  

Revenue Predictability and Sustainability of Local Governments in Albania

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# 1 Introduction

The terms of reference for this report outline in details the desired structure of report and reference data to be taken into account and analyzed. The goal of this report is to explore the predictability and stability of local government revenues in Albania, identify patterns in revenue assignments and possible impacts of structural changes in the intergovernmental tax system.

A sample of at least 13% of first tier local government units was selected for purposes of this analysis. This includes 48 local government units, of which 27 are municipalities. Capital Tirana and the six largest municipalities in terms of revenues and population – Durres, Vlore, Elbasan, Shkoder, Korce, and Fier are also included in the sample. Capital Tirana is an obvious outlier in the total sample and it will be often excluded from the analysis, although some of the findings of the report are equally relevant - if not more - even for Tirana. When Tirana and the six largest are excluded from the sample, the sub-sample contains 40 local governments, of which 19 are municipalities.

The selection was made on a regional basis, selecting at least three local government units in each region and more for the larger regions. The selection was based on the average population and revenue data within each region, selecting the largest LG within the region, one average and one that was significantly smaller than the regional average. In Shkoder and Lezhe regions five of the eight selected local government units have received technical assistance in the framework of dldp II programme.

The selected sample is as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Region** | **Selected units** | | | |
| **Berat** | Bashkia Berat | Bashkia Kuçovë | Komuna Kozare | Komuna Leshnje |
| **Dibër** | Bashkia Peshkopi | Komuna Z.Reç | Bashkia Burrel | Komuna Ulez |
| **Durrës** | Bashkia Durrës | Komuna Xhafzotaj | Komuna Ishem | Bashkia Krujë |
| **Elbasan** | Bashkia Elbasan | K. Labinot-Fushe | Bashkia Librazhd | K. Hotolisht |
| **Fier** | Bashkia Fier | Bashkia Ballsh | Komuna Aranitas | B. Divjakë |
| **Gjirokaster** | B. Gjirokastër | Komuna Antigone | Komuna D. Poshtem | B. Tepelenë |
| **Korçë** | Bashkia Korçë | Komuna Voskopoje | Bashkia Pogradec | K. Bucimas |
| **Kukës** | Bashkia Kukës | Komuna Kolsh | B. Bajram-Curri |  |
| **Lezhë** | Bashkia Lezhë | Komuna Kallmet | Bashkia Laç | Komuna Orosh |
| **Shkodër** | Bashkia Shkodër | Komuna Bushat | Komuna Dajc | Bashkia Pukë |
| **Tiranë** | Bashkia Kavajë | Bashkia Kamëz | Komuna Kashar | Komuna Petrele |
| **Tirane** | Bashkia Tiranë |  |  |  |
| **Vlorë** | Bashkia Vlorë | Bashkia Himarë | Bashkia Sarandë | Komuna Xarre |

The total weight of the selected sample in the overall picture of local governments in Albania is as follows:

Table 1. Composition of local revenues for the selected sample: relative weights in %

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | 2008 | | 2009 | | 2010 | | 2011 | | 2012 | |
|  |  | Total sample | W/o Tirana | Total sample | W/o Tirana | Total sample | W/o Tirana | Total sample | W/o Tirana | Total sample | W/o Tirana |
| **Population** | | 47.4 | **33.2** | 47.4 | **33.2** | 48.0 | **33.6%** | 48.1% | **33.7%** | 48.1% | **33.7%** |
| **Total revenues** | | 51.0 | **31.7** | 49.1 | **35.1** | 51.6 | **38.1%** | 51.2% | **37.3%** | 38.4% | **25.3%** |
| **Total own source revenues** | | 72.8 | **40.8** | 74.0 | **43.0** | 75.2 | **46.8%** | 73.1% | **46.6%** | 71.2% | **40.3%** |
| Of which: | Small business tax | 80.7 | **42.8** | 81.8 | **45.9** | 83.6 | **46.1%** | 81.4% | **45.0%** | 80.4% | **41.8%** |
|  | Property tax | 52.3 | **29.0** | 56.4 | **31.4** | 60.6 | **39.5%** | 62.0% | **32.1%** | 54.4% | **31.1%** |
|  | Infrastructure impact tax | 69.6 | **41.9** | 69.2 | **48.4** | 62.9 | **57.7%** | 63.5% | **55.1%** | 55.6% | **42.8%** |
|  | Public space tax | 86.8 | **23.2** | 70.6 | **43.8** | 81.4 | **41.8%** | 73.5% | **49.0%** | 77.0% | **55.4%** |
|  | Cleaning fee | 77.1 | **51.0** | 79.3 | **47.3** | 79.6 | **44.9%** | 79.3% | **45.4%** | 80.1% | **35.0%** |
| **Unconditional Transfer** | | 35.7 | **28.5** | 36.6 | **29.1** | 37.5 | **29.8%** | 37.9% | **30.1%** | 38.0% | **30.3%** |
| **Conditional transfers** | | 42.2 | **25.8** | 41.0 | **34.3** | 46.7% | **39.6%** | 43.0% | **34.7%** | 11.9% | **10.4%** |

Source: Ministry of Finance, Department of Budget Monitoring

As Table 1 shows, almost half of the population lives in the local government units that constitute the sample under the analysis. In 2014, the selected units together raise more than 70% of locally derived revenue (30% is raised in capital Tirana alone); but they receive only about 38% of general purpose grants (unconditional grant) and less then 12% of conditional funding overall. These data are already an indication of the main characteristics of the intergovernmental transfer system in Albania, which has been designed on the principle of equity and has a very strong horizontal equalization component.

This report looks at the main sources of revenue at the local level, including the system of transfers as well as the main taxes and fees in terms of the tax base, rate, administrative procedures, and particularly the local autonomy in setting tax rates, which is an important factor of efficiency especially in fiscally relatively decentralized environments[[1]](#footnote-1). It looks at possible policy options for improvement in the definition and administration of these taxes and fees in order to enable increased local government revenues while preserving the basic qualities of efficient taxes, including equity. Furthermore, this paper will try to explore the reasons for the underperformance in the taxation of certain sectors of local economies (such as real estate, business taxes or service fees) and attempt to understand the main factors that would support improved tax collections in given administrations or periods, including efficiency of tax collection, fiduciary risks and availability of taxpayers databases.

# 2 The relevance of well managed public revenue system

This chapter provides an overview of the main principles that guide intergovernmental transfers, as well as it introduces the challenges in resource mobilisation and management of local revenues.

## 2.1 Guarantee for service delivery and development

One of the main challenges for local governments is to meet the expectations for better services and governance. Decentralization and urbanization resulted in growing pressure on local governments to provide or at least to ensure public services and facilitate economic development. However, public services can only be delivered if adequate resources are available at the state level, which is responsible for the execution of the function. Therefore, the level of funding for local governments should be closely related to the functions they are mandated to perform. In general, it could be advisable to set norms for each service provided by local governments and calculate the costs associated with the specified norm. However, this approach may not be feasible in practice, as the cost of achieving a given standard may vary widely across different regions and jurisdictions.

Local governments in Albania are financed through a combination of general-purpose transfers (formula based equalization grant), conditional grants as well as local taxes and fees. As several studies note, the design of the system of transfers seems to be adequate for the current conditions in the country and achieve to a good extent the purpose of horizontal equalization[[2]](#footnote-2). In terms of vertical equalization, the levels of spending of local governments in Albania remain significantly low, at less than 3% of the GDP[[3]](#footnote-3). However, it needs to be established whether the current levels of spending (i.e. revenue adequacy) are adequate for the levels of services assigned to local governments. The main services performed by local governments in Albania relate to the maintenance of local infrastructure; water supply and sewerage networks; public urban transport, solid waste management and urban planning. In principle, the system allows for local governments to raise revenues to fund the majority of these services through the setting of service charges. Other services, including those in the area of social protection and education are partially or entirely financed through the state budget through earmarked grants and/or general-purpose transfers. The system of transfers and fiscal authority granted to local governments are generally in line with the general principles as highlighted above. However, it is worth noting that the current amount of funding does not seem to respond adequately to the huge needs for infrastructure improvements, especially in the sector of road and water systems where the physical infrastructure is missing and/or obsolete due to deferred maintenance. To date these needs have been addressed through a combination of conditional and/or competitive grants from the state budget. While it is understandable that the amount of such grants does not necessarily meet the overall demand due to budget scarcity, it is important to note that increased transparency and clearer allocation criteria would improve performance of such grants. The section on the allocation of conditional grants will look at this issue more closely.

When economic conditions change, distribution of income may become less equitable both vertically and horizontally. Frequent changes in the financing framework of local governments such as the reduction of the total unconditional grant pool; or the reduction of local authorities’ discretion over indicative local tax rates, have undermined consolidation of local government finance and operations.

## 2.2 Guiding principles for intergovernmental transfers

The design of the intergovernmental transfer system should be based on the principles of efficiency and equity of local service provision. Boadway and Shah argue that some of the guiding principles in the design of fiscal transfers are[[4]](#footnote-4):

*1. Clarity in grant objectives. Grant objectives should be clearly and precisely specified to guide grant design.*

*2. Autonomy. Subnational governments should have complete independence and flexibility in setting priorities. They should not be constrained by the categorical structure of programs and uncertainty associated with decision-making at the center. Tax-base sharing—allowing subnational governments to introduce their own tax rates on central bases, formula-based revenue sharing, or block grants—is consistent with this objective.*

*3. Revenue adequacy. Subnational governments should have adequate revenues to discharge designated responsibilities.*

*4. Equity (fairness). Allocated funds should vary directly with fiscal need factors and inversely with the tax capacity of each jurisdiction.*

*5. Predictability. The grant mechanism should ensure predictability of subnational governments’ shares by publishing five-year projections of funding availability. The grant formula should specify ceilings and floors for yearly fluctuations. Any major changes in the formula should be accompanied by hold harmless or grandfathering provisions.*

*6. Transparency. Both the formula and the allocations should be disseminated widely, in order to achieve as broad a consensus as possible on the objectives and operation of the program.*

*7. Efficiency. The grant design should be neutral with respect to subnational governments’ choices of resource allocation to different sectors or types of activity.*

## 2.3 The issue of revenue adequacy

At a time when functions and responsibilities of local governments keep growing, fiscal decentralization and intergovernmental transfers have not grown at the same pace, thus resulting in unfunded mandates to support local infrastructure.

Relatively weak local capacities and structural and institutional complications (including changes in the structure of local financing in the 2009 – 2014 period, as well as considerations of potential political costs of raising more taxes) remain obstacles to strengthening decentralized governance. Strengthening local management capacities is correlated with several factors, in particular strengthening of fiscal autonomy through fiscal authority to generate revenues (taxes and service fees); as well as predictability and stability of intergovernmental fiscal transfers. Although as mentioned the majority of local governments are overly dependent on state budget transfers, the weight of revenue from locally derived sources and the unconditional transfer has been growing.

In the circumstances of “competition” for budgetary funds and modest capacities to locally generate revenues, local government units are short of funds to finance investments, in particular for high demand investments such as road and water supply infrastructure. Their budgets are typically small. The Regional Development Fund that awards grants for investments remains small to meet all demands; while fiscal austerity measures enforced by the Ministry of Finance indicate that they will not grow in the short term.

## 2.4 The key role of revenue estimation for budget credibility

Local governments cannot manage their finances successfully or effectively if they cannot predict what their revenues will be for future years. Strategic development planning (and medium term budget planning) is based on the projection of expected revenues and expenditures over a medium term. The uncertainty of income over the medium period may seriously undermine efforts for strategic governance at the local level. Therefore, one of the key features of a good financial management system is predictability and credibility of the budget, as also set out in the PEFA framework. In terms of revenue assignments, this implies that revenues realized in the course of the budget year are very close to the revenue forecast.

Previous studies and reports have indicated that budget credibility at the local level is very low – there are large discrepancies in the actual level of revenues and eventually expenditures as compared to budget forecasts. Partially this is due in recent years to the general economic downturn that has caused tax income to fall both at the central and local level. Nonetheless, poor budget compliance on the revenue side is often intentional. The local budget in Albania needs to be balanced (0 deficit). Hence, local governments tend to overestimate revenues in order to be able to incur more expenditure. As there is no system for commitment accounting, local governments incur expenditures during the budget years that they are not able to fund; hence creating arrears that are carried over for years.

## 2.5 Quality aspects of a public revenue system

One important feature of any revenue source is its potential to yield revenues over and above the costs of administering it. In addition, taxation equity and the incentives (or disincentives) that a tax creates are very important factors - the rate of the tax and the burden it creates should be such that it does not adversely affect the behavior of taxpayers, whereas taxpayers in similar conditions (or benefiting similar public services) should be levied the same amount of taxes.

However, in a transition country like Albania, the tax administration procedures also prove to be a critical aspect of the success or failure of the tax. High administrative burden of tax declaration and payment may increase a potential taxpayer’s propensity to evasion, in addition inappropriate procedures for setting and applying the tax base and rate; or arbitrary procedures for estimating tax liabilities may affect tax collections as well as create inequities in the burden of tax. Such risks are reinforced under the presence of large and deep informality.

# 3 Development of revenues since 2008

This chapter looks in detail at the performance of the local revenue system over the years. It gives an overview of the development of different local sources of revenues – own source revenues and tax income and intergovernmental transfers.

## 3.1 Revenue assignment

The Organic Local Government Law (8652/2000) defines a set of principles aimed at ensuring the autonomy and financing of local governments, by giving them the opportunity to have

1. Diversified sources of revenue for fiscal self-sufficiency;
   1. Raise revenue independently from taxes and fees, in order to have sufficient autonomy in financing and execution of functions
   2. Receive revenue from national sources through transfers or shared taxes;
   3. Have a uniform consolidated local budget, distinct from the state budget.[[5]](#footnote-5)

Local fiscal revenues are composed of “locally derived revenues” (local taxes and fees and other revenue from economic activity), “revenue derived from national sources” – unconditional transfers and shared taxes, as well as conditional transfers. The focus during the first period of fiscal decentralisation (until 2002) was the development of an appropriate, formula-based equalizing unconditional transfer and strengthening of the local tax base and tax administration capacities.

The first significant progress in the fiscal decentralization reform was made with the enforcement of the local fiscal package of 2003, which defined new local taxes, and fees, expanded local taxing authorities by granting them discretion in imposing tax rates (within a fixed margin of the indicative rate set forth in the law), as well as gave them full authority to define the base and rate of service fees and other temporary fees according to the local policy. As a result, local government revenues grew significantly, although the local government revenue share of GDP remained low, at around 3%. Changes in 2009 and 2010 to the local tax system legislation had dramatic impact in the potential for own source revenues by severely limiting local fiscal potential. The enactment of these changes coincided with the onset of the economic slow-down in Albania. As a result, the local financial situation has been quite difficult, due to the reduced fiscal potential, the negative economic outlook, as well as the general fiscal austerity policy undertaken by the central government, which foresees major cuts in budget expenditures including intergovernmental grants.

## 3.2 Development of LGU revenues in total

The share of local tax revenues in the total local government revenues decreased over the period, from 31% in 2008 to 26% in 2012. In absolute figures, tax collections at the local level were almost the same in 2012 as those in 2008. The unconditional transfer also decreased for the first time in 2009, and ~~were~~ kept at steady levels since, although its relative share in total local government revenues decreased as well. Conditional transfers grew since 2005, mainly due to an increase in earmarked transfers for cash assistance programmes to the poor and disabled. It is obvious from the data that still to date nationally derived revenues constitute a large part of the local revenues, with many local governments heavily dependant on the unconditional (general purpose) transfer as their main source of revenue.

Table 2. Composition of local government revenues by type of financing 2008 – 2012 (All LGs)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | 2012 | 2011 | 2010 | 2009 | 2008 |
| Total revenues | 42,537,688 | 43,124,599 | 45,875,650 | 48,569,849 | 32,685,296 |
| Total own source rev | 13,306,001 | 14,164,715 | 15,660,560 | 14,858,513 | 12,956,948 |
| Of which: Total tax revenue | 10,640,572 | 11,791,232 | 11,895,762 | 11,582,986 | 10,266,469 |
| Unconditional transfers | 11,465,137 | 11,113,202 | 11,215,741 | 12,850,177 | 12,301,501 |
| Conditional Transfers | 17,766,550 | 17,761,587 | 18,999,348 | 20,861,158 | 7,426,847 |
| ***In % of total revenues*** |  |  |  |  |  |
| Own source revenues | 31% | 33% | 34% | 31% | 40% |
| Of which: Tax revenue | 25% | 27% | 26% | 24% | 31% |
| Unconditional grant | 27% | 26% | 24% | 26% | 38% |
| Conditional grant | 42% | 41% | 41% | 43% | 23% |

Source: Ministry of Finance

Table 3. Performance of local government revenue 2008 – 2012 by type (all LGs)

Data clearly indicate~~s~~ in 2012 a downward trend in local government revenue performance. In particular, the relative share of discretionary funding (meaning locally generated revenues and unconditional grant) in local government budgets has slightly decreased in 2012 as compared to the previous years. This does not necessarily indicate a worsening in the level of autonomy and discretion that local government may exercise over their expenditures. The steep increase in the size of conditional (earmarked) grants – especially in the social protection sector as of 2009, and the fact that these have remained at steady levels since account for the change in composition of local government revenues throughout the period 2008 – 2012.

## 3.3 Disparities in local per capita revenues

There are large disparities in fiscal revenue collections between different local governments. The capital and the seven largest cities[[6]](#footnote-6) make up for the overwhelming majority of own source revenues, with a relative weight of 73% in 2012. The relative weight of the largest cities has increased from about 53% in 2006, indicating that bigger local government are thriving more easily in the current system, despite the difficulties of recent years.

Per capita distribution of local tax revenues, a more accurate indicator to evaluate revenue collection disparities, also shows high variations in collections. The table below shows variations for 2012 data on per capita revenue collections per selected categories of revenues.

Table 4. Variations in local per capita revenues in selected sample

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | Total revenue | Total tax revenue | SBT | Property tax | Cleaning fee |
|  |  |  |  |  |  |
| Average | 9,382 | 2,427 | 460 | 426 | 311 |
| Min | 43 | 207 | 0 | 0 | 0 |
| Max | 40,573 | 19,969 | 1,399 | 3,835 | 1,390 |
| STDEV | 6,526 | 2,961 | 381 | 541 | 277 |
| CV | 0.70 | 1.22 | 0.83 | 1.27 | 0.89 |
| Sum | 450,359 | 116,473 | 20,454 | 14,933 | 14,933 |
| Median | 8,159 | 1,736 | 320 | 310 | 310 |

Data Source: Ministry of Finance, own calculations

The coefficient of variation for the total tax revenues of local governments may be considered as rather high at 1.22. Interestingly, collections of small business taxes and cleaning fee seem to have the most even distribution. Per capita distribution of revenues becomes more even for total local government revenues, which indicates that the system of transfers partly achieves its goals of equalization (see also Figure 4). When looking at local government performance in revenue collection, it becomes clear that the overwhelming majority of own taxes and fees is collected in the larger communities. For instance, over 70% of the small business tax and 80% of the cleaning fee in the overall sample is collected in the eight largest localities. However, after the equalization through the unconditional transfer formula income distribution becomes more even as evidenced by the dispersion of local per capita revenues (Table 5).

Table 5. Comparison of weight of total local government unconditional revenues and per capita revenues in selected sample

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Year: 2012 | Population | Total unc. revenue | Total tax revenue | Total SBT | Total property | Total cleaning fee | Total unconditional transfer |
| Tirana | 30.1% | 34.1% | 43.3% | 48.1% | 42.8% | 56.4% | 20.5% |
| 7 largest | 40.2% | 33.9% | 32.4% | 32.8% | 31.1% | 26.9% | 43.2% |
| Average[[7]](#footnote-7) | 24.5% | 26.2% | 22.6% | 17.8% | 22.1% | 15.4% | 29.0% |
| Small | 5.3% | 5.9% | 1.7% | 1.4% | 3.9% | 1.3% | 7.3% |
|  |  |  |  |  |  |  |  |
| Per capita indicators | |  |  |  |  |  |  |
| Tirana |  | 8,541 | 5,287 | 1,399 | 737 | 1,203 | 1,438 |
| 7 largest |  | 6,366 | 2,965 | 715 | 401 | 430 | 2,276 |
| Average |  | 7,543 | 3,673 | 876 | 518 | 642 | 2,115 |
| Small |  | 8,398 | 1,178 | 226 | 386 | 164 | 2,929 |
| Sample average | | 7,543 | 3,673 | 876 | 518 | 642 | 2,115 |

Table Equalization effects of the general purpose grants to achieve equity (per capita revenues)

Data Source: Ministry of Finance, own calculations

## 3.4 Development of own revenues

Local tax and fee collections[[8]](#footnote-8) at the local level in 2012 amount fluctuated during the period 2008 – 2012, with the lowest result recorded in 2010, the first year when 2009 changes in the local tax system came into effect. Collections in 2012 amount to 9,3 billion lek, a level that is comparable to collections in 2008. Account for the economic growth and inflation throughout this period, we may conclude that growth in locally derived revenues has been negative.

The Small Business Tax is the revenue that has the highest yield in the local budget, amounting to 20% of overall local tax revenues; followed by property taxes (Building and agricultural land tax) at about 11% and the infrastructure impact tax, which makes up for about 10% of local taxes in 2012, with a steep fall from over 20% in previous years. The cleaning fee is the second most important single revenue source in local budgets, yielding about 14% of the total tax budget in 2012.

Table Main local revenues in the selected sample in the period 2008 - 2012

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| ***Year*** | ***2008*** | ***2009*** | ***2010*** | ***2011*** | ***2012*** |
| Small business tax | 2,067,359 | 2,102,799 | 2,409,418 | 2,146,272 | 1,806,312 |
| Property taxes | 807,858 | 847,747 | 1,090,472 | 1,126,330 | 1,067,736 |
| Infrastructure impact tax | 1,761,554 | 2,271,817 | 1,815,821 | 2,266,475 | 926,965 |
| Public space tax | 389,531 | 175,882 | 310,049 | 250,624 | 338,602 |
| Cleaning fee | 900,395 | 1,049,903 | 1,005,476 | 1,058,264 | 1,324,188 |
| Other local revenues | 3,216,628 | 4,146,167 | 942,497 | 3,277,612 | 3,846,604 |
| Total local tax revenue | **9,145,334** | **10,596,325** | **7,575,743** | **10,127,587** | **9,312,418** |

Data Source: Ministry of Finance, Department for Budget Monitoring

The ***small business tax*** has represented for years the major fiscal revenue source for local governments. Its relative weight has however become less significant in recent years, falling from roughly 30% of total local tax revenues in 2010 to less than 20% in 2012, following the decrease by half of the tax rate in late 2005 by the Parliament as well as other consecutive changes to the tax base and rate until 2010. From January 1 2014, the small business tax was redefined as a tax on the profit of small businesses (7.5% of businesses with annual turnover up to 8 million lek).[[9]](#footnote-9) The small business tax rate is now exclusively determined at the national level. Before 2014, local governments had some degree of discretion in setting small business tax rates: up to -30% and or +10% of indicative tax rates.[[10]](#footnote-10)

The December 2013 changes in the fiscal legislation, including the Law on Local Tax System[[11]](#footnote-11) also introduced changes in the administration of the small business tax. As of January 1 2014, administration was handed over to central tax authorities allegedly due to poor fiscal performance of local tax administration. In terms of process efficiency, this may be considered as a positive move, given that the additional burden on central tax administration to handle small businesses should not be excessive given that the Central Tax Authority already handles personnel social security tax files and VAT (Value Added Tax) files on behalf of small business subjects. Furthermore, local administration of small business tax created a potential distortion in the system. The 8 million turnover threshold that separated subjects that paid taxes to the local budgets from those that contributed to the national budget was an incentive for local tax authorities to accept underdeclarations by businesses in order to continue receiving tax proceeds to their own local budgets. The small business tax had been administered locally since 2007. A slight fall in collections was evidenced during the first year, but performance later improved despite the frequent cuts in the tax rate. There are no official estimations of the fiscal potential from this tax, although anecdotal evidence suggests that reserves are considerable and enforcement could be strengthened.

Table Composition of local revenues for the local government sample (% of total locally derived revenues)

Table 9. Performance of individual tax revenues 2008 – 2012: selected sample

***Taxes on property*** (agricultural land and building tax) take up only a modest share of total local fiscal revenues. Performance in collection has however grown steadily and today they represent about 11% of total tax revenues at the local level. The tax base for the property tax is the surface area of the property (agricultural land and building in rural and urban areas respectively). The tax rate is defined by law as a flat amount per m2, depending on the location, type of use and quality/age of property, in an attempt to approximate market values. The indicative tax rates were revised for the first time since 2002 in late 2013. The proposal to significantly increase tax rates for property was rejected by Parliament and tax rates have remained very modest. The low indicative tax rates may serve as a disincentive for own tax collection efforts, given that administrative costs are high. Positive improvements were introduced such as the provisions of imposing the double of the indicative tax rates for second properties. However, revisions to the tax base and rate scheme were insufficient and incomplete and may create distortions in terms of taxpayer equity.[[12]](#footnote-12) This situation is unusual in as property taxes have for long been hailed as one of the most appropriate general tax sources for local governments, given that they do not create conditions for tax competition between local governments.

From the administrative point of view, the tax base is visible and changes at a very slow pace, hence it should not be difficult to administer. However, property taxes have proven difficult and costly to administer well. This stems in particular from the fact that although the tax base is visible, tax subjects are often difficult to identify, especially in a country, which has had a booming construction sector for over one decade, a considerable part of which has been informal. Tax registers are not up to date and local governments encounter difficulties in obtaining information from the Immovable Property Registration Office (IPRO). In recent years IPRO has been computerizing all its archives and databases and information exchange should become easier.

There are no accurate estimates for the fiscal potential from the property taxes; however estimates indicate that the shortfall in actual collections would be of more than 70%. Collections from the building tax are higher, but there are still huge reserves – for instance, the building tax is not collected in the informal peri-urban areas around larger cities. Collections from these two taxes have increased steadily from 2003 and observations from individual local governments indicate that there is increased focus on efforts for the improvement of collections from this tax. Underperformance in collection of property taxes may be attributable to a series of factors; of each the lack of accurate taxpayer databases is the most evident. However, it may be the case that in times of buoyant tax base and proceeds local governments have been inclined to rely on “easier” targets such as business taxes and intergovernmental taxes. It may not be a coincidence that there has been an almost 25% increase in property tax proceeds from 2009 to 2010, the first year when the “traditional” sources such as taxes and other service fees were drastically reduced by Parliament.

For years, the ***infrastructure impact tax*** was one of the most important taxes for local budgets, accounting for up to 30-35% of total tax proceeds at the local level. It has lost its relative importance in the local budget in the recent years, following the economic downturn and shrinkage of the construction sector; and it now represents about 10% of total local government tax revenues. The tax base is the value of investment for construction/development, at a rate ranging from 1-3% of the value of investment (2-4% in Tirana). Administration is relatively easy for the infrastructure impact tax, given that payment is a precondition for the issuance of building and other development permits. However, problems have been identified with the definition of the tax base and rate (does not make a distinction for different types of development that create different needs for new infrastructure) and there is large room for interpretation of the term “value of investment”.

Proceeds for the infrastructure impact tax are treated as a general tax and have been used to finance general operations of local governments, including to subsidize services and other current costs. The construction sector has experienced a boom in the last decade, resulting in a rapid urbanization and d expansion in the country’s residential building stock. Local governments have generally not succeeded in responding to the demand for new services and infrastructure created by these new urban developments through proper planning of investments. One way could be to use the tax on the impact on infrastructure of new construction to create contingent funding to support future investments. This is another case where there is room for improved accountability of local governments towards its taxpayers.

***Other taxes*** include more modest revenue sources such as the public space tax; hotel taxes, mineral tax (shared tax) etc. The Vehicle Registration Tax (VRT) was previously the second most important contributor to the local budget. All proceeds from VRT were transferred to the local level, although this was a centrally administered tax. In 2013 the vehicle registration tax and some other taxes on motor vehicles were abolished and a new combined tax on use of motor vehicles was introduced at the national level. The law established that 18% of the proceeds from the new tax on used motor vehicles should be transferred to local budget on an origin basis (depending on the place of registration of the taxpayer). The shared amount (18%) corresponds to the proceeds from the VRT before the redefinition of this tax (VRT is featured under other local taxes in Table 3 and Figure 2). Hence, the Used Vehicle Tax is the first significant shared tax in the country, which is transferred from the national to local budgets on a derivation basis (by point of origin). Distribution of this tax is relatively uniform across the country.

The ***cleaning (solid waste) fee*** represents the major fee revenue, and more than 14% of total tax revenues. Local governments, especially municipalities, which deliver a wider range of public services have exploited their autonomy and increased fee rates aiming at cost recovery for their services. Cleaning is typically the most important and most costly service that local governments in Albania perform. It remains heavily subsidized from the general budget of local government units, as service fees do not cover overall costs.

The local tax legislation in Albania is rather permissive as regards service fees. There is no specific regulation or nationally set indicative rates on service fees. The general principle governing service fees is valid also in Albania; it says that fees should be charged to service users up to service costs, not beyond. A dangerous precedent was set in 2009 with the amendments to Law 9632 on the Local Tax System, which indicated that, the sum of total taxes and fees charged on a business should not exceed 10% of the indicative Small Business Tax. This provision dangerously separated the concept of service fee from its actual costs. However, these errors were corrected and restrictions were lifted again with the fiscal package amendments that became effective as of January 1, 2014.

Table 4 indicates the dispersion in local per capita revenues in Tirana and the three local government groups (7 largest cities; 20 average and 20 small local governments). Interestingly, the average per capita revenues for the cleaning fee in the seven largest cities are not much higher then for the twenty average units, indicating that there may be larger fixed costs associated with this service for smaller local governments. The coefficient of variation in the dispersion of per capita revenues is not low for the average units (at 0.65) and rather high for the small local governments.

Table Cleaning fee collections per capita in large, average and smaller local governments (selected sample)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Cleaning fee/capita** | **Tirana** | **7 largest** | **20 average** | **20 small** |
| Average | 1203 | 449 | 400 | 129 |
| Min | n/a | 309 | 138 | 0 |
| Max | n/a | 727 | 1,390 | 516 |
| STDEV | n/a | 151 | 261 | 148 |
| CV | n/a | 0.34 | 0.65 | 1.15 |
| Median | n/a | 415 | 366 | 66 |
| Cleaning fee in % of total | 56.4% | 26.9% | 15.4% | 1.3% |

Cost recovery is problematic in general for all services performed by local governments in Albania, such as cleaning (solid waste disposal); urban transport or water supply. This suggests that local government rely too much on general-purpose revenues (such as business taxes and intergovernmental transfers) to subsidize their operations. This is understandable, as voters are more likely to support raising revenue from businesses (hence not them). Indeed, the picture is distorted even in the case of service fee collections: the majority of actual collections is generated from businesses (the weight is divided typically at a rate of 70:30% between businesses and households). Service fees for businesses are set at much higher levels than for households, even when the activity performed by businesses would not otherwise justify this approach. In terms of administration, collection from businesses is easier, whereas there is large evasion among households, as local governments lack adequate billing systems and enforcement mechanisms. There are strong efficiency considerations that would support the case for increased service fees. Naturally, the political reaction to this approach may be adverse as households/individuals are more antagonistic to paying taxes then businesses.

The cleaning fee is the single local revenue source that shows a straightforward increasing trend over the 2008 – 2012 period. This may be an indication of increased attention to the cleaning service[[13]](#footnote-13). Increased process efficiency may be another factor that has contributed, with more local governments using tax agents to collect cleaning fees from households. Scarcity of budget resources may be another factor that has prompted authorities take a more active stance in management of service fees as possibilities to subsidize these services become smaller. Despite positive progress in overall performance however there is no case to become overly enthusiastic: indeed, about 57% of the total collections from the cleaning fee are realized in Tirana; and about 27% is collected in the other seven larger cities. Hence, the remainder 40 units in the sample hardly collect less than 17% of total cleaning fee proceeds.

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| **DLDP response to service performance issues**  Performance of local government with collection of service fees is far from satisfactory. Until now they have been over reliant on general purpose budgets and have been subsidizing services that should otherwise be charged to the users. Cross-subsidy of services is a method preferred by politicians who fear the political costs of raising direct taxes on constituents. Typically service fees should be paid by individuals in the same fashion as businesses, in proportion with the amount and quality of services received (or demand each individual creates for such services). The cleaning service is the most universal service among local governments in Albania (albeit there are still local governments which do not provide such service). Besides the political costs associated with the process, a number of technical difficulties persist, including the lack of service provision standards; as well as lack of methodologies for cost calculation. Poor taxpayers information and awareness, hence lack of willingness to pay for services received - is another hindrance to a cost recovery policy by local governments.  DLDP worked together with a number of local government units and other partners to help tackle these issues in a comprehensive manner. DLDP’s intervention in the sector was multifaceted, ranging from work on cost definition methodology, to cost optimization; service expansion (i.e. recycling) as well taxpayer information and awareness activities.  The development of a tariff calculation methodology is a very positive step in this direction. The suggested methodology supports the concept of “paying for what you are getting”. In terms of waste management, this concept is based on the assumption that those individuals who put a bigger strain on public services should pay more then the average citizen. In practical terms, the methodology introduced a series of criteria that model behavior; such as type of taxpayer (household/non household/ other subcategories); size of households; distance from city center; type of dwelling. The total costs of service provision are allocated to each taxpayer in accordance with the preset criteria and the individual fee is calculated for each taxpayer.  Besides the tariff calculation methodology, DLDP has also put its efforts into calculating the real cost of service provision (based on the calculation of the amount of waste produced by each individual/taxpayer).  This model has its undisputable merit of being among the very first attempts to standardize cost calculation and tariff setting for the cleaning service in the country. Furthermore, interventions have been accompanied by awareness raising activities in order to inform citizens and increase their willingness to contribute. Preliminary results are positive: if a careful tariff methodology and enforcement is made; average service fees at individual households and/or business level are lower than what is actually charged by local governments. A careful awareness raising campaign has increased citizen sensitivity to environmental issues in Lezha where the first recycling “experiments” were made; and initial indications show that citizens are in average willing to pay more if they have more information.  There are certain weak aspects to the prospects of implementation of the methodology at a larger scale: the process of data collection at the local level is rather demanding and progressively so in larger local governments. Information is not always available as local governments lack taxpayer databases; hence a degree of subjectivity will undoubtedly persist. In terms of overall service cost calculation, in the absence of accurate measurements of the amount and types of waste produced, the starting point for the allocation of costs is the current budget spent on the waste disposal service. This approach leaves little room for improved service standards and/or expansion of services. Furthermore, the unfunded service part – notoriously from non-compliant subjects – should be clearly identified as such in public communications and subsidized from the general budget rather than reallocated to those who are willing to pay.  In general, the approach supported by DLDP in the waste management sector is extremely positive and it tackles all aspects of service provision in a comprehensive manner. While more work is being carried out to perfect the developed instruments; it will be necessary to hand over these methodologies to the central government and/or a central regulator that could support rolling out in a national scale. If the tariff calculation methodology is nationally regulated, attention should be paid to changing conditions in different local governments; disincentives for cost optimization scenarios and potential innovations must be avoided. |

# 4 The system of transfers

Following the 2000 decentralization reform, financing of local governments shifted towards unconditional discretionary funding, in the form of unconditional intergovernmental fiscal transfers from the state budget, as well as through increased tax autonomy.

From 2001 local governments started receiving unconditional grants, which is distributed based on an equalizing formula. The unconditional transfer is used to finance administration costs of local governments, as well as own functions.

However, the central government continued to support local governments through conditional transfers, even in areas of own functions. Until 2005 the central government allocated conditional grants for rural and urban road infrastructure, and capital investments in areas of shared functions (preuniversity education, primary healthcare). Today the majority of conditional grants are composed of earmarked social assistance transfers; some transfers to support delegated functions (i.e. civil registry, business registration centres), as well as smaller transfers in education, public works or economic development.

## 4.1 Unconditional transfer and formula allocation

The unconditional transfer to local governments in Albania is intended to adjust for the vertical fiscal imbalance resulting from the unevenness of revenue raising capacities at the national and local level, and the assignment of expenditure responsibilities. In addition, it also adjusts for horizontal imbalances, which will be discussed later (transfers). To date, no formal policy concerning the annual total pool of unconditional transfer exists; annual allocation have taken place without providing very clear explanations or clear and accurate figures. The total pool has fluctuated during 2001 – 2006, with a steep decrease in 2003.[[14]](#footnote-14)

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| **Formula based allocation of unconditional transfer**  The total pool of the unconditional formula is first divided into two separate subpools: More than 90% of the total pool is distributed through the formula to all municipalities and communes, and the remainder of about 9% is distributed to regions.  ***Transfer to municipalities and communes (A)***  The allocation of the unconditional pool for municipalities and communes follows the following steps:   * 70% of the pool is distributed proportionally to each unit, based on their population size relative to the total population. Population is the dominant criterion of the formula, as it can best approximate expenditure needs. * 15% of the pool is distributed exclusively to the 308 communes, based on the weighted surface area of each commune relative to the overall commune surface area. The surface area is multiplied by 4 for 178 mountainous communes, which are considered to face higher challenges given the relatively poor infrastructure and poor access to services. Thus, the relative surface area of these mountain communes and the relative share of the 15% of the pool they receive is higher. * The remainder 15% of the pool is distributed exclusively to the 65 municipalities, in proportion with the weighted relative population size to the total urban population of the country. The logic is similar as in the case of communes: a multiplier of 2 is used respectively for the population of “distressed” and/or mountainous municipalities. * The next step of the formula is fiscal equalization, which takes into consideration per capita revenues of each M/C from small business tax collections. The per capita revenues of each M/C from these sources are compared to the national average. Wherever M/C per capita collections are higher than the national average, they contribute by 25% of the difference, whereas units below the national average receive 25% of the difference (multiplied by population). * Than the formula considers the preliminary grant allocation in percentage of the previous year grant, and adjusts results in order to make sure that the result is similar to the previous year. * The final step in the formula is the minimum per capita revenue guarantee, in terms of the grant allocation+ collections from the abovementioned taxes that were used for purposes of fiscal equalization. The minimum per capita guarantee is lower for communes than for municipalities (respectively 2080 and 3050 lek per capita in 2013). The minimum per capita guarantee is compensated through the fund originating from the difference as per the point above (total grant increase higher than 15% minus total grant decrease) * A small compensation fund may result, which is retained by the ministry in charge of local governments (Ministry of Interior), and used to support local governments i.e. in case of emergency   ***Transfer to regions***  10% of the pool earmarked for regions is allocated equally to each region, as a fixed sum; 28% is distributed proportionally to the population size, and 32% proportionally to the estimated surface road in each region. The formula for regions also adds an equalization effort; by allocating the remainder 30% of the funds according to a weighted scale for respectively plain, hilly and mountain conditions. |

The unconditional transfer formula aims at achieving the objectives of vertical and horizontal equalization, while providing sufficient funds to local governments. The pool of this transfer in 2001 was determined based on the historic expenditures made by each line ministry for the functions that were being decentralized, which at the time of the 2001 budget constituted approximately 7.2% of total state budget tax revenues.

The total pool of the unconditional transfer (general purpose transfer) is determined each year through annual negotiations and through the Medium Term Budgeting Programme (MTBP). The fiscal gap is adjusted for through unconditional transfers from the state budget and national shared taxes. The Corporate Profit Tax (CPT) and the Personal Income Tax (PIT), which have been indicated by the Local Government Law as possible shared taxes still remain national.

The determination of the size of the unconditional transfer pool seems to have taken into account all sources available to local governments over the years. In 2003, when the Small business taxes and the VRT were allocated fully to local governments on a derivation basis, the total pool of the unconditional transfer was reduced by exactly the same amount of forecasted revenues from these two taxes. The vertical balance[[15]](#footnote-15) has decreased over the years, and is currently estimated at 5,6% of state budget tax revenues in 2012, down from 8.5% in 2006 and from 9.6% in 2002.

## 4.2 Conditional grants

Expenditures for shared and delegated functions are mainly financed through conditional (or earmarked) transfers. Generally these funds cannot be carried over to the next year. Expenditures in the social protection sector make up for the lionshare of conditional grants (more then 90% in 2012).

Social assistance is financed in the form of an earmarked block-grant from the state budget, and local governments have the authority to make the decisions on the allocation. The social assistance function can be considered as the only “true” shared function, as local governments have a defined responsibility in determining eligibility for the allocation of subsidies based on objective criteria established by law. Indeed, the National Strategy of Social Protection~~,~~ recognizes that local governments are best fit to provide social services to beneficiaries~~,~~ by being able to target and deliver those services better due to the proximity with the community and specifics of the local context.

The objectives of transfer from the central government to local government units are aimed at mitigating poverty and providing opportunities for basic services and minimum living conditions for all individuals in need. The main program under social protection services consists in the programs of cash benefits for the poor and for the disabled; these are financed by the state budget and directed through the local governments.

Conditional transfers in other sectors include subsidies for water systems from the Ministry of Public Works, grants to finance operations of regional vocational education schools from the Ministry of Education, furthermore, transfers for the promotion of economic development, etc. Conditional grants are decided annually during the state budget preparation stage, where the Ministry of Finance appropriates funds to the budget of line ministries for financing of local needs. The individual allocation to local governments is carried out by the line ministries directly. The relative importance of conditional grants for infrastructure funding has now decreased, as the majority of local interest developments are financed through the Regional Development Fund (competitive grants).

## 4.3 Competitive grants (Regional Development Fund)

The competitive grant scheme was initially introduced in 2006. An analysis of the allocation of investment funds for local own and shared functions had indicated a low performance, a tendency to overfragmentize funds, as well as high regional disparities in the allocation of investments. The system was judged to have been especially inefficient when line ministries allocated conditional investment grants directly to local governments, where a strong political bias was identified resulting in high variations in per capita allocation of funds; as well as lack of sustainability of projects, with many projects being left unfinished due to discontinued funding. The system was clearly lacking objectivity, predictability and transparency.

The competitive grant mechanism was aimed at providing financing for mid to large sized investment projects in own functions, through an objective and merit-based evaluation approach. The state budget law of 2006 set forth a number of general criteria for the allocation of grants, on the basis of which the project applications by individual local governments (including regional councils) were to be evaluated:

* Expected impact on social and economic development; and the extent of alignment with local and/or regional and national development priorities
* Expected impact in poverty alleviation and increase in access to basic services
* Availability of matching/contribution funds for the investment
* Ongoing projects, with contractual liabilities
* Quality of technical projects proposed by applicant

In 2010 the competitive grant scheme was expanded to include other eligible categories such as universities and Water Basin Boards. The Committee for Regional Development chaired by the Deputy Prime Minister was designated as the leader of the process, assisted by the secretariat of the Department for Strategy and Donor Coordination. Technical assistance is being provided by the Albanian Development Fund, a public investment fund with extensive experience in local government issues.

The criteria are obviously too general to be measurable or objective; however, the introduction of the competitive grant system already marked a considerable departure from the previous system. Funds originally used for the financing of local infrastructure in own functions – mostly road infrastructure – were taken out of the line ministry’s budget and a separate pool for the financing of own functions was created as a new line item in the state budget.

The concept for the mechanism has good chances to succeed in achieving the objectives of transparency and equity[[16]](#footnote-16). However, the criteria and standards for the evaluation and allocation of grants need to be made more specific and measurable.. Local governments often complain about two crucial aspects of intergovernmental transfers: clear objectives shared in advance, as well as predictability of funding. Timing of project submission and allocation is also inappropriate in terms of ensuring the proper project cycle, in line with the budgetary requirements – announcements and allocation are made late in the year, and disrupt the local government’s normal cycle of operations. Furthermore, many claim that the actual criteria of allocation should be shared in advance of the budget year, as well as some sort of “competition within categories” should be introduced.

As regards efficiency of competitive grants, another shortcoming in the system is to be considered, namely the average size of the projects, which is rather small. The original concept behind the establishment of mechanisms was to finance larger scale municipal infrastructure, which would typically be beyond the means of their discretionary budgets. However, it seems that the policymaking officials could not resist the pressure of having to “satisfy’’ more units instead of financing bigger projects in less units. In April 2013, the RDF allocated grants for 49 road infrastructure projects at an average value of 107,000 Euros, and 42 education projects with an average value of 23,000 Euros.

# 5 Budget credibility – planned vs. actual revenues

Budget credibility is a major source of concern for local governments. In recent years, the difficult financial situation and the fiscal austerity measures of central government, resulting in general budget cuts and therefore in repeated downward revisions of initial grant forecasts, put several local governments into an extremely difficult financial situation. Indeed, several local governments are on the brink of insolvency.

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| No | Type of revenue | **Plan 2012** | **Actual 2012** | **Fact/plan 2012** | **Plan 2013** | **Actual 2013** | **Fact/plan 2013** | **Plan 2013/ Plan 2012** | **Actual 13/ Actual 2012** |
| I | **Tax revenue** | 123,900 | 53,044 | 43% | 131,306 | 57,645 | 44% | 106% | 109% |
| 1 | Property tax | 13,000 | 6,844 | 53% | 15,000 | 5,974 | 40% | 115% | 87% |
| 1.1 | On business | 5,822 | 5,672 | 97% | 6,500 | 5,807 | 89% | 112% | 102% |
| 1.2 | On households | 7,178 | 1,172 | 16% | 8,500 | 167 | 2% | 118% | 14% |
| 2 | Small business tax | 30,521 | 18,199 | 60% | 30,500 | 17,174 | 56% | 100% | 94% |
| 3 | Tax on property transactions | 6,500 | 7,605 | 117% | 10,500 | 9,530 | 91% | 162% | 125% |
| 4 | Infrastructure impact tax | 69,000 | 18,505 | 27% | 70,000 | 23,489 | 34% | 101% | 127% |
| 5 | Publc space tax | 489 | 298 | 61% | 500 | 108 | 22% | 102% | 36% |
| 6 | Takse tabele | 3,770 | 1,593 | 42% | 4,656 | 1,370 | 29% | 124% | 86% |
| II | Te ardhurat jotatimore | 92,273 | 50,827 | 55% | 92,180 | 41,406 | 45% | 100% | 81% |
| A | Fees | 22,767 | 12,187 | 54% | 29,500 | 12,239 | 41% | 130% | 100% |
| 1 | Cleaning fee | 19,667 | 10,503 | 53% | 25,000 | 10,423 | 42% | 127% | 99% |
| 2 | Public space use | 2,200 | 1,262 | 57% | 3,500 | 1,049 | 30% | 159% | 83% |
| 3 | Licences and fees | 900 | 422 | 47% | 1,000 | 766 | 77% | 111% | 182% |
| 4 | Parking fee | 2,860 | 1,565 | 55% | 2,900 | 1,141 | 39% | 101% | 73% |
| B | Non tax revenues | 64,206 | 32,710 | 51% | 56,330 | 23,577 | 42% | 88% | 72% |
| 6 | Other | 22,812 | 16,294 | 71% | 27,000 | 16,951 | 63% | 118% | 104% |
| **Total** |  | **216,174** | **103,871** | **48%** | **223,486** | **99,051** | **44%** | **103%** | **95%** |

Table . Planned vs. actual revenues in a municipality

Central budget policy has played an important role in the last two to three years for poor compliance of local budget estimates wit actual budgets. For instance, unconditional transfers were reduced for the first time in 2011 without previous notice and despite the general orientation of a constant increase in the MTBP.

Insolvency problems and disputes at the central level between the government and the Electricity Company demanding for settlement of unpaid bills by publicly owned companies caused the Ministry of Finance to intercept the final installments of the unconditional grant from local governments’ budgets and pay for these debts.[[17]](#footnote-17)

Furthermore, fiscal authority of local government and its capacities to raise revenues were seriously undermined following the legal interventions in the local Tax System Law in 2009. All these factors, coupled with the onset of the economic crisis, created all the preconditions for poor budget performance (and poor compliance as opposed to revenue forecast).

However, fiscal discipline at the local level needs to be strengthened. Local governments intentionally plan for higher revenues than what is realistically achievable in order to be able to incur expenditures. The only fiscal rule applicable to local budgets is the need for a balanced budget (no deficit). Hence, Mayors and local administrations adopt an overly optimistic stance by incurring expenditures ahead of revenue realization. As there is no commitment accounting system in Albania, this approach creates a de facto deficit in the form of hidden arrears that are carried over for years.

Table 11 indicates the actual data for planned and actual revenues in one of the DLDP pilot municipalities[[18]](#footnote-18). Collections from the small business tax were 40% short of the plan in both 2012 and 2013. Collections from the property tax were 50% short of plan in 2012 and 60% short of plan in 2013. It is clear from the data that no process of reflection took place among the staff; forecasts for the new budget 2013 were sometimes even more optimistic then for 2012 despite poor collection levels.

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| **DLDP response to strategic planning and budgeting**  DLDP has concentrated a considerable part of its resources on assisting local units in the regions of Shkodra and Lezha improve their governance through strategic vision/strategic development plans; as well as policy/strategy based medium terms budgets. An innovative analytical tool (Financial Planning Tool) that enables more objective forecasts for purposes of strategic budget planning has complemented the package.  As the mid-term thematic evaluation for the DLDP programme also indicates, DLDP has largely achieved its objectives in this programmatic area; thus assisting local governments strategic thinking and resource allocation processes.  However, the entry point for DLDP’s assistance was on the input or planning side of the exercise until now. Whereas public entities in Albania perform well in terms of quality of strategic documents, implementation in practice brings about serious discrepancies in actual budget data as opposed to the plan (See also Albania PEFA 2012 for the national level). In an extremely politicized and closed environment in which some local governments operate; efficiency considerations are not necessarily the primary drivers for choices made. Hence, although capacities may have been build in the area of budget planning, more work needs to be done to increase accountability of policymakers – Mayors and city councils – towards their constituencies. On the technical side, it is imperative that DLDP starts working with budget execution~~,~~ in order to identify the actual challenges, improve financial management practices as well as assist local governments comply as best as possible. Lessons will be learnt from any intervention on the execution (output) side of the budget. Later on, these lessons can be shared with the Ministry of Finance and other shareholders in order to initiate a discussion on whether more fiscal rules should be imposed on the local budget. |

# 7 Conclusions/Recommendations

Overall, the fundamentals upon which the Albanian intergovernmental finance and transfer system is build comply with the general accepted good practice principles. The legislators ensured adequate ***autonomy*** for local governments by granting them a mix of discretionary funding composed of locally derived tax revenues as well as general purpose transfers.

A system of national shared taxes has yet to be established. The 2000 Local government Law indicate the Personal Income Tax and the Corporate Income Tax as possible taxes that could be shared between the levels of government. However, studies indicated that sharing of such taxes on a derivation basis would result in an inequitable system as more than 90% of these taxes are concentrated in a handful of bigger cities.

The system of intergovernmental transfers has a strong equalization component in order to achieve ***equity*** objectives. The size of intergovernmental transfers is bigger for units with smaller tax potential, thus resulting in a more even dispersion of per capita revenues at the national level. ***Efficiency*** considerations were also taken into account: the general purpose grant introduces no restrictions or directions on sectorial allocation.[[19]](#footnote-19)

***Predictability*** of local revenues worsened during the recent years. The unconditional transfer pool decreased without prior notice; frequent changes to the local tax system were not consulted with stakeholders and the funding and criteria for the competitive grants were not made public well in advance. The unconditional transfer formula however contains some buffer provisions to protect local governments from dramatic changes in revenue (negative/positive transition criterion; minimum per capita guarantee).

Another way to establish a tax sharing mechanism would be to link the size of the formula allocated unconditional grant pool to a fixed percentage of collections from a number of taxes. That would increase predictability.

The system continues to lack ***transparency***. Despite dramatic improvements through the allocation of the general purpose grant based on a (primarily) capitation formula; the criteria for the formula are not disseminated as widely and proactively as necessary. Furthermore, criteria have changed subtly but frequently over the years without providing clear justifications on the reasons and the desired outcomes.

In terms of ***Clarity in grant objectives,***there is an improvement with the introduction of the competitive grant/Regional development Fund Mechanisms. However, allocation criteria are still too general to be objective, and the allocation mechanisms does not seem to be efficient.

***Revenue adequacy*** is difficult to assess. Although the vertical (im)balance increased in the last five years; it was established that local governments still have he reserves and they do not exploit their full potential for locally raising revenues. Designated responsibilities at the local level are primarily urban services that should be financed through service fees. Social functions such as social protection or payment of education salaries are financed through the state budget. Other than urban services, maintenance of pre-university education facilities is about the only “social” function performed locally. In similar circumstances, equity considerations become less important and it may be arguable that the majority of resources should go to local units that need them most (with the most population, most economic activity) and are able to create value added around those resources. As long as information on standard service costs of local governments in general are missing as well as on factors causing higher or lower than average costs in individual local governments, it is difficult to determine the adequate level of local funding.

**Tax administration:** there is an urgent need to improve tax administration systems; including creation and updating of taxpayers databases and billing systems. The current share of households in local tax revenues is less than 15% in average, whereas burden for services i.e. waste collection is around 60%. Local governments have not made serious efforts to enforce taxes on households, as administration is much more complicated in this case. However, the clear identification of taxpayers for general tax purposes is a one time exercise that is likely to pay off. Furthermore, local governments are making increased use of tax agents (such as water utilities) to collect taxes on their behalf.

***Service cost*** recovery***:*** Cross-subsidies of general public services are no longer viable as these result in efficiency losses overall. Instead, local government should focus on elaborating their cost and tariff calculation methodologies. DLDP could continue its work to mainstream the methodology at the central level.

***Shared taxes:*** There is much argument among practitioners around the introduction of shared taxes. It would in theory be a very positive move. However, the exact mechanism for the sharing should be worked out as there is very high concentration of revenues from the designated resources (PIT and CIT) in Tirana and few other larger cities. Sharing on a derivation basis would increase inequalities. Another option would be to link the size of the intergovernmental pool to a percentage of collections from shared taxes. Anyhow, it is to be expected that if shared taxes will be introduced, the amount of the unconditional grants will be reduced by a comparable amount.

***Intergovernmental transfers:*** The current system of the unconditional transfer formula has its own merits[[20]](#footnote-20) in achieving equalization. Indicators may need to be revised; and transparency increased. In order to have better estimates and increase the ***predictability of national transfers*** to local governments, the total unconditional transfer pool may be linked with a fixed percentage of state budget specific revenues (e.g., tax revenues).

**Budgeting process:** The increase in the total formula based unconditional pool does not automatically imply an equivalent increase of individual grants, given the equalization and compensation system instituted in the formula, even if criteria are maintained unchanged – results should be communicated to LGs in advance of budget year. Changes in tax policy and other legislation affecting local government should also be communicated to local government through the MTBP and other appropriate channels early enough. This has not happened in the recent years, due to a high volatility in national and local fiscal policy.

***Budget compliance:*** More work needs to be done in order to increase accountability of local administrations towards their constituencies. On the one hand, this would entail work to strengthen their capacities for budget execution and monitoring, on the other hand it could necessitate work with central authorities to impose stricter fiscal rules on local budgets.

***Taxpayer education*** and increased transparency of administration are crucial preconditions to the success of any tax policy.

***Territorial reform.*** The government has announced its intention to go forward with the process of the reorganization of the administrative and territorial division of local governments within 2014. A new configuration of local governments could warrant a complete revision of their functions and relative system of financing.

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Local Government Taxes, Fees and Charges in Albania: Current and Future Challenges, SKl International/Albanian Association of Communes, 2010

White Paper on Fiscal Decentralization in Albania, PLGP – USAID, 2012

1. The main local tax revenue sources are (i) the small business turnover tax (profit tax since 1January 2014); ii. Property taxes; as well as iii. Cleaning fee. [↑](#footnote-ref-1)
2. Albania Local Finance Policy Note, The World Bank, 2008 [↑](#footnote-ref-2)
3. White Paper on Fiscal Decentralization in Albania, PLGP – USAID, 2012 [↑](#footnote-ref-3)
4. Selected from Intergovernmental fiscal Transfers, edited by Boadway, Shah; The World Bank [↑](#footnote-ref-4)
5. These principles are stated in Article 15 of Law 8652/2000. [↑](#footnote-ref-5)
6. Tirana, Durrës, Elbasan, Fier, Korçë, Shkodër, Vlorë, Kamëz [↑](#footnote-ref-6)
7. Berat, Sarandë, Kavajë, Pogradec, Gjirokastër, Kucovë, Lac, Lezhë, Bushat, Kashar, Kukës, Peshkopi, Xhafzotaj, Bucimas, Burrel, Krujë, Divjakë, Himarë, Ballsh, Librazhd [↑](#footnote-ref-7)
8. When speaking about overall own source (or locally derived) revenue performance at the local level the term tax has been used for both taxes and fees (service charges). This is the term that is generally used in the budget classification for both types of revenue, in contrast with “non-tax revenues” that are one-time proceeds from sale of assets, lease or similar activities. [↑](#footnote-ref-8)
9. The small business tax base until 2013 was the annual turnover of small businesses, defined as subject with an annual turnover of up to 8 million Lek. The tax rate was 4% in the early 2000, and it was reduced several times until 1.5% of the annual turnover in the recent years until the end of 2013. [↑](#footnote-ref-9)
10. +/-30% before 2010. [↑](#footnote-ref-10)
11. Law no. 9632 as amended. [↑](#footnote-ref-11)
12. For instance, properties in downtown Tirana that have the maximum yield are taxed at a rate that is about 15 times lower than the tax rate in the so called “tourist village” designated areas on the seaside. A property that is located in the seaside outside of these designated areas is taxed at a rate that can be 40 times or more lower than the tax rate of a property inside the tourist village, even though the distance between the two (hence the market value) may be less then one meter. Furthermore arguments to introduce a tax on urban land (undeveloped land) were not taken into consideration. [↑](#footnote-ref-12)
13. Legislation that regulates solid waste management and environmental protection entailing obligations for local governments has also been passed during these years. [↑](#footnote-ref-13)
14. The first year of implementation of the local fiscal package and increase in local tax autonomy. [↑](#footnote-ref-14)
15. Calculated as the ratio of the sum of the unconditional transfer and revenues from SBT and VRT (given that these were originally national taxes) with the state budget tax revenues [↑](#footnote-ref-15)
16. If equity is to be a significant objective in the case of competitive grants [↑](#footnote-ref-16)
17. Please note that the Ministry of Finance argued that these companies were owned by local government, hence the intercept. However, these are all joint stock companies (therefore limited liability); local governments typically do not yet exercise control over them; and debt were created during the period when the central government still owned these companies. [↑](#footnote-ref-17)
18. Name is not disclosed intentionally to avoid prejudice [↑](#footnote-ref-18)
19. In recent years the central government established a maximum ceiling of the unconditional pool funds that can be used to fund local government staff. Whereas this may be considered an actual restriction, it is in fact a loose condition as local governments earmark their local derived revenues to pay staff beyond these ceilings and reallocate the transfer to other sectors. [↑](#footnote-ref-19)
20. See also Albania Local Finance Policy Note, 2007, World Bank [↑](#footnote-ref-20)