tax on buildings and land, small business tax, vehicle registration tax), creating new local taxes and fees (property transaction tax, simplified profit tax, temporary tax), reclassifying and rationalizing the previously existing fees, and eliminating the existing local turnover tax (on restaurants, discos, hotels, and cafés and bars).

The new legal configuration of the tax assignment in Albania as of January 2003 goes around state non-shared taxes, national shared taxes, and local taxes, fees and charges. *State non-shared taxes* include the value added tax (VAT), customs duties, the solidarity tax, and a set of non-shared national fees; all policy decisions on rates and bases, proceeds appropriation, and tax administration are entirely reserved to the central authorities. The law on local government (Arts. 15 and 17) introduced for the first time in Albania the category of *national shared taxes*, which includes the personal income tax (PIT) and the profit tax (corporate income tax-CIT), although to date no tax has been shared with the local governments, under the argument that this would add considerably to the revenue disparities among jurisdictions.

Local own taxes are levied on properties (including buildings and agricultural land), property transactions, turnover of local small businesses—the Local Small Business Tax (LSBT) and the Simplified Profit Tax (SPT)—vehicle registration, hotel services, business signs, construction, use of public space, and some temporary activities. Local fees and charges are authorized mainly on business registration, solid waste services, advertisements, slaughterhouses, new residence registration, car parking, and hunting and fishing. To date, with the exception of the larger urban centers (e.g., Tirana, Durrës, Elbasan), local taxes, fees and charges have been characterized as ineffective fiscal instruments, since they constitute a myriad of small rates, which are complicated to administer (some of them costing more to collect than their tax yield) and which have low compliance rates owing to the economic conditions of the local population and/or the perceived low capacity of local enforcement mechanisms.

Currently, in regard to tax assignment, the Government of Albania faces the following main issues: (i) local revenue autonomy is low; (ii) the 2002 fiscal reforms introduced new pitfalls; (iii) decisions on sharing national taxes are still pending; (iv) the legal provisions for the use of local fees and service charges are inappropriate; (v) property value assessment is still inadequate; (vi) local capacity in tax administration is weak; and (vii) the disparities in per capita revenues across municipalities and communes are significant.

Local revenue autonomy in Albania remains low even after the introduction, with the 2002 fiscal reform, of the LSBT, the SPT, the Agricultural Land Tax (ALT), and the vehicle registration tax. Relative to its European comparators, local government in Albania lags behind quantitatively, and cannot decide on bases and rates for the SPT and the vehicle registration tax. Moreover, the Regional Councils remain without any fiscal power of their own.

The pitfalls introduced by the 2002 fiscal reform may entail a non-buoyant local tax system for local governments, since (i) the tax liability of the newly assigned local taxes is not ad valorem based; (ii) the indicative LSBT fixed quota scale and the SPT rate are still centrally determined; and (iii) although the entire tax yield is local government's the LSBT and SPT

taxpayers are subjected to two separate tax administrations, and this implies a perverse incentive for the collection of the local tax.

Allegedly because it would increase horizontal disparities, a broad-based national tax-sharing scheme has not as yet been implemented, which leaves room for an unpredictable “gap-filling” negotiation of transfers and grants. This approach to complementing the financing of local budgets is highly inefficient from the economic perspective of resource allocation, and has been subjected to all forms of political and bureaucratic influences.

Albania makes inadequate use of fees and service charges, owing to an inappropriate legal provision in the local government law (Art. 33) which requires a three-fifths majority of Local Council votes for the approval of decisions on local taxes and fees. This rule renders a fiscal system that is inflexible, and which tends to be particularly problematic for the near future with the transfer of the “water and sewerage supply” responsibilities to the local governments. This is important because Albania does not yet have clear tariff policies for the utility services, which, while providing affordable services to the poor, would allow the utility companies to recover costs (and to stop accumulating arrears) and the consumers to minimize waste. Clearer utility tariff policies could help rationalize the use of resources, increase efficiency, ensure a sustainable supply of public services, and reduce the vertical fiscal imbalances and pressures to raise revenue from general taxes.

Property value assessment is also inadequate, owing to the underdeveloped real estate market, insufficient parameters for differentiating property valuation, lack of a reliable cadastral system of properties, and potential loopholes (allowed by the tax exemption mechanisms) in the property tax legislation. These inadequacies may depress the local tax base and the effectiveness of the property taxes as potentially the most relevant source of local revenues.

The local capacity for administering taxes, fees, and service charges is variable in Albania. While the larger urban centers seem reasonably equipped to take on more responsibilities for administering their own revenues, the smallest municipalities and the communes may have difficulties in performing this function in the short run. On the one hand, the General Tax Department (GTD) has argued that, apart from the lack of a minimum required scale of operations, not all local governments have the infrastructure and technical expertise to satisfactorily administer the assigned local taxes (in particular, the LSBT). On the other hand, the local governments have contended that the GTD has usually been more concerned with collecting the larger national taxes (CIT, PIT, and VAT) and only marginally pursues the collection of local taxes.

Finally, the already large disparities in per capita local revenues between and across municipalities and communes will tend to increase in the near future, since the 2002 fiscal reform’s emphasis is on the allocation of tax yields on a derivation basis. While the reform encourages local tax efforts in rich communities, the poor communities tend to be left behind for lack of tax capacity.

To address the above challenges of increasing local revenue autonomy, the Government may wish to consider adopting the following three major lines of action:

Boosting fiscal efficiency and accountability as a major goal of the Government's decentralization strategy by:

- (i) Improving local revenue autonomy and fostering a buoyant local tax base, by examining the feasibility of assigning to the local governments on a residence basis (either municipalities/communes or regions, selectively) a proportional PIT surcharge piggybacking on the national progressive PIT rate. This would give local authorities a tool to efficiently exploit their tax bases and reduce vertical imbalances.
- (ii) Setting up a legally pre-determined, broad-based national tax-sharing mechanism as a proportion of (some) national taxes, to be distributed according to a formula-based equalization scheme. This measure would put in place a predictable revenue mechanism for the local governments while removing any political or bureaucratic influence on the determination of the overall size of the pool of transfers/grants.
- (iii) Consolidating the small business turnover taxes (the LSBT and the SPT) to simplify tax administration and restore a buoyant revenue base for the local governments. This would remove the actual and potential inefficiencies of the current turnover and profit taxes.
- (iv) Rationalizing the use of fees and service charges by removing the “nuisance” charges and fees; spelling out sectoral strategies and tariff policies for utilities separated from social policies; replacing the three-fifths voting requirement rule for decisions on local taxes, charges and fees by a simple majority rule; and considering the introduction of some buoyant and equitable sources of local revenues, such as levies on electricity and telephones, on vehicle property transfers, and on driver's licenses. These are sine qua non measures if Albania is to have in place a reasonably rational system of fees and service charges.

Maximizing local own revenue collection to provide local authorities with the necessary means to discharge their responsibilities by:

- i. Improving the system of property value assessment with the adoption of an ad valorem market assessment system as a strategic direction for the medium and long terms. To this end, steps should be taken immediately in order to find proper financing, build capacity, and pilot the main cities. Meanwhile, the Government should resolve the two main weaknesses related to the current valuation system: (a) bringing the eligibility criteria for granting exemptions for the poor strictly in line with the criteria applicable for social assistance; and (b) upgrading cross-reference information among the four main components of property tax administration (identification of properties, record keeping, assessment and collection).
- ii. upgrading the capacity for local tax administration in general, including the equipment and training of local government staff. This is the case for the LSBT during the two-year transition period, and the property tax, where the Ministry of Local Government and Decentralization (MoLGD)—in collaboration with the DOPA⁷/ITPA, the GTD, and the Association of Municipalities, Communes and Regions—should put in place as soon as possible a national capacity building program supported by the state.

⁷ Department of Public Administration.

Improving the fairness of the fiscal system by compensating for the horizontal disparities, which have been exacerbated by the recent creation of the new own taxes, fees and service charges on a derivation basis. The utilization of fiscal equalization mechanisms (see Chapter 4 of the report), which are already partially in place (e.g., the “unconditional grants”), should be completed, adjusted and strengthened accordingly over time to compensate for the limited revenue capacity of the poorest jurisdictions. This is an unequivocal policy direction to sustain social stability in Albania.

VII—FISCAL IMBALANCES AND THE SYSTEM OF TRANSFERS

Decentralization in Albania, as in many other countries, has tended to lead to vertical and horizontal fiscal imbalances.⁸ This phenomenon tends to be an inevitable outcome which may arise from efficiency reasons (for example, from economies of scale in tax administration that require the centralization of certain taxes, vis-à-vis local preferences and costs in service delivery that recommend subsidiarity in expenditure decision-making) and/or out of differential economic conditions across jurisdictions (for example, a distinct distribution of economic resources across jurisdictions vis-à-vis the distribution of social needs, that will affect tax capacity and expenditure patterns asymmetrically).

Following international best practices, Albania has shown remarkable progress in designing and implementing transfer/grants mechanisms to compensate for these fiscal imbalances and externalities. Since the early 1990s, these mechanisms have evolved from an almost exclusively earmarked system of conditional grants (where local governments essentially performed the role of agents for the central government in the delivery of local public services) towards a mixed system of “conditional” and “unconditional” transfers—the latter was preceded (between 1999 and 2001) by a block grant system, used to allocate (non-labor) operations and maintenance expenditures in the health, education, public works, and culture sectors.⁹ The “conditional grants” mechanism still keeps its old features of being non-transparent, being unpredictable and depending basically on the bargaining powers of local authorities and the line ministries. The “unconditional grants” mechanism was initiated with a provisional formula for *distribution* based on differential local needs and is still evolving towards a true equalization transfer. Nevertheless, the *size* of the unconditional grant is neither transparent nor predictable: rather, it is an ad hoc amount resulting from purely bureaucratic and political bargaining without any technical rationale behind it.

Notwithstanding the recent progress in decentralization, it is important to observe that: (i) decision making is still mostly retained by the center (with about one-quarter of total public expenditures de-concentrated), which has required a corresponding substantial amount of transfers from the center on a conditional basis,¹⁰ and (ii) local governments are still highly

⁸ Vertical fiscal imbalances result from a mismatch between expenditure *responsibilities* and revenue-raising *powers* at different levels of government. Horizontal fiscal imbalances result from a divergence in expenditure *needs* and the respective *tax capacity* across jurisdictions at the same government level (regions or municipalities/communes).

⁹ Personnel costs and capital expenditures are still covered by conditional grants financed by line ministries’ budgets.

¹⁰ Conditional grants to the local governments are essentially earmarked for: (i) wages and social benefits and investments in education, health, and social assistance; (ii) certain subsidies and delegated functions (including food,

“transfer-dependent” (87 percent as projected for 2003), and will continue to be so in the near future.

Apart from the considerable fiscal imbalances, the most critical issues pertaining to intergovernmental grants in Albania include: (i) the lack of any rationale for the size of the unconditional transfer pool; (ii) the excessive complexity (and incompleteness) of the current formula for the distribution of the unconditional grants; and (iii) the lack of transparency in the determination and allocation of conditional grants.

In fact, there are still no rational criteria for the annual determination of the *size* of the unconditional pool of resources to be transferred (i.e., the general purpose transfer pool), which tends to be non-transparent and unpredictable, and does not differ much from the old inefficient vertical “gap-fill” negotiated approach. This approach has been highly vulnerable to political and bureaucratic influences. It has generated perverse incentives for soft budget constraints, by allowing for endless, costly and open negotiations, that permanently engage most of the influential central and local executive and legislative authorities.

Despite the commendable effort by the Government to put in place a pre-established rule to discipline the *distribution* of unconditional transfers, the formula used to date is too complex (although unsatisfactory as an equalization mechanism) to be administered centrally and understood by the main beneficiaries. The formula still deals with too many compensation funds (the general, the regional, the municipal/communal) which depend on too many conditions. The factors affecting the general purpose component and the equalization factor are still poorly specified in the formula, and a convincing rationale is needed for the structure of coefficients that weights the factors.

Conditional grants for the *operations and maintenance* of existing institutions are basically allocated on a historical basis, while the few fund allocations for *investment* have mainly been the result of political influence. There is considerable imbalance in the size of the conditional grants vis-à-vis the size of the unconditional transfers, which tends to negatively affect the expenditure autonomy of local governments. There is a lack of criteria and of competition for the allocation of conditional recurrent grants, which has simply followed an incremental approach. Reliable monitoring and evaluation systems on local public service delivery are absent, which rules out any possibility of verifying the effectiveness of policy implementation. And, there are no clear national standards for local public services set up as yet, which renders meaningless any monitoring and evaluation system on local government performance regarding service delivery.

The effectiveness and efficiency of the system of transfers in Albania could be improved in several ways, including the following:

Pre-determining the current financing level of the pool of unconditional transfers as a fixed percentage of national shared taxes. This percentage could eventually be adjusted later on, whenever the attribution of responsibilities/competences is considered complete. This would

accommodation, and the transportation of teachers and students); and (iii) capital grants for investment in reconstruction of local infrastructure and public works.

simultaneously resolve the problem of determining the size of the unconditional (equalization) transfer fund (in an objective, transparent manner) and of the pending decision on sharing national taxes (without increasing revenue disparities). This would be a simple automatic mechanism, linking the shared-tax scheme with the transfer system, and rendering both of them transparent, predictable and immune to bureaucratic and political influences.

Improving the current distribution formula for unconditional grants by emphasizing and simplifying the equalization component, which could simply be computed by the inverse of the local per capita revenue *capacity* (or any meaningful proxy, properly weighted).

Improving the distribution of conditional grants by: (i) moving the system towards a more balanced allocation of resources between conditional and unconditional transfers, in order to increase autonomy and allocative efficiency; (ii) setting national standards for public service delivery that can be monitored and evaluated through independent and reliable indicators of performance; (iii) improving the equity and efficiency of conditional recurrent expenditure grants by allocating grants through a targeted capitation basis and through “block grants;” and (iv) increasing the transparency and efficiency of conditional capital grants through the use of explicit rules for project selection.

VIII—TOWARDS A ROAD MAP FOR REFORMS

Proper prioritization and sequencing of the needed reforms are critical to a credible implementation agenda for the fiscal decentralization strategy. In this regard, the desirable reform of the *territorial-administrative division* of the country (although not necessary in the short-run) should be considered a long-term issue, and the present territorial division should be taken *as given in the short run*.¹¹ Therefore, this particular reform issue should not detract from the other necessary and more urgent steps towards implementing administrative and fiscal decentralization. The immediate focus of the required reforms should be on the other institutional arrangements and incentive mechanisms that will more directly effect efficiency and accountability in public services delivery. Nevertheless, given the fragmented structure of the territorial-administrative organization, the attribution of *responsibilities to local government units should be asymmetric* (i.e., in accordance with the respective local authority’s current capacity to deliver), and should be guided by pre-established objective criteria for eligibility. Simultaneously, however, the incentives for the delegation of authority (to the regions and to the better equipped self-governing units), for the outsourcing of contracts, and for *voluntary* amalgamation should be promoted, but the results of these incentives should be expected only in the long term.

¹¹ Since this is a socially and politically charged issue, reforms of the territorial-administrative structure of the country (including *compulsory amalgamation* of the currently self-governing units) will probably require a major consultation process and coordination effort. This is likely to involve difficult legal and technical considerations and extensive debate with all stakeholders (e.g., central and local authorities and politicians, associations of local governments, local civil organizations), which may take time. Although this process should start sooner rather than later, the implementation of the decentralization reform agenda should be independent and should not be held back by events regarding territorial-administrative structure reforms (see Chapter I of the report).

The proposed road map that the Government of Albania may consider pursuing for a sustainable implementation of fiscal decentralization is outlined in the following critical steps. The recommended policy measures, consistent with the NSSD (2003-2006), are grouped sequentially as immediate measures, short-term measures, medium-term measures, and long-term measures.¹²

A. Immediate Measures (to be implemented in the next three months)

1. Shifting the paradigm of central institutions away from micromanaging local public service delivery and toward setting up regulations, and monitoring and evaluation.¹³ This should start immediately by instructing central institutions to exert their new role, and urging each line ministry to present to the CoM (by October 2003) their action plan (for the next year) on setting the standards of local public services, establishing reliable monitoring and evaluation mechanisms, and exerting effective control both on finance and on the quantity and quality of services delivered by local governments.¹⁴
2. Re-assigning the responsibility for expenditures with a national benefit area from “shared” to “delegated” functions (e.g., contagious diseases, HIV, *ndihma ekonomike*), and the responsibilities for education and health O&M from “delegated” back to “shared”, with the specification of competences. This new arrangement should be effective as of January 1, 2004.
3. Reviewing and assuring consistency between sectoral strategies and the Government’s decentralization strategy (on both policy formulation and the implementation agenda). This should be conducted immediately and should be explicitly included as one of the cross-cutting analyses in the next 2004-2006 MTEF.

B. Short-Term Measures (to be implemented in the next year)

1. Strengthening governance institutions, by enacting the local budget law and the law on local government finance, clearly defining the responsibilities of local governments (including those for shared functions), and implementing effective capacity building programs.
2. Strengthening downstream coordination, by setting up the ICDI and ensuring that it is complementary to the GED and NCD.
3. Effecting the implementation of exclusive functions, by establishing programs to complete the implementation of exclusive responsibilities, and explicitly addressing the assignment of capital investment.
4. Defining specific competences on shared functions and starting implementation.
5. Assigning specific responsibility to the Regions compatible with the subsidiarity principle, considering economies of scale and scope, and externalities.

¹² Based on the above discussion. See also the Report’s main text and the Matrix of Issues and Options/Recommendations for details.

¹³ The immediate awareness of the new critical role of the central institutions is necessary, although not sufficient, to start the process of changes. Shifting the functions/competences themselves to local authorities may take longer, since transparency, efficiency and accountability should be assured for a responsible decentralization of service delivery.

¹⁴ The preparation of this action plan can be significantly facilitated by the technical assistance (on the “strengthening of policy formulation, coordination and performance-management mechanisms”) to be provided under the Civil Servant Component of the World Bank’s Public Administration Reform Project.

6. Pre-determining the current financing level (i.e., the *size*) of the pool of unconditional (general purpose) grants as a fixed percentage of the national shared taxes.
7. Improving the current *distribution* formula for unconditional grants by considering the equalization component as the inverse of the local per capita revenue *capacity* (properly weighted).
8. Improving the distribution of conditional grants (by a better balance with the unconditional transfers, setting national standards, targeting on a capitation basis and using “block grants,” and using explicit rules for competition and project selection in the allocation of conditional capital grants).

C. Medium-Term Measures (to be implemented in the next two years)

1. Defining the role of the regions ([in]direct election for Regional Councils, implementing the new role of Prefects, a degree of autonomy for the Regional Councils, statistical data compiled in conformity with EU NUTS, evaluation of the consistency of semi-autonomous agencies [e.g., TRHA] with the decentralization strategy).
2. Increasing the efficiency of public service delivery by restructuring, re-mapping and re-deploying facilities and personnel across jurisdictions from the depressed areas to the immigration areas.
3. Boosting local fiscal efficiency and accountability (by considering the introduction of new buoyant and equitable sources of local revenues—e.g., surcharge PIT, levies on electricity and telephones, on vehicle property transfers, and on driver’s licenses—implementing tax-sharing mechanism as a financing source for the pool of equalization transfers; consolidating the LSBT and the SPT; and rationalizing the use of local fees and services charges—removing the “nuisance” charges and fees, spelling out sectoral strategies and utility tariff policies separately from social policies, and replacing the three-fifths voting requirement for decisions on local taxes by a simple majority rule).

D. Long-Term Measures (to be implemented when the necessary conditions are in place)

1. Overcoming administrative fragmentation (attributing asymmetric responsibilities, articulating incentive instruments for amalgamation/association).
2. Assigning capital expenditure responsibilities (for both maintenance and investment) consistently to local governments.
3. Strengthening the role of the private sector in the financing and provision of local public services (including NGOs and the civil society).
4. Maximizing local own revenue collection by improving the system of property value assessment, and upgrading the capacity for local tax administration.