

## FISCAL DECENTRALIZATION IN ALBANIA: EFFECTS OF TERRITORIAL AND ADMINISTRATIVE REFORM

Mariola KAPIDANI<sup>1</sup>

<sup>1</sup> University of Tirana, Faculty of Economy, Department of Finance,  
[mariolakapidani@feut.edu.al](mailto:mariolakapidani@feut.edu.al)

**Abstract:** *The principle of decentralization is a fundamental principle for the establishment and operation of local government. It refers to the process of redistributing the authority and responsibility for certain functions from central government to local government units. In many countries, particularly in developing countries, fiscal decentralization and local governance issues are addressed as highly important to the economic development. According to Stigler (1957), fiscal decentralization brings government closer to the people and a representative government works best when it is closer to the people.*

*Albania is still undergoing the process of decentralization in all aspects: political, economic, fiscal and administrative. Decentralization process is essential to sustainable economic growth and efficient allocation of resources to meet the needs of citizens. Albania has a fragmented system of local government with a very large number of local government units that have neither sufficient fiscal or human capacity to provide public services at a reasonable level (World Bank). However, recent administrative and territorial reform is expected to have a significant impact in many issues related to local autonomy and revenue management.*

*This paper is focused on the progress of fiscal decentralization process in Albania, stating key issues and ongoing challenges for an improved system. The purpose of this study is to analyze the effects of recent territorial reform, identifying problems and opportunities to be addressed in the future.*

**Key words:** fiscal decentralization, local autonomy, local revenues, territorial reform

**JEL classification:** H2, H6, H7.

### 1. INTRODUCTION

The concept of local autonomy corresponds to the right and the ability of local government units to regulate and to lead their public affairs, within the law and under their own responsibility, focused on meeting the population needs. The decentralization of local government is a very important process for democratic development of countries and it is a fundamental principle for the functioning of local government. Decentralization is defined as the process of political, fiscal and decisional devolution by the central government at the local level. Underlying the decentralization is the principle: the exercise of public responsibilities should, in general, belong more to the authorities closer to the citizens. Decentralization aims to stimulate the creation of a stable economic development basis.

According to Bailey (1999) there are three forms of decentralization: economic, political and administrative. Financial Decentralization refers to the transfer of financial power to the local level, in order to equip local units with greater authority in incomes and expenses management. For many countries and, particularly the developing countries, decentralization and local governance issues are taking an increasingly important role, apparent in the administrative and political reforms undertaken by them. The most important reasons for decentralization are primarily related to the concept of efficiency. According to Stigler (1957), fiscal decentralization

brings government closer to the people and a representative government works best when it is closer to the people. Oates (1972) formulated a "theorem" of decentralization, stating that each public service should be provided by the authority having control over the minimum geographic area that can hold within it the benefits and costs of this service.

Decentralization increases efficiency because local leaders have better information on needs of their community than the central government. Decisions on public expenditure undertaken by a level of government that is closer to citizens and, as a result accountable to them, is likely to better reflect the choices and needs of citizens than the decisions taken by the central government. In order for decentralization to be effective and successful, the transfer of fiscal authority from central government to local leaders should be supported by institutional arrangements that enable the monitoring of the system. Decentralization increases the level of citizen participation in decisions making that directly affect the community. Based on this principle, it gives to citizens the right to decide on the type of government, representation, policies and services that are necessary.

With the democratization of the government, Albania started the process of decentralization in all aspects: political, economic, fiscal and administrative. While in the early '90s the focus was on decentralization of political and administrative aspects, later it was focused on sustainable economic development and efficient allocation of resources to meet the needs of citizens with services. The Constitution of the Republic of Albania has adopted the concept of decentralization which refers to the restructuring or reorganization of power and that enables the creation and operation of a system of co-responsible government institutions at central and local level under the principle of branches. This process has its own political, administrative and financial dimensions that interact among themselves and represent three core components of power. However, previous studies in our country indicate an asymmetric decentralization. Such policy of the central government creates conflicts with the local governments, especially of those locals that generate large incomes to the state budget.

According to international institution's studies, regarding the organizational structure until 2014, it is mentioned that Albania has a fragmented system of local government with a large number of LGUs with nonsufficient fiscal or human capacity to provide public services at a reasonable level. Fragmentation of local government units and the undefined role of regions could complicate the evenly attribution of responsibilities and can affect the efficiency of local public service delivery (World Bank document, Decentralization in Transition V1). As mentioned above, fiscal decentralization cannot be understood separately from aspects of efficient administration of local units and proper mechanisms of autonomy. So the argument for a new territorial reform is highly relevant to the fiscal decentralization of our country.

The need for territorial reform is a topic discussed for many years in Albania, starting from the extreme fragmentation of the country's territory, which has harmed the community development potential, under the conditions of curtailed opportunities to mobilize income and provide services for the citizens. In particular, the territory fragmentation has created deep inequalities between municipalities and communes in the country, making the decentralization asymmetric; although the competencies and authorities were transferred in a fully symmetrical way. The average population of local government units has decreased during the last decade, so the configuration of local government units no longer reflected the population distribution. In the last twenty years a great number of European countries such as Sweden, Denmark, England, Finland, Greece, Macedonia, Georgia and more recently Ireland, Armenia, Ukraine, etc. have undertaken territorial reforms aimed at the establishment of larger local government units. (General Report, April 2014, Ministry of Local Issues)

## 2. AN OVERVIEW ON FISCAL DECENTRALIZATION REFORM IN ALBANIA

The collapse of the socialist regime in Albania in late 1991 marked the beginning of the reconstruction of governmental system, the transfer of authority and transition to a market economy. Initiatives for political and administrative decentralization after the change of political system included a new territorial administrative division. As part of the reform for democratization, decentralization process took place in three phases:

(1) The first phase from 1991 to 1998 was a shift from deconcentration to decentralization; the creation of local government units (LGU) municipalities and communes; it was focused more on political rather than fiscal decentralization. European Charter of Local Government was adopted in 1998 and ratified in 1999. Albanian territory was divided into 65 municipalities and 309 communes (first level of LGU) and 12 regional councils (second level of local government). Despite territorial differences, including urban and rural land, municipalities were assigned the same functions.

(2) The second phase of decentralization began in 1999 and continued until 2005-2006. In 1999 it was drafted the National Strategy for Decentralization and Local Autonomy, which was followed by Law 8652 (31.07.2000) on the Organization and Functioning of Local Government (known as the Organic Law). During the years 2000 - 2001, local government units provided almost 45% of their income from conditional grants. This means that LGUs were not only dependent on the national government for a large part of their income, but they were also very limited in their spending decisions. This changed radically in 2002, when the amount of conditional grants in the system was reduced significantly; the size and the proportion of unconditional transfers increased dramatically, and the Law on Local Tax System gave local governments new competences regarding their incomes. After that, the period 2002 - 2005 was characterized by the increase of revenues and a decrease on the percentage of conditional grants. Before 2006, the decision on conditional grants for investments was addressed to the relevant ministry.

Fiscal decentralization reached its apex during the years 2005-2006. Some of the major developments consist of the passing of Small Business Tax under the responsibility of local government (Law 9632 dated 30.10.2006), which can be considered as the second crucial moment of fiscal decentralization reform. Adoption of the Law "On local tax system" increased the discretion of local councils to determine the level of tax to +/- 30%, and expanded even further the competences of local government. However, the right of LGUs to manage and administrate local taxes and fees was limited somewhat by the adoption of Law 10117 dated 23.04.2009. The justification for adoption of this law was to facilitate small businesses and household taxpayers from the burden of local taxes and fees, but this was accompanied by a series of regressive effects in the reform of fiscal decentralization, impinging local budgets by reducing the discretion of local government to +20% (from +/- 30% to + 10 / -30%) for the small business tax and property tax, it also changed the level of tax burden for some taxes to 10% by directly impacting the budget. All this resulted in negative effects on the budgets of LGUs: (1) impinging of at least 20% of its revenue to LGUs; (2) reduction of borrowing capacity; (3) the decline of the capital budgets for the financing of capital projects.

(3) The third phase of decentralization has its beginnings in 2007 and is still ongoing. During this period the undertaken reforms were non-significant to the fiscal decentralization process, until year 2010, when their impact on local budgets was substantial. Changes made in the fiscal legislation during the years 2008 - 2010 aimed to reduce the tax burden for businesses and increase revenues, which was expected as a result of the reduction of tax evasion (reduction of

informality) stimulating LGUs to expand taxpayer base and business activity monitoring within their jurisdiction. Some important legislative initiatives undertaken during this period are:

- Decision no. 1058 dated 21/10/2009 "On the reduction of the registration limit to the value added tax" means lowering the threshold of VAT from 8 million in 5 million and resulting in reduction of the number of contributors to the local budget with at least 4 categories of taxpayers.

- Budget reform marks another change with the adoption of Law 9936, dated 26.06.2008 "On the management of the budgetary system in the Republic of Albania" and 7/1 Instruction dated 22.02.2010 "On the drafting of the Medium Term Budget Program at the local level". Based on this law, the budgetary system was regulated in terms of: a) structure; b) principles; c) financial relations and; d) responsibilities in the implementation of the budget legislation through linking budget (expenditures and revenues) with development policies and medium-term objectives.

The structures of local government were not able to govern with efficiency and transparency; they also failed to involve citizens in decision making. Generally, local government has been a closed government and it failed in community involvement. The lack of accountability of local authorities regarding budget expenditures has brought down the confidence of citizens and businesses, consequently creating lower revenues from taxes and fees. High fragmentation of the local government until 2014, meaning a large number of LGUs, has increased the overall local administrative and management cost, and has made it difficult to provide efficient and high quality services. Moreover, the balance of costs and benefits has shifted since the last major reorganization of local government in 1992, due to massive internal migration, technological progress and the growing expectations of citizens to public services.

Financial autonomy of local government still remains a challenge. Local authorities do not have adequate financial resources under their competences. LGUs are still very dependent on financial assistance from the central government, especially small units of local government. As it was noted in 2012, 60% of the local budgets were funded at over 80% from the state budget. There is also a high level of unpredictability of government transfers over the years. Local government units lack the capacity to collect own revenues, particularly the property tax and other taxes and local fees.

Despite progress made in the last decade with regard to the increase of autonomy of local governance through the transfer of numerous legal and financial instruments from the central government to LGUs, the fiscal decentralization reform made considerable regress during 2009-2013. In terms of fiscal decentralization indicators, Albania is much below of other countries of south east Europe. It is the last one in the region with regard to local government revenues share (2.2% of GDP) and LGU revenues per capita (670 euro). The share of property tax within the local government revenues and GDP is 0.18% of GDP, living behind only Croatia by 0.13% of GDP. Our country is the last one with regard of local government investment per GDP (0.9% of GDP). Albania ranks second, behind Moldova, in terms of outstanding local government debt per capita at 23 Euros per capita. (National crosscutting strategy for decentralization and local governance, 2015)

As in many other European countries, Albania undertook and implemented the reform of administrative-territorial consolidation by adopting the law 115/2014 "On the administrative and territorial units of local government in the Republic of Albania" for resolving the issue of fragmentation of local units.

### 3. TERRITORIAL AND ADMINISTRATIVE REFORM CONSIDERATIONS

The previous territorial division and the role of regions have led to problems related to the effectiveness as well as to political reasoning of whether the local administrative units (especially communes) are too many in number and too small in size. As mentioned above, the earlier territorial division consisting in 374 units of local government (65 municipalities and 309 communes) has led to a situation in which 48% of these self-governing units, representing 17% of the country's population, were made up of communities with less than 5,000 inhabitants. As with many other European countries in transition, this fragmentation raises concerns that go beyond economic efficiency arguments (for example the economies of scale), including political and administrative considerations. On one hand, fragmentation means that the decision makers are closer to voters, which increases democratic representation and, depending on the design of decentralization of competences and incentives, it can increase accountability to the public. On the other hand, excessive fragmentation of the territory tends to leave the smaller communities without financial resources of its own and without the technical and administrative skills necessary to effectively implement policies in the delivery of public services - an argument that contradicts decentralization.

The experience of other European countries illustrates the scope for variety in size and configuration of local government (both between countries and, in some cases, in the same country over time). On average, the population of first-tier local authority areas in the EU is smaller than that of Albanian communes and municipalities, although many countries have powerful intermediate tiers of government that perform some of the functions allotted to the local level in Albania. In South East Europe, first-tier local authorities tend to cover a significantly larger population, which partly reflects the relatively large share of the population living in capital cities (NALAS, 2012).

According to several primary studies, a very important argument on the need for territorial and administrative reform is the efficiency in service delivery. The reorganization of local government creates opportunity to provide efficiency in the distribution of investments; especially about education, infrastructure, water supply service, etc. Territorial reform is expected to reduce the costs of public services per capita and to provide the space needed to create economic schemes to develop small and medium business (Institute for Public and Private Policies). Larger units of local government have more capacity to exercise a greater range of functions, so the territorial consolidation enables more delegation of local government services. Given that larger units of local government can perform more functions, there are more opportunities for citizens to be more interested in participating in political processes related to local governance, indicating that territorial consolidation helps to promote local democracy. A territorial organization with larger units of local government creates less inequality in income of municipalities, so there is less pressure to compensate local governments from the central government, an issue that costs the state budget and is associated with political sensitivity.

Administrative-territorial reform was approved by Law 115/2014 adopted on 31.07.2014 "On the administrative and territorial units of local government in the Republic of Albania". The main and final purpose of the territorial administrative reform is to increase the efficiency of local administration, enhancing the quality and standards of service delivery, proper development of territory by enabling greater human and financial resources, more responsibilities and authority at the local level and orientation towards a transparent and participatory decision-making. In accordance with the new administrative map, the territory is divided in 61 new municipalities (from 373 municipalities and communes in the previous reform) and 12 regions. Such an administrative consolidation represents the merge of 8-9 current LGUs in one new unit. New

LGUs will bear full responsibility for the management of human resources and financial capital within their territories. Regions are not affected directly by the territorial reform; therefore, their number does not decrease.

This reform provides a good planning for local economic development and the reduction of problems between administrative boundaries and the area of influence of the services provided by neighboring local government units. It will also enable the effective use of funds through local government compaction, good management of expenses but also by increasing the capacity of tax administration and matching the functions of local government with the financial administration. According to the Ministry of Finances if the service of waste management is organized based on a territory that corresponds to district territory, the cost of this service will decrease by 40%, due to the economy of scale effect. In the same logic goes the administration of natural resources, and capital assets of local government. The well-administration of human resources is estimated to have an economic impact of around 80 million dollars. It also addresses the issues of beneficiaries (free-riding), situations where a resident living in a certain local unit consumes services provided by another local unit. In other words, territorial consolidation helps to reduce discrepancies between the boundaries and areas where the services are provided.

Meanwhile, positive effects on sustainable development, strategic planning and investment orientation, reducing costs and barriers for business, modernization of public services, are already proven effects from the examples of other countries that have undergone this process. These positive effects can not be entirely attributed to the territorial reform, but that reform is a necessary basis for achieving these positive effects. Large municipalities have better capacities than a small municipality and capacities are very important when it comes to planning and implementing investments. Major achievements of the developed countries apply to the fact that there is administrative organization of the territory based on decentralization of powers and responsibilities. Likewise, keeping in mind the economic and social efficiency that must be ensured by the territorial organization has played a very important role in the overall development of those countries. Undoubtedly, patterns of developed countries are always helpful, but we cannot pretend that they are fully imitable considering the fact that in Albania, like in any other country, there are specifications relating to size, natural features, political system and level of economic development and socio-cultural relations between stakeholders.

The administrative organization of the territory is a long and complex process. Its aim is to divide the country into administrative units (primary and secondary) with balanced spatial and demographic size to allow the rational use of natural, human and economic resources. This activity must consider all economic and social sectors, as well as to take in account the local communities needs. Population and all stakeholders should be aware of the need for interventions to improve the system, in accordance with the achieved progress and the prospects of demographic and socio-economic development.

However, there are issues to be taken in consideration. Striking the balance between efficiency and local democracy is one of the main challenges to the organization of government in the territory. Without proper interventions to balance the territorial consolidation with democratization, proper accountability mechanisms and community participation in decision-making, the reform risks its progress. Reducing the fragmentation of the territory does not lead to reduction of corruption. Therefore, it is necessary to regulate the council as a structure representing the broad interests of citizens, elected freely by the communities, listening the voices of the chairmanships of the villages, and able to control the executive power of mayors.

Also there are needed wider procedures and standards of internal control within the executive. It is recommended a higher level of information to the public regarding territorial changes, aspects

related to services directly benefited by citizens and the managerial levels responsible for them. The territorial reformation process should be accompanied by consistent steps of fiscal decentralization. A consentaneity of both reforms is very important for sustainable local governance, which must be supported by a detailed legal and technical framework to make the administrative and territorial changes more effective.

#### **4. CONCLUSIONS**

The decentralization of local government is a very important process for democratic development of countries and it is a fundamental principle for the functioning and operation of local government.

The fragmented governance of numerous local government units has been an issue in Albania, and it has created inequalities and efficiency problems in the system. The reorganization of local government is needed to provide efficiency in the distribution of investments; especially about education, infrastructure, and water supply service.

Financial autonomy of local government still remains a challenge. There is a high level of unpredictability of government transfers over the years. Local government units lack the capacity to collect own revenues, particularly the property tax and other taxes and local fees. These traits must be taken in consideration and addressed with the new organizational and fiscal reform.

Larger units of local government have more capacity to exercise a greater range of functions, so the territorial consolidation enables more delegation of local government services, creates less inequality in income of municipalities, there is less pressure to compensate local governments from the central government, and it is expected to reduce the costs of public services per capita.

Despite progress made in the last decade with regard to the increase of autonomy of local governance through the transfer of numerous legal and financial instruments, Albania is much below compared to other countries of south east Europe in terms of fiscal decentralization indicators.

The administrative organization of the territory is a long and complex process; it should be accompanied by consistent steps of fiscal decentralization and must be supported by a detailed legal and technical framework to make the administrative and territorial changes more effective.

It is recommended a higher level of information to the public regarding territorial changes, aspects related to services directly benefited by citizens and the managerial levels responsible for them. Population and all stakeholders should be aware of the need for interventions and they should be part of the decision making to improve the system.

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