The Fiscal Decentralization Initiative
for Central and Eastern Europe

Intergovernmental Finance and Fiscal Equalization in Albania

by
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Executive Summary

Started in Albania in 1998, decentralization efforts made real progress after the adoption of the National Decentralization Strategy in January 2000. The first step marking the implementation of the strategy was the adoption of the Law on Organization and Functioning of Local Governments (LGs) in July 2000 (hereafter: Law on Local Governments). The law institutes two levels of local governments, (a) municipalities and communes and (b) regions, and defines principles of their functioning, rights, functions, responsibilities, and the manner of their funding.

Functions defined in the law on LGs are categorized as exclusive, shared, and delegated. Shared functions include pre-university education, primary health services, and social services, which are much dependent on national standards and funding. Shared functions still are provided by the central government as delegated or mandated functions. Delegated functions are those which shall be provided by LGs within the authority and funds delegated by central government based on the specific laws. At present, investment responsibilities have been delegated to local governments.

Since 2002, local governments have taken the authority and are exercising autonomous spending and taxing powers. The 2002 Annual Budget Law has introduced the formula for distributing general transfer to local governments. In 2003, the fiscal package defined the local taxes and taxing powers of local governments.

Local governments' autonomous spending has increased in both actual and relative terms. The share to GDP is still small but it increased from about 0.34 percent in 2000 to nearly two percent in 2003. The share of local spending under full discretion of local governments as a percentage of total local expenditures was increased from 9.21 percent in 2000, the year prior to the decentralization process, to 47.48 percent in 2003, and budgeted 53.39 percent in 2004.

A major step in intergovernmental relations was made in 2003. LGs have the authority to accept or reject a tax defined by law; set tax rates within limits below or above the indicative rates defined by law; and impose temporary taxes and any kind of fees or charges for services they provide to their communities. Shared taxes defined in these laws are based on the place of origin. The flat indicative rates are fixed by law, which makes them inelastic and reduces the potential for increasing revenues.

The level and composition of local taxes by cities shows that there are large differences in per capita taxes. In 2003, the median per capita total tax burden across all local governments was slightly more than ALL 400, while the median for municipalities was about ALL 1,400; in communes the median was less than ALL 300. On the other hand, the biggest and more urbanized cities have a higher level of the per capita tax, i.e., the capital city, Tirana, collected over ALL 7,700 per capita in taxes in 2003.

In 2002, the initial total pool of unconditional (general) transfer was based on the historic cost of services transferred and the taxing powers provided to local governments. Later, as spending responsibilities for delegated functions (health services, urban and rural road investments) were changed, the pool was adjusted.

The general transfer pool first is divided (by certain percentages) into three sub-pools respectively for regions, municipalities, and communes, and the "compensation fund," distributed on the basis of a formula. The formula is based on the population, area, indicators of the economic status of each region, and length of the road network. In addition, the basic results are adjusted for differences in the tax capacity.

Fiscal capacity for adjustment purposes is measured based on the expected actual collection of revenues. LGs with per capita local tax collections higher then the national average lose 35 percent of the difference, and those with lower then the average are compensated by 35 percent of the difference. Compared to 2002, the coefficient of variation of per capita transfers (the amount

of individual cities around the mean) has been reduced in 2003 and 2005.

To meet the vertical equalization objectives, the pool of local government expenditures are determined in the annual budget process. Initially, it was based on the historic operating and maintenance cost of capital outlays, with a minimum level. The pressure for transferring investment responsibilities to the LGs is increasing and in 2006 the investment pool for local roads was included in the general transfer pool.

In addition to the investments of own functions, delegated and mandated functions are also financed through conditional transfers. Among them are pre-university education, local health, and social welfare services. This transfer is allocated by line ministries without discretion to the LGs.

Introduction

In the early 1990s, Albania started the transition towards a market-oriented economy and the reform process also involved local governments. The interim constitutional provisions passed in 1991 established two different levels of local government: (a) municipalities and communes and (b) districts. Other laws adopted later defined their roles and responsibilities and provided a limited administrative and fiscal autonomy to local governments.

The Law on Organization and Functioning of Local Government adopted in July 2000 replaced districts as the second level of local governments with regions. In this law, communes and municipalities are defined as the first and lowest level of local government. Currently there are 308 communes, which represent the LGs governing in rural areas. The population in their jurisdiction is relatively small, with an average of 5,226 inhabitants. Municipalities are local government units governing urban areas. At present, there are 65 municipalities with populations ranging from only 1,995 to 343,078.

The second level of local government defined in the organic law is the region. The former 36 districts were replaced by twelve regions, which have specific roles and responsibilities in their jurisdictions. Their governing body is the council, which elects a chairman, being in charge of day-to-day management. Members of the regional councils are elected by the municipal and communal councils within the region's jurisdiction based on the population of the region and each locality.

By law, communes and municipalities have the same functions and responsibilities. However, they provide different public services to their communities. Traditionally, local governments in rural areas have provided limited communal services. Their infrastructure does not allow for the provision of public services such as sanitation, sewerage, lighting, parks, decoration, etc., as they are provided in the urbanized areas. The decentralization process has provided opportunities for independent decision-making, and some communes provide garbage collection and other services, finance and infrastructure permitting. A region is a broader level of government and it does not play any major role, because at this time the law defines their functions only in general terms, which include coordination and economic development roles.

Basic Structure of Intergovernmental Finances

The principles of the local governments' financing are defined in the Law on Local Governments. Their purpose is to ensure the autonomy and functioning of local governments through:

- The right for diversified local sources such as taxes, fees, and charges; other local revenues; transfers from the central government (directly or through shared national taxes and levies); and loans;
- The authority for establishing revenues in an independent manner;
- Receiving sufficient funds from the central government; and
- The rights to prepare, adopt, implement, and administer their own annual budget.

The following sections describe the implementation of these principles in the intergovernmental finance system in Albania.

Own Local Revenues

Own local revenues of communes and municipalities include those assessed, invoiced, collected, and spent entirely by them in an independent manner. They are diverse and based on their nature they might be grouped as follows (see Table 1.).

Local Taxes

Local taxes are those for which local governments can set the rates or have some authority on the tax base assessment. The Law on Local Governments has established a system of local taxes and levies on local businesses and properties. It has increased the number of local taxes

Table 1.
Basic Elements of Major Local and Shared Taxes

Taxes	Base	Rates	Local Autonomy	Collection Administration
Building Tax	Surface area of building	Flat amount per m^2 depending on location, age, and type of use	May increase or decrease rates ± 30 percent from indicative rates in the law	By the local government
Agricultural Land Tax	Surface area of agricultural land	Flat amount per hectare; depends on district in which located and quality category of land	May increase or decrease rates ± 30 percent from rates in the law	By the local government
Property Transfer Tax	Surface area of buildings; value of other immovable property	Flat amount per m^2 depending on location and type of use; other property taxed at two percent of sales price	None	Office of Asset Registry (central government agency)
Infrastructure Impact Tax	Value of infrastructure investment	1–3 percent of value of investment (outside Tirana); 2–4 percent (in Tirana)	Can set rate within stated bounds	Construction permit issuing authority
Small Business Tax	Existence of Small Business [a]	Flat rates per annum; differ by type of business and location in country	May increase or decrease rates ± 30 percent from rates in the law	Currently Central Government Tax Directorate; in 2005 to be local responsibility
Simplified Profits Tax	Turnover of Small Businesses	1 percent	None	Central Government Tax Directorate
Vehicle Tax	Registered vehicle	Flat annual amount depending on type of vehicle	None	Regional Directorate of Road Transportation Services

Note: [a] A small business is defined to be not subject to the VAT; at present, this is any business with turnover less than ALL eight million. No differentiation is made among small businesses of different size.

and fees and provided the tax authority to the LGs (see Box 1.).

Box 1.
Tax Authority of Local Government

1) Accept and apply or not a local tax established by law;
2) Decide the tax rate within maximum and/or minimum indicative tax rates defined in the relevant laws;
3) Decide the manner for tax collection and administration within the limits and criteria set forth in the respective laws (i.e., establish additional land and building classes, assess the actual property base, hire the tax agent, and undertake other internal tax administration steps);
4) The same authority as the central government tax administration to undertake legal steps or impose sanctions for unpaid tax liabilities.

In addition to the building and hotel taxes, which were assigned as local taxes, the new local tax system includes: (i) taxes devolved from national to local level (small business tax) and (ii) new local taxes (infrastructure impact tax for new construction, agricultural land tax). The law also grants authority to local governments for setting up temporary local taxes and tax rates for all local taxes within limits above or below the indicative tax rates established by law.

Service Fees

Service fees (see Box 2.) represent those sources that the local government acquires from charges for administrative and public services provided to citizens. The Law on Local Governments defines the jurisdiction of the local governments for imposing fees and charges including: (a) public services (water, sanitation, sewer, greening, etc.), (b) the right to use local public property (parking, fairs, advertisements, cinemas, theaters, museums, etc.), (c) the issuance of permits for businesses and residents, and (d) other functions, which by law shall be provided by the local government. The law on local fees, adopted in 2002, defined all local fees and their rates, and granted full authority to local government for defining the base and the rate for any fee they may impose for services assigned as its exclusive functions.

Box 2.
Local Service Fees

- Public services
- The right to use local public property
- The issuance of licenses, permits, authorizations, etc.
- The issue of certificates/documents
- Other exclusive local services

Other Revenues

The Law on Local Governments entitles communes and municipalities to generate revenue from their economic activity (see Box 3). Included in this group are revenues from the sale of capital assets such as land, buildings, and other local facilities; earnings from financial investments; rent on land, buildings, and other facilities; proceeds from privatization of local economic enterprises or the share from privatization of other state property; sponsorships, donations, and other aid from internal and external individuals, companies, and other institutions; fines and forfeits; and other revenues of this type.

Box 3.
Other Revenues

- Local economic activities
- Rent and sale of property
- Donations
- Interest income
- Penalties
- Aid or donations

Shared Taxes

The Law on Local Governments defines two shared taxes: personal income tax and profit tax (see Box 4.). It did not make any specific regulation about their sharing system, so a group of shared taxes was established by the Law on Local Taxes adopted in 2002.

The latter does not use specifically the term "shared taxes," but according to the generally accepted definition on shared taxes, the following local taxes are included in this group: (i) simplified profit tax, (ii) tax on vehicle registration, and (iii) tax on immovable property transfer.

The law lists them as own local taxes but does not define any authority for local governments related to their tax bases and tax rates. They are collected by central government authorities and allocated to local governments based on principle of the locality, which means that the amount allocated to each local government unit depends on the businesses, vehicles, and properties located in their jurisdictions.

Box 4.
Shared taxes

- **By the Law on LGs:**
  - Personal income tax
  - Profit tax
- **Effective:**
  - Simplified profit tax
  - Immovable property transactions
  - Vehicle registration

Shared taxes in Albania do not incur any reallocation of revenue, and the lack of local government tax authority is the only rationale used to classify them as shared taxes. As can be seen, they also do not represent the shared taxes defined by the Law on Local Government.

Regions, as the second level of local government, can generate revenues from both own and national sources. Since the law is vague about the regions' functions the same applies to their revenues. At present, own revenues of the regions are comprised of the membership fee from all local governments under their jurisdiction and any fee they apply for their administrative services. In addition, they receive a share from the general transfer based on the distribution formula.

Central Government Transfers

In addition to the shared taxes, the Law on Local Governments specifies two other types of transfer instruments: (a) unconditional transfers and (b) conditional transfers. Even if the law does not provide the mechanisms to determine the general pool of the transfer and its distribution to local government units, it clearly defines that the equalization of resources should be the primary objective of the unconditional transfers. Provisions of the law regulating the transfer system (see also Boxes 5. and 6.) are based on the following rationale:

- Provision of adequate revenue to local budget, in addition to local taxes;
- Assistance for the lower levels of government; and
- Financial equalization to compensate for inequalities between central and local governments.

Unconditional (General) Transfer

General transfers are commonly used to provide the local governments with sufficient funds to exercise their exclusive functions. The Law on Local Governments states that "the unconditional transfers must be given based on the criteria defined by law, the exclusive functions of municipalities and communes, and the purpose of achieving equalization of resources among local governments." In 2001, the general transfer was introduced as a block grant, and the 2002 National Annual Budget Law has defined the formula for the general transfer distribution and the variables that tend to equalize expenditure needs. Then the amount calculated by formula is adjusted to equalize revenue capacities of the LG units and any undesired impacts of the new transfer system.

Box 5.
Unconditional Transfers

- **Based on**:
  - Exclusive and shared functions
  - Criteria defined by law
  - Horizontal and vertical imbalances
- **No limits where will be spent**
- **Can be carried over to the next years**

The local authorities are free to use revenues received from unconditional transfers in the most efficient way. The determination of the pool total of the unconditional transfers is made in the annual budget process and not based on the predefined criteria.

Conditional (Earmarked) Transfers

The conditional transfers represent the funds transferred from the central government to the local government for those services and activities that will be financed by the central government through local authorities. The local authorities cannot transfer or spend them for other purposes. The Law on Local Governments defines the conditional transfer as a tool for providing "the necessary financial support primarily to exercise the delegated functions and powers."

In this case, central government or its delegating authority defines the sum and the manner in which the earmarked transfer will be spent. Their disbursement is also made in compliance with budget execution rules, which give full authority to the delegated central government agency. The unspent balance by the end of the fiscal year cannot be carried forward to the coming year.

Box 6.
Conditional Transfers

- **Given for:**
  - Delegated functions
  - Achieving national objectives
  - Specific projects
- **Must be spent for the given purpose**
- **Cannot be transferred**
- **Cannot be carried forward**

The law also provides for the use of this tool for achieving specific objectives or meeting national standards. The experience during the years after its implementation shows that the conditional transfer has been used both for delegated and own local functions. The latter represents the share of the earmarked transfer allocated for funding investment responsibilities. The difficulty is defining the distribution criteria. However, other experiences suggest different criteria which can be used, and suggestions will be made later in the analysis of this component.

Implementation of Local Fiscal Powers

The Law on Organization and Functioning of Local Governments provided for a set of taxes that local governments were empowered to impose without defining details regarding the tax bases, the rates imposed, and tax administration. The 2002 revenue laws package defined in detail the local tax system and revenue-raising powers of the LGs. The basic approach used by the law was to establish an effective tax system that harmonizes both fiscal and policy objectives. The former deal with the provision of revenue needed for financing local functions, while the latter deal with their impact on businesses and categories of taxpayers. The following shows how these objectives have been combined in the local revenue system:

- *The ability to yield revenues in response to increases in economic activity.* The laws define flat indicative rates, which do not bring additional revenues to the local government when the local economy or inflation grow.
- *Equity in the treatment of different taxpayers*. The law does provide some rates differentiated on the nature of the tax base or the taxpayers' capacity.

- *Impact on the taxpayers' behavior*. The system of the local taxes is based on low tax rates, which minimizes any potential negative effects.
- *Tax administration cost*. The revenue laws provide the collection responsibility for some local taxes to central government agencies, and they also allow local governments to make their own choice about tax administration. This has encouraged local governments to use central government tax agents for collecting different taxes or fees, and they also have reached mutual agreements for having joint tax administration offices.

The 2000 Law on Local Governments marks a great change in the fiscal environment at the local level. However, the lack of autonomy in the previous system, and during the first ten years of the post-communist transition, has affected the implementation of functional responsibilities that the law transfers to local governments.

Analysis of Local Revenues and Expenditures

Analysis of Revenues

Beginning from 2001, local government revenues have been increasing and the highest increase can be seen in the share of revenues controlled by local governments. Tables 2 and 3 show that earmarked revenues transferred from the central government to the local governments once had a greater share, which has reduced since 2001. In 2003, they funded 50 percent of local expenditures, and in 2004 they are expected to be less then 50 percent. From 2003, local autonomy and fiscal decentralization in Albania has been increasing significantly and local governments control about one-half of their revenues. Local taxes and unconditional transfers (beginning from 2001) also had significant increases. Shared taxes do not show a big increase because all previous taxes assigned to local governments have been classified as shared taxes due to the lack of the local tax authority over them.

In the previous official analysis of the sources available to local governments, the share of the locally controlled revenues is lower because of the higher share of the conditional transfers, which are reduced in this analysis. The adjustment has been made for the salaries of teachers and health workers, who are paid by LGs in the agents' role. Since LGs do not have any authority related to these expenses, they are included in the budget of the central government ministries and also excluded from the conditional transfer.

Analysis of the detailed composition of own source revenues (Table 4.) shows that non-tax revenues were dominant until 2000 and remained an important revenue source until 2002. In 2003, the impact of the fiscal

Table 2.
General Composition of Local Revenues, 1998–2004, in Percent of Total

	1998	1999	2000	2001	2002	2003	2004
Own taxes and fees (rates set by LG), of which:	**0.7**	**3.6**	**6.0**	**7.2**	**8.7**	**19.3**	**22.5**
• Taxes[a]	0.0	0.4	0.4	0.5	0.4	12.5	17.7
• User charges and fees	0.7	3.2	5.6	6.8	8.3	6.8	4.8
• Local non-tax revenues	3.5	5.4	4.2	2.6	3.8	3.2	2.2
• Shared taxes[b]	2.7	0.8	1.1	1.3	1.4	6.8	9.6
• General purpose grants	0.0	0.0	0.0	21.7	33.7	20.8	19.1
Subtotal Local Discretionary Revenues	**6.9**	**9.8**	**11.3**	**32.9**	**47.6**	**50.1**	**53.4**
Subtotal Unfunded Mandates[c]	**1.6**	**3.8**	**3.6**	**8.4**	**6.1**	**5.6**	**N/a**
Net Local Discretionary Revenues	**5.3**	**5.9**	**7.7**	**24.5**	**41.5**	**44.5**	**N/a**
Earmarked Conditional Transfers	**93.1**	**90.2**	**88.7**	**67.1**	**52.4**	**49.9**	**46.6**
Total Local Revenues as percent of GDP	**3.86**	**4.90**	**3.91**	**4.27**	**4.06**	**4.23**	**3.94**
Net Discretionary Revenues as percent of GDP	**0.20**	**0.29**	**0.30**	**1.05**	**1.69**	**1.88**	**N/a**

Notes: [a] Includes the Local Small Business Tax and all taxes listed in the Law on the Local Tax System, except those in [b].
[b] Includes local taxes without tax powers before 2003; after the SPT and two taxes from the Law on Local Tax System on vehicle registration and immovable property transfer.
[c] Includes expenditures paid with local discretionary revenues for functions mandated or delegated by the central government.

Sources: F. Conway and data from the Treasury Department of the MoF of Albania.

Table 3.
Local Revenue Trends, 1998–2004, in Percent to Previous Year

	1999/1998	2000/1999	2001/2000	2002/2001	2003/2002	2004/2003
Total Local Government Revenues	**146.05**	**89.50**	**125.28**	**105.76**	**114.56**	**104.36**
Locally Generated Revenues Total, of which:	**207.15**	**103.31**	**124.21**	**131.67**	**241.11**	**122.27**
• Own Local Revenues, of which:	310.88	101.87	120.82	134.49	205.55	114.64
• Taxes	N/a	97.24	149.43	96.28	3,369.82	147.95
• Fees	623.03	157.55	150.68	129.06	94.26	74.00
• Non-tax Revenues	228.27	69.31	78.10	155.33	96.18	71.72
• Shared Taxes	43.29	119.68	157.00	110.71	562.14	147.44
Revenues from National Sources Total, of which:	**141.53**	**88.01**	**125.42**	**102.50**	**94.10**	**96.94**
• General transfers	N/a	N/a	N/a	163.92	70.66	95.77
• Earmarked Conditional Transfers	141.53	88.01	94.72	82.60	109.17	97.43

Table 4.
Composition of Own Source Revenues, 1998–2003, in Percent of Total

Own Source Revenues	1998	1999	2000	2001	2002	2003
Local Taxes Total, of which	**0.00**	**3.67**	**3.46**	**4.16**	**3.04**	**42.52**
• Property tax	0.00	0.00	0.00	0.00	0.00	7.88
• Infrastructure impact tax for new construction	0.00	0.00	0.00	0.00	0.00	19.05
• Small business tax	0.00	0.00	0.00	0.00	0.00	14.89
• Other taxes on business activities	0.00	3.67	3.46	4.14	3.04	0.71
• All other local taxes	0.00	0.00	0.00	0.02	0.00	0.00
Local Fees Total, of which	**10.89**	**32.74**	**49.93**	**60.57**	**59.37**	**23.21**
• Cleaning and solid waste disposal fee	0.00	5.17	6.42	15.98	12.92	7.02
• Civil registry fee	0.00	0.00	0.04	0.00	0.00	0.00
• Registration fee for different activities	0.00	6.74	8.27	5.39	3.32	2.37
• Driver's license permit fee	0.00	0.00	0.00	0.28	0.07	0.03
• Infrastructure impact tax for new construction*	0.00	2.63	14.17	10.37	19.10	0.02
• Other Fees	10.89	18.21	21.03	28.55	23.96	13.77
Non-tax revenues	**50.35**	**55.48**	**37.23**	**23.41**	**27.61**	**11.01**
Shared Taxes, of which	**38.76**	**8.10**	**9.38**	**11.86**	**9.97**	**23.25**
• Property Tax	0.09	7.79	7.90	11.18	8.88	0.00
• Simplified Profit Tax	0.00	0.00	0.00	0.00	0.00	16.96
• Vehicle Registration Tax	0.55	0.31	1.49	0.66	0.58	5.00
• Other taxes**	38.12	0.00	0.00	0.02	0.51	1.29

Notes: * In 2003, changed into a local tax.
** Prior to 2003, includes all local taxes assigned to the local governments without taxing powers.

Source: Treasury Department of the MoF of Albania.

package is evident. Revenues from taxes and fees have increased, and within them the small business tax and the infrastructure impact tax together yielded about 50 percent of total own-source revenues.

Analysis of the trends of the general groups and items of local revenues (Table 5.), shows the transition from a centralized system to a more decentralized system. High increases in the property tax, infrastructure impact tax, vehicle registration tax, and other local taxes show that their base in the preceding years has been very small. At the same time, they show that there is a trend of rapid growth for total own source revenues, which is the result of the potential created by decentralization. Considering that inflation in these years varies by two to four percent, it can be said that revenues have been increased also in real terms.

Analysis of local revenues on a per capita basis shows best the capacities created by decentralization and their use by each local government unit. The analysis is focused on 2003, the year after the passage of the new revenue package. Table 6. shows the average (mean) and median per capita revenues for major local tax and non-tax revenues for all local governments and their different groups. The data show that, on average, each local government received ALL 211 from each resident from the SPT (Simplified Profit Tax) in 2003, but one-half of the local governments received less than ALL 84 per person from that levy (the median value). The data show that median values are zero for the agriculture land tax, new construction impact tax, and property transfer tax, which means that one-half of local governments are not collecting revenues from these sources. For the new construction impact tax and property transfer tax, this is explained by the lack of new constructions and locally taxed property transactions, while the agricultural tax has been neglected by local governments. There are also pending issues related to the land ownership, but in most cases this is because of poor efforts made by local governments.

Since the tax capacity is different among municipalities and rural communes, comparisons of the per capita taxes are made also for each group. Total per capita

Table 5.
Trends of General Groups and Items of Locally Generated Revenues, 1998–2003, in Percent to the Previous Year

	1999/1998	2000/1999	2001/2000	2002/2001	2003/2002
Locally Generated Revenues Total, of which	**207.15**	**103.31**	**124.21**	**131.67**	**241.11**
Local Taxes Total, of which	0.00	97.24	149.43	96.28	**3,369.82**
• Property tax	0.00	0.00	0.00	0.00	213.93
• Infrastructure impact tax for new construction	0.00	0.00	0.00	0.00	240.45
• Small business tax	0.00	0.00	0.00	0.00	0.00
• Other taxes on business activities	0.00	97.24	148.74	96.73	56.23
• All other local taxes	0.00	0.00	0.00	0.00	0.00
Local Fees Total, of which	**623.03**	**157.55**	**150.68**	**129.06**	**94.26**
• Cleaning and solid waste disposal fee	0.00	128.47	308.93	106.49	130.91
• Civil registry fee	0.00	0.00	0.00	0.00	0.00
• Registration fee for different activities	0.00	126.89	80.87	81.05	172.66
• Driver's license permit fee	0.00	0.00	0.00	34.24	100.39
• Infrastructure impact tax for new construction	0.00	557.46	90.91	242.47	0.21
• Other Fees	346.57	119.27	168.68	110.50	138.60
Non-tax revenues	**228.27**	**69.31**	**78.10**	**155.33**	**96.18**
Shared Taxes, of which	**43.29**	**119.68**	**157.00**	**110.71**	**562.14**
• Property Tax	17,054.54	104.72	175.86	104.54	0.00
• Simplified Profit Tax	0.00	0.00	0.00	0.00	0.00
• Vehicle Registration Tax	116.51	498.56	54.77	117.20	2,065.82
• Other taxes	0.00	0.00	0.00	2,886.12	609.62

Source: Treasury Department of the MoF of Albania.

Table 6.

Mean and Median Per Capita Own Source Revenues of Municipalities and Communes, 2003, ALL Per Capita

	SPT	SBT	Sm Bus Taxes	Buildings	ALT	Vehicles	Cons-truction	Tran Tax	Other Taxes	Total Taxes	Fees & Non-Tax	Own Source	Uncon-ditional Transfer	Local Revenues
All Municipalities and Communes														
• Mean	211	157	367	71	63	69	121	5	58	755	514	1,268	2,064	3,332
• Median	84	86	165	26	—	47	—	—	13	409	145	584	1,689	2,539
Municipalities Only														
• Mean	699	488	1,187	167	17	162	316	19	103	1,970	1,296	3,266	2,005	5,272
• Median	617	415	1,043	138	—	160	73	—	45	1,410	963	2,643	1,753	4,794
Municipalities w/o Tirana														
• Mean	680	473	1,153	157	17	159	279	16	97	1,878	1,289	3,167	2,021	5,188
• Median	611	413	1,035	136	—	158	63	—	44	1,393	947	2,597	1,754	4,775
• Tirana Municipality														
	1,893	1,410	3,304	176	—	358	2,612	267	447	7,763	1,767	9,530	1,031	10,561
Communes Only														
• Mean	110	89	198	51	73	50	80	2	49	504	352	856	2,076	2,932
• Median	50	70	122	16	—	39	—	—	7	293	110	438	1,654	2,288

Notes: SPT: Simplified Profit Tax
SBT: Small Business Tax
SB Taxes: Small Business Taxes (SPT+SBT)
ALT: Agricultural Land Tax

Source: Schroeder (2004).

local tax revenues are nearly four times greater for the municipalities than for the communes. This is explained mostly by the location of businesses in more urbanized areas but also with differences in their management capacities. An illustration of obvious differences in the tax capacity is Tirana. The capital city has substantially greater per capita revenues for all taxes, even when the building tax for residents is uncollected. On the other hand, building activity occurring in Tirana provides the city with substantial revenues from the Infrastructure Impact Tax.

Analysis of the tax compliance for each local government shows that many local governments are not collecting revenues from some taxes under their authority or the same tax has a different compliance among cities. Thus, the data showing the actual per capita tax revenues understate the revenue potential from these local taxes. The average, calculated after the number of cities with a value of zero for 2003 collections has been excluded, is higher than that calculated including all local governments (Table 7.).

Other aspects of the analysis here show that there still may be problems associated with the collections of some of these local tax revenues. Management problems exist for both local governments and central government agencies, being in charge of local tax collection. Still there are cities that do not collect the residential building tax or they have a low compliance rate. The data show that two municipalities have no collections from building tax, which means that they are not collecting the property tax, even from businesses. Other indicators, such as zero collections for some taxes collected by central government agencies, show that there are the problems related to accounting and cooperation between these agencies and local governments. One illustration of these problems is the SBT (Small Business Tax) and SPT (Simplified Profit Tax) for some communes, which are obtaining revenues from the flat-rate portion of the SBT but no positive revenues from the SPT.

Analysis of Expenditures

The transfer of functional responsibilities and revenue powers to local governments have made an impact on the Albanian economy. Table 8 shows the role of local government activity measured in relation to the public sector and the gross domestic product (GDP). The share of the general budget including local government to the GDP is decreased, which shows the decrease of the relative importance of the government in the economy. The share of the local government expenditures to the GDP is almost the same as a result of decentralization reform. While still not large relative to the overall economy, the new fiscal decentralization policies have raised autonomous local government activity from only about 0.3 percent of GDP in 2000 to nearly two percent in 2003.

The government plans a further increase of local government's role in the economy. Thus, in 2006, the increase of the unconditional transfer was four percent higher then the average increase of expenditures in the central budget compared to 2005. In addition, local investment programs formerly under line-ministries' budgets were appropriated as an investment grant and

Table 7.
Mean per Capita Tax Revenues of Municipalities and Communes, 2003, in ALL

	SPT	SBT	Total SB Taxes	Build-ings	ALT	Vehicles	New Const-ruction	Prop Tran Tax
	ALL per capita for local governments with non-zero tax revenues							
All Local Governments	386	234	165	102	193	85	187	42
• No. with zero revenues	38	19	18	113	251	68	133	330
Municipalities	699	488	1,187	172	78	192	374	59
• No. with zero revenues	0	0	0	2	50	10	10	43
Communes	211	125	94	80	207	62	133	26
• No. with zero revenues	38	19	18	111	201	58	123	287

Notes: SPT: Simplified Profit Tax.
SBT: Small Business Tax.
SB Taxes: Small Business Taxes (SPT+SBT).
ALT: Agricultural Land Tax.

Sources: Ministry of Finance and Local Government Assistance and Decentralization in Albania Project.

Table 8.
Local Government Expenditures and their Role in the Macro-economy, in ALL Million

Indicators	1998	1999	2000	2001	2002	2003	2004*
Gross Domestic Product (GDP)	425,356	488,611	551,282	611,622	677,272	744,974	835,448
State Budget Expenditures	141,628	165,692	170,620	186,049	192,517	201,152	240,360
State Budget to GDP (in percent)	33.30	33.91	30.95	30.42	28.43	27.00	28.77
Local Expenditures	15,729	23,674	20,307	24,906	26,611	29,983	32,920
Conditional Transfers**	14,802	20,949	18,437	17,464	14,426	15,748	15,343
Unconditional Transfers	0	0	0	5,659	9,276	6,554	6,277
Own Local Expenditures	927	2,725	1,870	1,783	2,909	7,681	11,300
Local Expenditure to State Budget (in percent)	11.11	14.29	11.90	13.39	13.82	14.91	13.70
Local Expenditure to GDP (in percent)	3.70	4.85	3.68	4.07	3.93	4.02	3.94
Own Local Expenditure to Local Expenditure (in percent)	5.89	11.51	9.21	7.16	10.93	25.62	34.33
Own Local+Unconditional Transfers to Local Expenditure (in percent)	5.89	11.51	9.21	29.88	45.79	47.48	53.39
Own Local+Unconditional Transfers to GDP (in percent)	0.22	0.56	0.34	1.22	1.80	1.91	2.10
Own Local+Unconditional Transfers to State Budget (in percent)	0.65	1.64	1.10	4.00	6.33	7.08	7.31

Notes: * Budget estimates and assessments based on first nine months of 2004.
** Excluding Salaries and Social Security Contributions for Education and Health due to the agent role of LGs.

Source: Treasury Department of the MoF of Albania.

allocated by formula. The latter is 2.6 times higher compared to investments allocated from central government ministries to the local governments in 2005. According to the Medium-term Budget Program 2007–2009, the transfer from central government to local governments shall be increased by 25 percent each year.

The behavior of local governments, as a result of their increased autonomy, is shown in the functional allocation (Table 9.) of local government spending funded from the unconditional transfers and own source revenues. Functional allocation of all funds including conditional transfer made to the local governments shows a large share of funds for which decisions are not made by local governments. Included here are operating expenditures for delegated education, health, and social welfare responsibilities, which represent more than 50 percent of total local government spending.

After 1998, there was a relative increase of the funds flowing through local governments and spent on capital infrastructure. This indicates the larger role that local governments began to play in local public service provision. Particularly important is the spending of the largest share for public works both from own local and national sources. Investment spending increased more after the introduction of the unconditional transfer. Even if shown as an increase under the general administration, in fact, it represents investments made for urban infrastructure. This is related to the accounting system that is focused on administrative responsibility instead of functional allocation.

The data show a decrease in share of the maintenance spending for education. This is explained by other funding provided by the central government for teaching materials, but it is also an illustration of the local governments' major need for public works.

The data for analysis are provided by the treasury system, which is a central government unit in charge of budget execution and reporting both for central and local governments. This may also reflect some errors in the functional allocation of local spending because this agency is more concerned about controlling local spending in terms of fund availability rather than their functional allocation. Accurate recording and publication of revenues and expenditures for each local government can contribute to improving financial management practices.

Table 9.
Functional Allocation of Local Expenditure, in Percent to Totals

Functions	Discretionary Share		All Local Expenditures					
	2002	2003	1998	1999	2000	2001	2002	2003
Operating Expenditures								
General Administration	42.10	40.00	14.12	11.38	17.28	17.79	15.21	17.74
Education	13.00	8.60	7.86	7.57	7.26	7.78	7.82	6.15
Culture and sports	6.70	5.40	3.60	2.73	3.22	2.25	2.78	2.44
Health	3.70	3.30	3.74	2.87	3.30	2.32	1.56	1.59
Social Assistance	1.10	0.00	39.44	27.76	32.58	27.87	28.56	25.90
Parks and cemeteries	0.20	0.00	0.00	0.00	0.00	0.00	0.06	0.00
Cleaning and solid waste	1.60	12.90	0.00	0.00	0.00	0.00	0.59	5.74
Public works	24.90	29.30	11.36	7.95	10.48	9.15	13.03	13.10
Public transport	5.10	0.00	0.74	1.24	0.41	0.33	1.81	0.00
Civil registry	0.00	0.00	0.67	0.51	0.74	0.63	0.55	0.49
All other expenditures	1.60	0.50	3.43	11.36	1.31	0.93	1.89	1.68
Total Operating	100.00	100.00	84.97	73.35	76.59	69.05	73.85	74.81
Capital Expenditures								
General Administration	48.40	48.10	1.09	1.23	2.38	3.11	3.56	5.26
Education	1.30	1.50	6.09	8.24	5.44	5.73	4.01	3.93
Culture and sports	1.50	1.30	0.65	0.49	0.44	0.61	0.94	0.72
Health	0.40	0.60	0.22	1.29	1.02	0.22	0.64	1.24
Social Assistance	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Parks and cemeteries	0.10	0.00	0.00	0.00	0.00	0.00	0.01	0.00
Cleaning and solid waste	8.10	16.60	0.00	0.00	0.00	0.00	1.22	1.76
Public works	5.50	18.50	3.45	1.56	6.04	13.46	9.33	10.85
Public transport	3.70	0.00	0.00	0.00	0.00	0.00	0.56	0.00
Civil registry	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
All other expenditures	31.00	13.40	3.53	13.84	8.11	7.82	5.88	1.43
Total Capital	100.00	100.00	15.03	26.65	23.41	30.95	26.15	25.19

Intergovernmental Transfers

Analysis of local revenues showed that intergovernmental transfers are of great importance to fund adequately municipalities and communes in exercising their service responsibilities. The intergovernmental transfer system in Albania is comprised of the unconditional (general) transfer and the conditional (earmarked) transfer. The first one is determined in the budget process and allocated by a formula, while the second is appropriated to the budget of central government ministries and then allocated by their decision to local government units. The following sections provide an analysis of the transfer system regarding its adequacy to meet the costs of local services; elasticity to respond to the increased demand and cost of public services; as well as its certainty, predictability, equity, transparency, and simplicity.

The Current Transfers System and Vertical Equity

The total pool of both conditional and unconditional transfers is defined in the budget process based on different mechanisms. However, they are interrelated and influence one another. The introduction of the general transfer in 2001 has decreased the size of the conditional transfer both in actual and relative terms. On the other side, the 2003 local revenue package reduced the size of the unconditional transfer pool equal to the assessment made for additional local revenues to be yielded from central government tax revenues transferred to local governments (Table 8.).

It also should be noted that, in turn, the conditional transfer was decreased (Table 3.), which means that the flow of funds from central government to the local governments has been slightly increased (3.5 percent). During the past four years, the transfer system has provided the greater part of all resources available to the local governments. The data show that transfers have dominated the local financing sources, which means that they represent the most important determinant of vertical equity. The transfers system can be considered vertically "equitable" when, in combination with own local revenues, it provides adequate funding for covering the costs of services assigned to local governments or provided by them on behalf of the central government.

The pool of the general transfer was determined based on the historic cost of the services transferred, delegated, or mandated to local governments, which does not reflect a cost based on standards or levels of services. In addition, this cost was adjusted for minor own sources available to local governments at that time. The law also provides the same responsibilities for municipalities and communes, while the latter did not provide urban infrastructure and public work services when the transfer system was introduced. All of these question horizontal equalization; however, a reasonable answer can be given only after considering the impact of the revenue transfer to the local service cost funding. In 2003, a list of central government taxes was shifted to the local governments and new local taxes were established. The fiscal package also provided unlimited authority to local governments to impose fees and charges for local services. Among the local taxes, three of them—respectively, the small business tax, simplified profit tax, and vehicle registration tax—were assessed for purposes of the unconditional transfer adjustment, meaning that the package provided new additional sources to the local governments.

Analysis of local revenues shows that aggregate local government resources during these years of reform have been stable. The increase of the size of the local government sector relative to GDP also shows that vertically the transfer system is relatively equitable.

Conditional (Earmarked) Transfers

Spending for all delegated and transferred services is funded through the conditional transfer system. Formally, the transfers are recorded and reported as part of the local government budget, whereas local governments have no discretion at all regarding their use. The total pool of these conditional transfers is determined as a part of the annual budget process of the central government. The amount to be transferred depends on the historic costs of the services and increments made for inflation or changes in the priorities of the central government and the macro-economic and fiscal situation. The conditional transfer for local governments is not shown as a separate component in the state budget. The appropriation is made by functions under the budget of the line-ministries for each function they are responsible for providing. The amount of unspent conditional transfers at the end of the year elapses.

The process of the conditional transfer distribution across different municipalities and communes depends on the purpose of its use. The annual budget law appropriates the line-item budget for each functional responsibility of the ministry and expenditure items under the function. For operating conditional transfer, the Ministry of Finance allocates the budget total to the respective line-ministries, and then the latter apportion the allocated amount for delegated responsibilities to each local government. Recipient local governments are authorized to spend within the limit allocated for each item. Thus, the ministry decides the spending total for the delegated functions and also specifies the purpose for which it can be spent. Local governments have no autonomy regarding the combination of inputs to be used on the delegated services.

The allocation of the conditional transfer appropriated for capital investments across localities is also the decision of the responsible ministry. Formally, local governments submit their investment budget requests to line-ministries, and the latter make the decision about how the projects are to be financed. The process is far from transparent because it does not follow any rule or predefined criteria for investment allocation. Experience shows that the allocation of investment funding relies upon the personal judgment of central government officials or the influence of the mayors, members of Parliament, and community leaders.

Analysis of the aggregate data (Table 10) shows that the total and per capita flows of the conditional transfer did not grow substantially through the period. The conditional transfer for own functions is decreased as a result of the functions shifted exclusively to local governments. However, the aggregates as well as the per capita amounts of the conditional transfer are considerably greater then those for own source revenues. The education service has the largest share in

Table 10.
Allocation of Conditional Transfers across Sectors

Conditional Transfers (ALL thousands)	2000	2001	2002	2003
Social benefits and assistance	6,841,776	7,071,296	7,707,969	7,824,297
Education*	12,068,218	11,719,572	12,870,703	13,561,527
Health	2,750,245	1,853,028	2,035,273	2,130,827
All other operating grants	5,726,417	3,329,847	1,721,999	2,979,537
Capital investments	3,985,809	6,799,791	4,099,508	4,201,433
Total	**31,372,466**	**30,773,534**	**28,435,452**	**30,697,621**
Conditional Transfers (ALL per Capita)	**2000**	**2001**	**2002**	**2003**
Social benefits and assistance	22,162	22,905	24,967	25,344
Education	39,091	37,962	41,691	43,928
Health	8,908	6,002	6,592	6,902
All other operating grants	18,549	10,786	5,577	9,651
Capital investments	12,910	22,026	13,279	13,609
Total	**101,622**	**99,682**	**92,108**	**99,436**

Note: * Including salaries for education and health.
Source: Ministry of Finance and Local Government Assistance and Decentralization in Albania Project.

the flow of conditional transfers (salaries for education and health are included there), followed by the social welfare sector. It also should be noted that investment spending is less than fifteen percent of the total, except in 2001.

Functional allocation of the conditional transfers shows that their main components are pre-university education, health, and social welfare. The law defines them as shared responsibilities and their expected sharing will imply the conditional transfer. The implementation of the sharing scheme is more important for pre-university education and health, which bring benefits primarily to the local community, and then for the country as a whole. Social welfare involves large income redistribution, which is not the case for own local responsibilities. However, some responsibilities of this function can be shared with local governments for the sole purpose of the efficiency and effectiveness of social welfare spending.

Unconditional (General) Transfers

As provided by the law, in 2002, the unconditional transfer was distributed based on a formula, and the amount to be allocated to each recipient local government was appropriated by the annual budget law. The law provided full discretion to the local governments for spending the unconditional transfers according to their own priorities, both for current operating expenditures and capital investments. In the first year of its introduction the principal objective was balancing expenditures and revenues. Other adjustments made during the first years of its implementation have intended to avoid any opposing effect of the fiscal decentralization program to the aggregate state budget. The rationale in favor of this approach is the stabilization of the macro-fiscal situation.

Major adjustment of the unconditional transfer pool total was made in 2003 when the local revenue package was adopted. The latter increased substantially the shared and own local taxes and fees of local governments. As a result, the unconditional transfer pool was decreased for the amount assessed to reduce central government revenues and increase local revenues. In 2004 and 2005, there was a moderate increase of the unconditional transfer pool, while in 2006 the increase has been higher; in addition, the investment transfer for local roads previously distributed by the central government was included in the unconditional transfer pool.

The general pool of the unconditional transfer is determined to provide funding for two levels of local government. The allocation of the pool follows a multi-step process, shown in Table 11. The general transfer pool, as determined by the central government in the budget process, is first divided into the following sub-pools respectively for:

a) Municipalities and communes,
b) Regions, and
c) Compensation fund.

Table 11.
Formulae Used to Distribute the Unconditional Transfer, 2002–2004, in Percent

Distribution of Total Pool	2002	2003	2004
Regions	10	19	15
Municipalities/Communes	86	79	83
Compensation Fund	4	2	2
Distribution of Municipal and Commune Share			
By Formula	95	88	94
Compensation Fund	5	12	6
Municipal and Commune Formula			
Equal Shares	3.5	3.5	4
Population	62.5	62.5	62.5
Area of Communes	4	4	9
Municipalities other than Tirana	20.5	20.5	18
Tirana Share	9.5	9.5	6.5
Tax Capacity Adjustment (see below)	No	Yes	Yes
Further adjustments	Yes	Yes	Yes
Distribution of Regional Share			
By Formula	100	85	97
Regional Compensation Fund	—	15	3
Regional Formula			
Equal Shares	30	25	25
Population	15	15	15
Geographic indicator	30	30	30
Area of Region/Length of Roads	25	30	30

The share to municipalities and communes is then divided into two sub-pools that are allocated: (i) according to a specific formula and (ii) as a compensation fund for municipalities and communes.

Formula-based Allocation of Funds

The sub-pool to be distributed to municipalities and communes by the formulae is allocated across the following factors:

1) An *equal share* for all communes and municipalities,
2) A share distributed based on the relative *population size* of the jurisdiction,
3) A share for communes distributed on the basis of the approximate relative *surface area* of each commune,
4) A *share for municipalities* other than Tirana distributed on the basis of relative population of those municipalities, and
5) An exclusive share for *Tirana* (the capital).

The share of the sub-pool for regions is also divided into two sub-pools that are allocated: (i) according to a specific formula and (ii) as a compensation fund for regions.

The sub-pool, distributed to regions by formula, is allocated across them and based on the following factors:

1) An *equal share* for all regions,
2) A share distributed according to the relative *population size* of the region,
3) A share distributed according to a relative score indicating *natural economic advantages* of different regions, and
4) A share distributed based on the length of *rural roads* in a region.

The investment pool introduced in 2006 was allocated to municipalities and communes only. Distribution criteria were almost the same as those used for the other transfer, except an adjustment was made for the inequality in investment distribution during the last four years.

To define the above factors, formula developers in Albania have taken into consideration the objectives of the formula and the availability of data at the local level. They are faced with different constraints in this process, and through a series of simulations have concluded to use the above factors, which can be measured at the local level and better meet the objectives of the formula. The size of population is a commonly used factor and the data are available for each jurisdiction since the 2001 census. The surface area of each commune is currently unavailable and a substitute measurement is based on the documented surface area of the former districts. The district surface area, excluding the areas of any municipality in the said district, is divided by the number of communes in the district, and the result is used as the approximate surface area for each commune in the district.

In 2002, the regional allocation formula used surface area of the communes as the fourth factor. The organic law defines the functions of regions in general terms, including the intergovernmental road network. Rural roads have been viewed as their priority and the surface area factor was replaced by the length of roads in the region. Also, the regional allocation formula attempts to differentiate between the natural comparative economic advantage of each region with a proxy variable constructed for this purpose. Each region is assigned an indicator of natural economic advantages; the indicators take on values one, three, or five, with one indicating a relatively high level of economic advantage and five suggesting a relatively low comparative advantage. These index numbers are totaled and a region's relative share is constructed as its indicator relative to the sum of all regional indicators. In this way, those regions with good economic advantages (scored one) receive a smaller share of this component of the formula than a disadvantaged region that scored five.

A major objective of the unconditional transfer is horizontal equalization. One of the most important adjustments is the equalization of fiscal capacity. Since the measurement of true fiscal capacity in a country like Albania is difficult, the adjustment for this component is done based on the estimated and actual collections from local taxes. Table 12 summarizes the adjustment process and additional explanations are given in the following paragraphs.

In Albania's case, the list of taxes for measuring tax capacities of local governments includes the small business tax (SBT), simplified profits tax (SPT), vehicle registration tax, and the tax on transactions of immovable property. The rationale for their inclusion is that the transfer of these taxes from central government to local governments creates vertical and horizontal inequities. Vertical inequity is related to the additional sources provided to local governments, while no additional responsibilities were transferred to them. To adjust for vertical equalization, the general transfer pool was decreased for the additional revenues assessed, to be generated from the transferred taxes. Horizontal inequity is related to the large differences in the basis of these taxes among localities. To adjust for horizontal equalization, the original allocation by formula should be redistributed, based on tax capacity.

The adjustment for horizontal equalization leads to the second issue: how are the indicators determined for measuring differences of the tax capacity across local government units? The indicator selected for this purpose was the difference in the per capita collections from the above-mentioned taxes. The adjustment is based on the comparison of the per capita tax collection in each municipality and commune from the above four local taxes with the average per capita tax collection for the country as a whole.[1] If the difference is positive, 35 percent of that difference multiplied by the population of the locality is subtracted from original allocation of the unconditional transfer; if the difference is negative, 35 percent of the difference is added to the original allocation.

The quality of data used for calculating the per capita collection is another issue. In 2003, the above-listed taxes were shifted from the central government to local governments, and no data about collection of these four taxes were available. As a result, tax capacity for these four taxes was measured based on an estimate made by the Ministry of Local Government and Decentralization (MLGD), in cooperation with the Tax Department of the Ministry of Finance. Such forecasts are obviously subject to error.

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[1] The national per capita amount is computed simply as the projected total yield from these four taxes divided by the national population. Also, for 2004 the tax on property transactions was removed from the computation of tax capacity due to apparent difficulties associated with the collection of this levy.

Table 12.
Adjustments Made to the Unconditional Transfer Allocation Formula

<table>
<tr><th colspan="2">Fiscal Equalization Adjustment, 2003 and 2004</th></tr>
<tr><td colspan="2">$(PCTax_i – PCTax_A)$ x $(\pm 0.35^* Population_i)$
$PCTax_i$: Estimated per capita collections of SBT, SPT, vehicle tax, and property transactions tax in locality i
$PCTax_A$: Average per capita amount of the above taxes for the country
If $(PCTax_i – PCTax_A)$ is > 0 [above average local taxes], –0.35 is used to create a negative product
If $(PCTax_i – PCTax_A)$ < 0, +0.35 is used to create a positive product</td></tr>
<tr><th colspan="2">Transition Adjustments</th></tr>
<tr><td colspan="2">2002: $(UT'_{2002, i} – CT_{2001, i}) = D_i$. If $D_i > 0$, reduce UT'_i by 0.50 x D_i; If $D_i < 0$, increase UT'_i by 0.50 x D_i where $UT'_{2002, i}$ is amount of unconditional transfer computed for jurisdiction i for 2002 using basic formula and $CT_{200}1$, i is the amount of conditional transfer received in 2001 in jurisdiction i for services now responsibility of local government.</td></tr>
<tr><td colspan="2">2003: $\{(LTR_i'+UT_i')_{2003} – (LTR_i + UT_i)_{2002}\}^*$ 0.75 if bracketed difference is negative;
$\{(LTR_i'+UT_i')_{2003} – (LTR_i + UT_i)_{2002}\}^*$ – 0.25 if bracketed difference is negative.
Where: LTR_i' is the expected sum of local tax revenues (including new local taxes) for 2003;
UT_i' is amount of unconditional transfer for 2003 computed under basic formula;
LTR_i is the actual sum of local tax revenues collected in jurisdiction i in 2002;
UT_i is amount of unconditional transfer derived by jurisdiction i in 2002.</td></tr>
<tr><td colspan="2">2004: Same as 2003 except that coefficient 0.75 changed to 1.00 if the bracketed difference is negative;
coefficient –0.25 remains the same if bracketed difference is positive.</td></tr>
<tr><th colspan="2">Further Adjustments</th></tr>
<tr><th>2003</th><th>2004</th></tr>
<tr><td>ALL 600,000 per commune or municipality in mountain area or commune with urban center, regardless of above.</td><td>80 poorest communes (centrally determined) receive additional allocation; total amount allocated under this provision is ALL 50.9 million; allocated on the basis of relative population of the 80 communes.</td></tr>
<tr><td>All communes will receive a minimum of ALL 1,500 per person in population; all municipalities will receive a minimum of ALL 2,500 per person in population.</td><td>Minimum per capita amounts now ALL 1,750 in communes and ALL 2,750 in municipalities.</td></tr>
</table>

The adjustment for fiscal capacity aims to equalize revenue capacities across local governments. The transition from conditional transfers, directed by the central government, to formula-based unconditional transfers could change considerably the amount of transfers received by local governments. To reduce differences that might have been created as a result of the new transfer system, the transition adjustment was applied. In 2002, communes and municipalities, having received less under the formula than they had previously obtained for those functions transferred to them, would receive compensation by one-half of that difference. This means that they would be "penalized" by only one-half of the transfer amount reduced as a result of the allocation by formula. In the same way those local governments, which qualified for more funds under the formula than they received prior to its implementation, would receive only one-half of that difference in 2002.

In 2003, this transition adjustment was more complex and took into consideration the increased tax powers of local governments. The sum of revenues, assessed from the yield of local taxes used in the tax capacity adjustment plus the results from the formula (after adjustments for tax capacity), was compared with the total allocations in the previous year. If the difference was positive, the locality would receive only 75 percent of the difference, i.e., it would lose 25 percent of the additional funding from taxes and transfer formula. However, if the difference was negative, the locality would receive 75 percent of the difference as an addition to the unconditional transfer.

The transition adjustment in 2004 was made with the same ratio (–25 percent) for local governments receiving more under the formula (adjusted for tax capacity) plus projected local taxes than they had obtained previously, and any negative difference would be compensated fully by the adjustment. The latter made the new intergovernmental transfer system risk-free for localities receiving less because of the system.

When the transition adjustment was introduced, Pigey and Hoxha (2000: 6) recommended only a two-year transition period. The effects of the transition adjustment have declined over the years, as would be expected. For 2004, the net fiscal effect of this adjustment was approximately ALL 121 million (with ALL 248 million received by local governments that would lose funds under the formula and ALL 127 million "contributed" by those who would gain from it). Since the total program size is approximately ALL 5.1 billion, the transition adjustment is relatively small. It seems quite feasible that the adjustments can be phased out for 2005 (although there will probably always be pressures to insert risk-free provisions in the system).

In principle, the determination of the general transfer pool considers the spending needs of local governments. Variables of the formulae also tend to equalize differences in the spending needs, i.e., different variables for municipalities and communes, higher share for public infrastructure in urbanized areas, and a special share for Tirana. However, it was acknowledged that certain local governments have special spending needs and some minor additional adjustments have also been made to the result of the formula. In 2003, each commune and municipality located in a *mountain area* was provided with an additional ALL 600,000 to compensate for higher costs of public services, and communes with urban centers were also provided with an additional ALL 600,000.

The higher weight given to the population component in the formula resulted in very low per capita allocations for low population communes. This result is compensated in some way by the factor of equal allocation for all municipalities and communes, but the latter should be assured that they will receive a minimum per capita allotment under the allocation scheme. Therefore, to equalize the flow of revenues, each commune was guaranteed at least ALL 1,500 per resident for 2003 and each municipality was guaranteed at least ALL 2,500; in 2004, the per capita minimums were raised to ALL 1,750 and 2,750, respectively.

Compensation Funds

One additional feature of the unconditional transfer program is the presence of the three "compensation funds"—the general compensation fund, the communes and municipalities' compensation fund and the regions' compensation fund. These funds are distributed by the MLGD on a case-by-case basis. The assumption used for instituting compensation funds was that unforeseen events may arise during the implementation process of the formulae. Some general criteria for their allocation were defined but, in fact, their allocation relied upon the MLGD decision.

All of the provisions discussed above are determined as a part of the state budget as passed by the Parliament and made public. This is not a common practice in many countries it though reduces the certainty of discretionary local revenues. The latter is protected by the Medium-Term Budget Programme (MTBP) which also includes intergovernmental fiscal relations. This is illustrated by the stability and year-by-year increase of the own local financial sources. At the same time, the distribution made by the annual budget law allows formula corrections identified during the fist year of the unconditional transfers system implementation. However, legislation permanently regulating the unconditional transfer system should be considered in the near future.

Analysis of the Unconditional Transfers Implementation Results

Implementation of the unconditional transfer system has increased the autonomy of local governments. The overall conclusion is that the system is appropriate and working well; determination and distribution of a transfer are made in the budget process. It means that, potentially, there still may be uncertainty regarding the total amounts to be made available to local governments in Albania.

The indicators of the equalization objective are the amount of the transfer per capita and the differences in per capita amounts among localities. Table 13 provides the dispersion of the transfer per capita for all local governments and separated for municipalities and communes. In 2000, the local governments were financed primarily through a block allocation to be spent for specific purposes approved in the annual budget law. That year, 141 of the localities received less than ALL 1,000 per person, while nine received more than ALL 5,000 per capita. The dispersion was even greater in 2001, although the number of jurisdictions receiving less than ALL 1,000 per person that year fell to only 62; on the other hand, three local governments received more than ALL 9,000.

In 2002, the first year the unconditional transfer formula was used, the dispersion of the transfers was decreased greatly; no commune received less than ALL 1,500 per capita that year and the largest per capita allocation was less than ALL 5,000. In 2003, the

Table 13.
Size Distribution of Unconditional Transfers Per Capita, 2000–2004

Years	Number of local governments in each size group										
	ALL Per Capita Unconditional Transfers										
	<1,000	1,000–1,500	1,500–2,000	2,000–2,500	2,500–3,000	3,000–3,500	3,500–4,000	4,000–5,000	5,000–7,000	7,000–9,000	>9,000
All LGs											
2000	141	88	41	41	28	6	10	10	9	0	0
2001	62	88	63	32	42	23	19	24	12	6	3
2002	0	0	177	87	37	61	3	9	0	0	0
2003	0	0	157	65	38	42	32	25	11	4	0
2004	0	0	141	72	47	36	32	29	12	5	0
Municipalities											
2002	0	0	0	0	9	55	1	0	0	0	0
2003	0	0	0	0	14	18	14	15	4	0	0
2004	0	0	0	0	12	13	15	21	4	0	0
Communes											
2002	0	0	177	87	28	6	2	9	0	0	0
2003	0	0	157	65	24	24	18	10	7	4	0
2004	0	0	141	72	35	23	17	8	8	5	0

Source: Local Government Assistance and Decentralization in Albania Project.

dispersion of the per capita allocations increased slightly in comparison with 2002; however, the lower bounds of the allocations remained in the ALL 1,500–2,000 per person category. Nineteen municipalities received more than ALL 4,000 per capita as did 21 communes. For 2004, there has been a slight equalization in the per capita unconditional transfers to municipalities relative to 2003, while the distribution of allocations to communes remained stable.

The dispersion in unconditional transfers is also measured based on the standard deviation of per capita allocations. To make the standard deviations comparable, the coefficient of variation (the ratio of the standard deviation to the average allocation, expressed as a percentage) is calculated for 2003 and 2004. For these years, Table 14 shows various summary measurements of the distribution of unconditional transfers across the municipalities and communes of Albania.

In the first part of the table, column one (1) shows the results of the formula before any adjustments are made; it would have resulted in a range of per capita allocations from ALL 927 to 2,737 per capita in 2003, and an even greater range in 2004. In column two (2) similar summary statistics are shown for the estimated own local taxes and fees, and their dispersion is even greater due to differences in the local governments tax capacity. Column three (3) shows the effects of fiscal capacity adjustments to the basic formula results, where the differences between the minimum and maximum transfers per capita are increased relative to the basic formula but the coefficients of variation in each year were smaller. Statistics for revenues after the fiscal capacity adjustment (column four [4]) show its impact in decreasing the dispersion of total available resources for local governments. The final adjustments (columns five [5] and six [6]) have increased the dispersion of per capita revenues, and it can be explained by the indicators used, which are unrelated to specific policies instead of fiscal capacity or other basic indicators.

Objectives and Criteria Fulfilled by the Unconditional Transfer Formula

Factors of the formula are determined in the budget process and then are adopted as a special provision in the budget law. Initially, the criteria were discussed among specialists and other stakeholders. The latter have a good understanding of the formula factors and the annual budget law makes the criteria known for everybody. Thus, it can be concluded that each local government receives a transfer allocated on publicly known criteria,

Table 14.

Summary Measures of the Aggregate Unconditional Transfers before and after Adjustments to the Allocation Formula (All LGs and by Quartiles) (In ALL Per Capita)

Measures for All Local Governments	Basic Formula Results (1)		Estimated Local taxes (2)		Transfer After Fiscal Capacity Adjustment (3)		Total Estimated Revenue After Fiscal Capacity Adjustment (4)		Transfer After Final Adjustment (5)		Total Estimated Revenue After Final Adjustment (6)	
	2003	**2004**	**2003**	**2004**	**2003**	**2004**	**2003**	**2004**	**2003**	**2004**	**2003**	**2004**
Mean	1,291	1,777	580	519	1,545	2,037	2,126	2,556	2,059	2,209	2,639	2,728
Median	1,151	1,505	307	248	1,483	1,794	1,839	2,213	1,711	1,907	2,248	2,294
Minimum	927	1,036	155	—	700	510	1,550	1,580	165	520	1,501	1,751
Maximum	2,737	6,405	4,122	3,754	3,127	6,821	4,823	6,896	7,522	7,522	7,869	8,212
Std. Dev.	343	805	663	688	305	820	670	955	1,091	1,053	1,204	1,182
CV	26.60%	45.30%	114.30%	132.60%	19.70%	40.20%	31.50%	37.40%	53.00%	47.70%	45.60%	43.30%
Quartiles (25%	**Basic Formula Results (1)**		**Estimated Local Taxes (2)**		**Transfer After Fiscal Capacity Adjustment (3)**		**Transfer After Final Adjustments (4)**		**Total Estimated Revenue After Final Adjustment (5)**		**Would have been allocated without adjustments (6)**	
	2003	**2004**	**2003**	**2004**	**2003**	**2004**	**2003**	**2004**	**2003**	**2004**	**2003**	**2004**
Average												
Richest	1,588	1,921	1,501	1,478	1,520	1,842	1,946	2,084	3,021	3,562	3,089	3,394
Less Rich	1,138	1,917	418	396	1,449	1,887	1,720	1,988	1,867	2,384	1,556	1,979
Less Poor	1,159	1,583	245	165	1,531	1,930	2,011	2,048	1,776	2,213	1,404	1,710
Poorest	1,280	2,055	164	48	1,679	2,481	2,553	2,705	1,844	2,753	1,444	2,104
Median												
Richest	1,713	1,519	1,254	1,204	1,531	1,554	1,718	1,811	3,013	3,533	3,016	3,491
Less Rich	1,032	1,159	391	392	1,345	1,487	1,318	1,488	1,770	1,876	1,423	1,630
Less Poor	1,071	1,326	245	162	1,446	1,723	1,612	1,671	1,695	1,848	1,316	1,511
Poorest	1,174	1,818	155	48	1,572	2,258	2,226	2,359	1,740	2,423	1,340	1,855

which make the unconditional transfer system *transparent.* However, local governments claim the process to be more participatory; they prefer the existing unconditional transfers much more to the previous system of conditional transfers decided by central ministries.

Another criteria met by the formula is *simplicity*. The allocation formula can be evaluated as reasonably *simple* if we refer to the shares and factors of the basic formulae. Even the adjustments made for fiscal capacity and the post-communist system's transition can be understood easily by those who are familiar with the local revenue system in Albania. The adjustments are expected to be even easier in the future when the tax capacity will be measured with reference to the true basis of taxes and the transition adjustment will be phased out.

The introduction of the unconditional transfer was made to provide discretionary funding sources available to local governments. Local governments have full discretion to use the unconditional transfer for the quantity, quality, cost, and mix of services that better match local needs and preferences. In this way, the transfer system meets satisfactorily the *autonomy* objective.

However, the determination of the transfer pool total may not provide *adequate funding*, though the process has been built to insure that the amounts available will allow local governments to meet their costs of service continuation. On the other hand, the determination of the initial transfer pool total, and the adjustments made later, do not support service improvement. This is evident in the overestimation of local taxes for some local governments in 2003, the use of the historic cost in determining spending needs, and the central government taking hold of investment responsibilities for own local functions. However, it would be recommended to consider the transfer of the investment responsibilities as an important issue, while the other negative impacts can be compensated somewhat with strengthening tax administration and other management capacities.

Since local governments now can make independent decisions related to the quantity, quality, cost, and mix of services that most closely match local needs and preferences, the unconditional transfer system leads to *effective use* of the funds. Recent experience in Albania shows that many local governments are committed to improve public services through citizens' feedback. Another indicator of their commitment is the use of own local funds for investments and delegated functions that are the responsibility of the central government. Increasing autonomy has made local governments more responsible and participatory due to the transparency of the allocations made to the locality, which in turn increases their awareness of the community about available funding sources and their involvement in making better spending decisions.

Despite uncertainties related to the adequacy, the government has applied the incremental approach in determining the unconditional transfer pool. The data show that the share of the local budget to the general budget is small but its relative share has been increasing. The unconditional transfer, in combination with own local sources, has been increasing and they are an important component of the MTBP. In addition, during the last four years of implementation, the unconditional transfer program has not applied cutbacks when the central government budget has been reviewed. All these aspects indicate that the financial flows from the central government to local governments have been reliable.

The transparency and simplicity of the formula make the allocation for the following year reasonably *predictable*. The only potential limit to this achievement is that the exact size of the transfer pool and the exact effect of the fiscal capacity adjustments are not known until the state budget becomes law. However, in July of the preceding budgetary year, the Ministry of Finance announces officially (through the budget circular) the target to increase the general transfer in the forthcoming budgetary year. The MTBP also shows the increase of local funds from the central government in the medium-term framework. This makes it possible for local governments to organize their independent budget processes and fiscal management systems. The predictability also can be improved by using the actual local tax collections in measuring the tax capacity of local governments. The previous years' collections are known with certainty and they can be used for estimates of the forthcoming fiscal year.

Fiscal management and the ability to provide services without major adjustment problems were also assisted by the inclusion of the transition adjustment. As recommended by experts, this adjustment should be dropped in the near future. This helps make the formula simple and should be considered according to progress made in the accuracy of the information used for the allocation factors of the formula.

One provision in the current system that can reduce the degree of predictability, transparency, and good fiscal management is the set of compensation funds. Their allocation is not transparent and any possible increase to their size would undermine the potential advantages of the system. The experience of the last four years shows that in some cases these funds have compensated fiscal underperformance of local governments. However, the data show that the 2004 allocations to the compensation funds are lower then those made in 2003; its reduction would be highly recommended.

The highest share allocated by the relative size of population can be considered as an important factor that indicates public service needs. The size of population used in the formula is from the 2002 census, which showed a lower number of population compared to what cities had in their civil registry offices. This was assumed to have affected those cities with a higher increase of population as a result of population migrating from rural areas. However, the rationale for using the 2002 census is that nearly all local communities reported undercounts.

Municipalities are providing additional services compared to communes, and 20.5 percent (18 percent in 2004) of the municipalities and communes' share was set aside for the additional spending needs of municipalities other than Tirana. The latter was given a special allocation as a more densely populated area and additional spending requirements as a capital city. However, Tirana is not receiving any additional allocation compared to other municipalities because it has about 23 percent of the total population of municipalities and is receiving approximately 26.5 percent of the unconditional transfers allocated for all municipalities, including Tirana. Thus, the special allocation set aside for Tirana does not create any essential inequity. In addition, formula allocation is then adjusted for the fiscal capacity, which makes Tirana yield only nine percent of discretionary revenues from the unconditional transfer.

Different needs of local governments also are reflected in the changes of the factors and additional adjustments made for special circumstances. Factors have been changed for regions: in 2003, they received the allocation based on topography; and, in 2004, the area was replaced with the length of roads. An additional adjustment was made for 80 communes identified as poor and which have special economic needs. Their critical economic needs are not directly related to the public services assigned to communes and small additional allocations are unlikely to improve their economic condition, which is more related to their access to markets, road system, and local economic structure. Other programs in this area could be more helpful then the small additional transfers given to poor communes.

Summary Findings

Albania has made substantial progress in fiscal decentralization in a short period of time. The Law on Local Government adopted in 2000 provides a framework that keeps all central government agencies under pressure to provide fiscal autonomy to local governments. While most of the exclusive functions have been transferred to LGs, shared functions are still provided by the central government as delegated or mandated functions. The implementation of own local functions has increased local government autonomous spending in both actual and relative terms. The definition of the responsibilities of local governments and transparent financing schemes for shared functions should be considered as key issues in the ongoing discussions.

The fiscal package adopted in 2002 (effective in 2003) provides a reasonably accurate assignment of own local taxes, shared taxes, and taxing powers of local governments. Its implementation has increased own local sources, and in 2003 about 70 percent of own source revenues were from locally mobilized taxes and fees. However, the flat indicative rates fixed by law make local taxes inelastic and reduce the potential for increasing revenues. This requires a provision allowing the adjustment of the indicative rates based on the real growth of the local economy and the inflation rate.

The great progress of local taxes also shows large differences in per capita taxes. These differences are mostly from the differences in the tax base and also from revenue efforts. They are adjusted for providing horizontal equity, but the assessment, based on the estimated and/or actual collections, does not provide strong incentives for increasing tax collection efforts. In the future, the true tax base should be used to measure the tax capacity of local governments.

The unconditional (general) transfer system is combined with shared taxes, own local taxes, and service fees. Altogether, they provide a reasonably increased local autonomy and adequate funding for key local services assigned to local governments. Implications of the increasing demand, costs, and national standards for providing local services should be considered in the determination of the general transfer pool and distributing factors and adjustments.

Intergovernmental Finance System

The most important component of intergovernmental fiscal relations remains the unconditional transfer. Determining the unconditional transfer, distribution formula, and adjustments of the basic formula allocation led to both vertical and horizontal equalization. The analysis showed that equalization, as a primary objective of intergovernmental finance, has been accomplished satisfactorily. However, adjustments are needed in consideration of the size of the unconditional transfer pool, distributing factors and adjustments, and the implications of new own or shared responsibilities expected to be transferred to local governments.

At present, the pool to be distributed under the unconditional transfer program is determined as part of the annual budget process. This could place local governments at some potential fiscal risk since government priorities can change over time. This paper suggests the linkage of the transfer pool to an elastic central government revenue source. Shared taxes are also related to intergovernmental transfer program. Collections from the existing shared taxes are, on a per capita basis, extremely unequal across the communes and municipalities of the country. Thus, the introduction of other shared taxes (personal income and profits taxes) provided by law will result in larger dispersions.

A potential issue related to the transfer is the current arrangement for local capital investments. The transfer of the investment responsibility for own and shared functions is expected to happen in the future. This should be considered for establishing a mechanism that can provide a transparent and effective investment transfer system. Some possible alternatives are: (1) the use of the same allocation formula, with some thresholds requiring a minimum spending of the transfer allocation for investments, (2) creating a separate allocation formula to distribute capital investment funds, or (3) allocation based on the evaluation of project proposals submitted by the local governments.

Some Possible Reform Efforts

Fiscal decentralization is a process that still is continuing in Albania. Some possible reforms to be undertaken in the future could be the following:

i) Transfer of investment responsibilities for own local functions and adequate funding through a transparent and effective unconditional transfer system.

ii) Sharing of responsibilities for the shared functions defined by law. Definition of national standards for responsibilities shared with the local governments and their implications in the local budgets and intergovernmental fiscal relations should be key tasks in this process.

iii) Strengthening capacities of local governments for increasing local tax compliance and making budget choices that most closely match local needs and preferences.

Since fiscal decentralization is a process, it should be monitored and based on the decentralization outcomes, and its policies may be adjusted. In this context, other policy reforms may be undertaken by considering the difficulties experienced by local governments and the progress made in improving local services.

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Box 7.
Assignment of Functions to Municipalities and Communes

I. Exclusive Functions

I.A Infrastructure and public services

1. Water supply*
2. Sewage and drainage system and [flood] protection canals in the residential areas*
3. Construction, rehabilitation, and maintenance of local roads, sidewalks, and squares
4. Public lighting
5. Public transport
6. Cemeteries and funeral services
7. City/village decoration
8. Parks and public spaces
9. Waste management
10. Urban planning, land management, and housing according to the manner described in the law*

I.B Social cultural and recreational functions

1. Saving and promoting local cultural and historic values, organization of activities and management of relevant institutions
2. Organization of recreational activities and management of relevant institutions
3. Social services including orphanages, day care, elderly homes, etc.

I.C Local economic development

1. The preparation of programs for local economic development
2. The setting [regulation] and functioning of public market places and trade network
3. Small business development as well as the carrying out of promotional activities, like fairs and advertisements in public places
4. Performance of services in support of the local economic development, as information, necessary structures and infrastructure
5. Veterinary service
6. The protection and development of local forests, pastures, and natural resources of local character

I.D Civil security

1. The protection of public order to prevent administrative violations and enforce the implementation of commune or municipality acts*
2. Civil security*

II. Shared functions**

1. Pre-school and pre university education
2. Priority health service and protection of public health
3. Social assistance and poverty alleviation and ensuring of the functioning of relevant institutions
4. Public order and civil protection
5. Environmental protection
6. Other shared functions as described by law

* All services were to be the exclusive responsibility of local governments on January 1, 2001, except for services shown with asterisks in parentheses following the listed service. In those cases local government authority was to commence on January 1, 2002.

** All sharing arrangements were to commence on January 1, 2002.