

## Decentralization Reform, Case of Albania

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### Abstract

*During the last two decades the process of decentralization has been extended worldwide. This process has taken place in developed countries but in nowadays, this process is also being applied in developing countries in order to challenge the monopoly of centralized decision making of governments. The decentralization reform in Albania has done progress during the transition period. Today the local governance in Albania is absorbing and implementing the decentralization legal framework which is approved up to now and also is moving toward a complicated but progressive process of decentralization and autonomy that combines the decentralization of functions/services with fiscal decentralization supported by the process of strengthening the local democracy and accountability through free election and local community participation. This practice is supported by the economic theory of decentralization that it is a process that can and should lead to the improvement of the services that citizens receive from government by balancing local needs and expectations regarding the quantity, quality, cost and mix of services. This paper makes a snapshot of the process of decentralization by evaluating what has already been achieved, what is in process and what are the challenges laid ahead. It does the analysis of fiscal decentralization and fiscal autonomy in Albania and also gives a short description about the European models (West and East European countries). This paper touches upon the main achievements and challenges on all the complex issues that relate to decentralization. It is mainly focused on the progress of decentralization during the last couple years.*

### 1. Introduction

Although an independent country since 1912, Albania started building its democratic institutions only from the early-1990s, after almost half a century of dictatorship and centralized government. Throughout the nineteen-nineties, Albania's transition from one of the most isolated countries in Central Europe to a democratic society and market economy has been beset by multiple political, economic and regional crises. The years of 1991 to 1998 were dominated by central reforms, including the establishment of the basic structures of a democratic system, and the structures of a market economy.

Starting from the year 2000, when the Decentralization Strategy was approved by the Government, Albania has made considerable progress in the process of decentralization. The implementation of the strategy has in fact passed the intensive phase of the basic laws that define the competencies and establish the relations between central government

and local government.

The law No. 8652, date 30.07.2000 "On organization and Functioning of the Local Governments", is very important for local government which, sometimes called the Organic Law or the Local Government Law, defines the functional responsibilities of the two tiers of local governments in the country – the communes and municipalities, and the regions. The Local Government law has defined a long-term profile of Local Governments. In addition to other issues, the law defines on one side, local responsibilities and functions and on the other side, local fiscal authorities and property rights. The relations and links between these two pillars are quite clear and sufficient to lead to the effective achievement of this profile.

The fiscal decentralization process in Albania is underway with good progress shown during the past five years. Attention during that period has focused on putting appropriate policies into place. Nevertheless, local governments, governed by popularly elected councils and mayors/heads, are providing local public services and are mobilizing revenues based on autonomous taxing powers.

Today the local governance in Albania is absorbing and implementing the decentralization legal framework which is approved up to now and also is moving toward a complicated but progressive process of decentralization and autonomy that combines the decentralization of functions/services with fiscal decentralization supported by the process of strengthening the local democracy and accountability through free election and local community participation. This practice is supported by the economic theory of decentralization that it is a process that can and should lead to the improvement of the services that citizens receive from government by balancing local needs and expectations regarding the quantity, quality, cost and mix of services.

Pursuant to the Constitution of the Republic of Albania, there are two levels of the local governance in Albania: a) the first level consists of communes and municipalities and b) the second level consists of the regions.

The Constitution of the Republic of Albania defines "Communes and municipalities are the basic units of local government.

The region is the second level of the local government which, according to the Constitution, compiles and implements the regional policies (not in the sense of EC regions – author's note) and where such policies are harmonized with the state policy.

## **2. Decentralization process in Albania**

The first legal framework and financing system is established for local governments during the years 1992-1993. During this time are approved from the Parliament Law "On Organization and Functioning of Local Governments and Law" "On Local Government Budgets". However, still the responsibilities of local governments were very vaguely defined and subject to considerable control by the Central Government. The system of grants consisted of a dispersed system, with allocations made by each line Ministry, in a non-transparent, ad hoc manner. Grants were strictly conditional, and ensured a very minimum level of provision of public services, although constituting 95 percent of local budgets. Local government had only partial expenditure authority over 5 percent of incomes coming from own local taxes and fees, but had no incentive to collect additional funds. Such funds could be used only for non-wage operating expenditures and investment, with approval of the Ministry of Finance in a system of public expenditure limits, with surpluses transferred to the State budget.

From late 1998, the situation of local governments began to evolve with a central-local dialog on the need to implement local government and decentralization reform.

On May 1998, the Government of Albania signed the European Charter for Local Self-Government, which defines common standards and principles for the protection and promotion of local autonomy and rights in all signatory countries. One of the main principles of the Charter states: "Local self-governments denote the right and ability of local authorities, within the limits of law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interest of the local population". The Charter is both a model and an objective for Albania. It is a model of how to establish modern, democratic and effective governance based on the principles of local autonomy and subsidiarity<sup>1</sup>. On the other hand, subsidiarity is one of the guiding principles of the Charter meaning that responsibility for a public service should be assigned to the lowest level of government consistent with allocative efficiency.

During this period (1998), the new Constitution was approved by national referendum of November 1999. The very important step was the sanctioning of the basic principles of autonomy in the Constitution. The article 13 of constitution

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<sup>1</sup> This principle means that competencies and powers should be assigned to the level of government that is closest to community.

establishes that "Local Government in the Republic of Albania is founded upon the basis of the principle of decentralization of power and is exercised according to the principle of local autonomy." The Constitution establishes also the main concepts and principles regarding the local government institution, their composition, their basic responsibilities and their authorities.

The Government has adopted in January 2000, a formal multi-year Decentralization Strategy (which was reviewed in 2006) as an integrated policy document that defines the long-term vision of local government in Albania, as well as the general goals and objectives of decentralization. The long term vision of local government in Albania has fixed a strong and powerful first level (municipalities and communes) and a coordinative role of the Regional Council as an upper level of local government. The approach of compiling Decentralization Strategy was through an open, transparent, participatory dialog of all the interested stakeholders. They reached an agreement among themselves on functions, authorities, financial resources and properties to be decentralized and carried out by local governments. The outcome of this dialog was a consensus among the participants from the national and local governments and from civil society on the priorities and phases of the decentralization process. Since that, Albania has in place a strategy and mechanisms of dialog among stakeholders to implement a phased process of decentralization.

Since October 1<sup>st</sup>, 2000, local governments are operating based on the new Local Government Law.<sup>2</sup> Local governments should receive title to their properties for the first time, through implementation of the Property Transfer Law.

The Government year by year issued formal mandates to continue the structured dialog on decentralization, including representatives of the national and local governments, as well as civil society through the Group of Experts for Decentralization/Inter-Ministerial Committee for Decentralization. These measures have created an opportunity that is unique among the transition countries. Another mechanism of dialog since February 2000 is the Medium-Term Budgetary Program (MTBP). This program is the instrument aiming at defining the priorities as well as the long and short-term objectives on development through a consultation process with all interested actors and is the framework for defining and implementing country economic and social policy developments. At the initiative of Ministry of Finance, decentralization became a cross cutting theme of the MTBP process in Albania, starting in 2001. Decentralization reform and local government's revenues and expenditures have a separate chapter in the Program with implications of the reform on the annual budget and for three-year period. Measures to strengthen local government finance are considered formally as part of the process of developing national fiscal policy and targets.

If we would consider the phase of these laws (basic) the first phase, the second phase is about absorbing the new competencies and creating the complementary legal and regulatory framework for implementation of these new competencies.

### **3. The local Government functions**

Since that, Parliament has adopted key laws, starting with the most important Law "On Organization and Functioning of Local Governments" approved in 2000 which together with Decentralization Strategy marked the official start of the process of decentralization in Albania clearly defining the functional responsibilities of both levels of local governance as well as autonomy for the generation of revenues in conformity with the Constitution and the European Charter for Local Self-Government.

At present, Albania is organized with two levels of local government, consisting of 12 regions, and 373 first level local government units, of which 65 municipalities (urban areas) and 308 communes (rural areas). Mayors and members of municipality/commune councils are directly elected, while regional councils consist of indirect representation, being formed from representatives of the municipal/commune councils in the region. National territorial structures include 12 Prefects, one in each Region, representing the authority of the central government in the territory, and territorial branches of some line Ministries.

According to the law, "On organization and functioning of local government", the functions of local government are defined in three categories: i) own functions, ii) shared functions and iii) delegated functions.

For own functions, local governments enjoy full decision-making authority. Own functions of municipalities/communes include basic local public services, such as solid waste, roads, public areas and parks, public lighting, water/wastewater, local economic development, local culture and sports.

Some own functions of Local Government in Public Services are:

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<sup>2</sup> Law No. 8652, dated 31.07.2000 "On Organization and Functioning of LG". In this document it will be shortly called Local Government Law

- Garbage collection and cleaning,
- Construction and maintenance of local roads,
- Sidewalks,
- Public lights,
- Parks and green spaces,
- Cemetery,
- Urban public transport,
- Kindergartens,
- Veterinary service,
- Water/wastewater
- Municipal police etc,

Shared functions are a new concept of Albania's local government system, and they cover key sector areas such as education, health, social care and public order; the respective roles of the central and local governments still need to be elaborated in separate sector laws. Dedicated law for each public service must define what competences will possess the municipalities and communes within each sector. Once established, Local Government Units will exercise such competencies as autonomous.

Delegated functions are those that while the core responsibility remains at central level, for implementing opportunities, Local Government Units are engaged to a certain extended and for defined tasks. Delegated functions can be either mandatory (such as civil register), if defined by dedicated laws including also the financing of the related expenditures, or non-mandatory thus based on free negotiations between a ministry and a municipality/commune or regional council.

The own functions of the regions include adoption and implementation of regional development policies. Other functions can be delegated to them by their constituent municipalities/communes, or by the central government.

#### **4. Fiscal Decentralization**

Decentralization policy should first assign service responsibilities before defining local revenue powers, that is, "Finance Follows Function". The rationale for this phasing (in Albania) is to make it more likely that the revenue powers assigned to local governments can be in line with the costs associated with those services. This helps determine the appropriate size of a resource transfer system (flows of intergovernmental transfers from "higher" to "lower" tiers of government). The Law, "On Organization and Functioning of Local Government" defines the principals of local government finance that tries to guarantee the autonomy and functioning of local governments units through:

- Establishing the right for diversified local sources such as taxes, fees and other local revenues, funds transferred by central budget (directly or in the form of participation in national taxes and fees) and loans;
- Granting authority for collecting revenues in independent way;
- Delivery of sufficient funds from central government and the fulfillment of all defined standards, as well as functions and authorities delegated from it;
- The right of drafting, approving, implementing and administering their own annual budget.

Fiscal decentralization is considered a key component of the reform. It has incorporated the principle that money follows the responsibilities. Fiscal decentralization aims at generating more local revenues for supporting the improvement of quantity and quality of local services but it also would contribute to a further strengthening of the local sense of accountability and understanding that first of all it is the local community that decided for the local priorities and contributed for their achievements.

Based on the authorities given by Organic Law, changes during 2002 and 2003 made up the most important and serious steps in fiscal decentralization progress in Albania. The key elements of this reform include the reform on national revenues for local governments and the reform of locally generated revenues that tries to satisfy basic goals of local government finance system. The reform of locally generated revenues aims to create chances in generating more fiscal revenues for supporting the improvement of quantity and quality of local services but it also would contribute to a further strengthening of local sense of accountability and understanding first of all it is the local community that decided for the local priorities and contributed for the achievements

Based on the current legislation of the local government the local taxes are:

- The small business tax,

- Immovable property tax, which includes the building and agricultural land taxes;
- The hotel tax;
- New constructions infrastructure impact tax;
- Immovable property right transfer tax;
- Vehicles' annual registration tax;
- Tax on occupation of public spaces;
- Table tax;
- Temporary tax.

The council of local units has full discretion to decide for tax base and tax rate within term of local tax laws.

#### 4.1 Reform of Transfers

In the State budget 2002, the concept of unconditional transfers for local governments was adopted for the first time and the total transfer pool was the outcome of the annual budget process for that year. The total unconditional pool was distributed among local governments (municipalities, communes and regions), based on a formula. This formula balanced the need to take account of objective criteria related to costs of local services and to ensure a measure of equalization to support poorer local governments. The major results of the formula were to improve equity; to create a greater relation between size/population and amount of funds received; and to ensure some equalization effect. For the first time, the local transfers from the state budget were made transparent and predictable, which was an immeasurable improvement to aid the budget management of local officials.

When the project budget is prepared, each municipality and commune can preliminarily calculate for the next year the amount in its budget that it will take from the state budget in the form of unconditional transfer that started on 2002.

**Table:** Formula Used to Distribute the Unconditional Transfer, 2002 - 2010

Distribution of Total Pool	2002	2003	2004	2005	2006	2007	2008	2009	2010
Regions	10%	19%	15%	9%	8.5%	9%	9%	8.5%	8.5%
Municipalities/Communes	86%	79%	83%	91%	91.5%	91%	91%	91.5%	91.5%
Compensation Fund	4%	2%	2%	-	-	-	-	-	-
<b>Distribution of Municipal &amp; Commune Share</b>									
By Formula	95%	88%	94%	100%	100%	100%	100%	100%	100%
Compensation Fund	5%	12%	6%	-	-	-	-	-	-
<b>Municipal &amp; Commune Formula</b>									
Equal Shares	3.5%	3.5%	4%	-	-	-	-	-	-
Population	62.5%	62.5%	62.5%	73%	70%	70%	70%	70%	70%
Area of Communes	4%	4%	9%	12%	15%	15%	15%	15%	15%
Urban Services <sup>3</sup>	20.5%	20.5%	18%	15%	15%	15%	15%	15%	15%
Tirana Share	9.5%	9.5%	6.5%	-	-	-	-	-	-
Tax Capacity Adjustment	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Further Adjustments	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
<b>Distribution of Regional Share</b>									
By Formula	100%	85%	97%	98%	98%	98%	98%	98%	98%
Regional Compensation Fund	-	15%	3%	2%	2%	2%	2%	2%	2%
<b>Regional Formula</b>									
Equal Shares	30%	25%	25%	15%	15%	10%	10%	10%	10%
Population	15%	15%	15%	25%	25%	28%	28%	28%	28%
Geographic Indicator <sup>4</sup>	30%	30%	30%	30%	30%	30%	30%	30%	30%
Area of Region/Length of Roads <sup>5</sup>	25%	30%	30%	30%	30%	32%	32%	32%	32%

<sup>3</sup> This amount (2002-2005) was distributed among the municipalities other than Tirana on the basis of the relative populations of these municipalities, in 2005-on going; Tirana Municipality is included to Urban Services criteria.

<sup>4</sup> This is an indicator which takes on the value 1, 3, or 5 with 1 indicating that the terrain of the region (e.g. flat plain) as well as other comparative advantages of the region whereas a 5 would indicate a mountainous region with few comparative advantages

<sup>5</sup> In 2003 the area factor was changed to km. of roads in the region; road length continued to be used in 2004

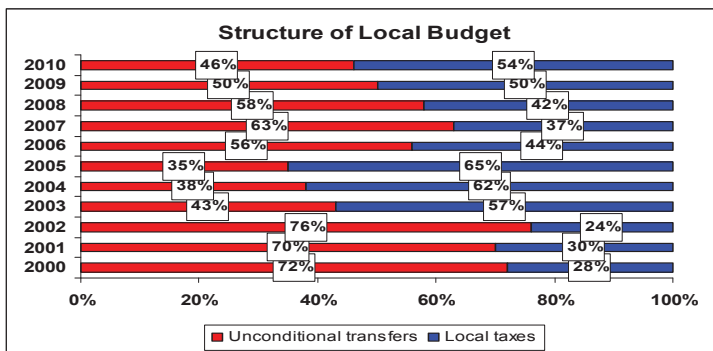
Fiscal equalization was used during 2003 for the first time because of implementation of fiscal package for the first year and huge disparities expected to be created in different local government especially from local small business tax, and vehicle registration tax. Fiscal capacity is calculated only on small business tax and on vehicle registration tax. First adaptation of this allocation is done in accordance to the coefficient of fiscal capacity. Each municipality and commune with revenues per capita higher than the national average, will contribute 25 percent of the fiscal equalization difference, divided with its population. This sum is subtracted from initial calculation of grant. Each municipality and commune that is below national average will be compensated with 25 percent of this difference, divided by its population; this sum is added to initial calculation of grant.

#### 4.2 The Fiscal decentralization Impact

There is an especially significant change with regard to composition of local revenues. The proportion of revenues from the State budget has decreased considerably from 76% that was in 2002 to 43% in 2003 and to 46% in 2010. The revenues that comes from local taxes and fees (own revenues) are increased from 24% in 2002, to 57% in 2003 and to 54% in 2010. This represents an increased autonomy of municipalities and communes to determine own local revenues and their rates; enhances the capacity to ensure more efficient collection; and, increases responsibility and autonomy for the allocation of these revenues, based on local priorities and needs. Greater local revenue autonomy also supports a process of improving the accountability of local governments, first of all to their local communities.

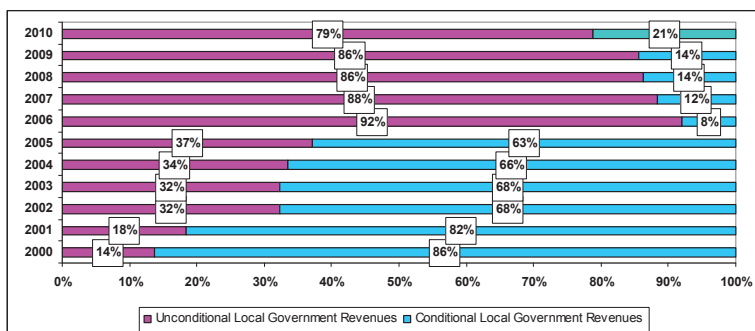
The expenditures of local government per GDP, where council of local governments have full discretion to make the decision year by year are increased. In 2000 the expenditures with the local autonomy was 1.13% of GDP and in 2010 are 2.9% of GDP and also the tendencies is to increase in coming years.

Graph 1



Source: Ministry of Finance

Graph 2



Source: Ministry of Finance

### 4.3 *Municipal Borrowing*

In the long term, the Government could remove itself from the business of allocating funds for local capital investment and turn this function over to the private capital market. Local governments could identify their own investment priorities and seek funding from private banks. Some move in this direction is reflected in the Government's decision to remove the prohibition on local government borrowing and substitute limited borrowing powers.

The law on municipal borrowing that was approved by Parliament in 2008 has several valuable features<sup>6</sup>. This law offers the opportunities to finance the investment program of local governments. It defines debt broadly, to include any monetary obligation or liability created by a financing agreement, the issuance of securities, or a guarantee to third parties. As such it closes several loopholes which have been a source of problems in neighboring countries. It also provides an appropriate level of Ministry of Finance oversight. Up to now very few of local governments have borrowed from internal financial markets and this is related closely with the economic crisis.

## 5. **Problematic issues**

### 5.1 *Capacities to absorb the transfer of competencies*

While there are still issues to be resolved regarding the legal framework it should be said that the main core of the laws that define the framework of decentralization is already here. The decentralization it has entered into a phase of absorbing the laws that are in place rather than creating new ones. Local units sometimes lack the capacities to implement the competencies they now have. Most of the problems of capacities relate to the issues of budgeting, its design and monitoring, tax collection and planning, Strategic Planning for Local economic Development etc. Training is most necessary in these areas.

During the last years a New Agency for Local Government Training was formed under the Association of Municipalities. However this Agency is still in the process of defining itself and preparing the curricula. There is also the issue of training costs. Who is going to bear it? Local Governments (who have almost no resources for training of their employees) or Central Government? Another problem related with capacities to implement is that of human resources for small municipalities and communes. Educated people are leaving these areas and migrating to bigger towns leaving the local units without professionals they need to carry out the job.

### 5.2 *Further specification of the competencies*

Although the Organic Law has made quite a progress in defining the competencies/functions for the local government, still there is need for further specification on these competencies and function. Especially the common functions (education, health, social assistance, public order, and environment protection) need further specifications on what is every layer of government responsible for. There has been some movement towards the so called "elite decentralization" especially for shared functions. This is a decentralization that those that have the capacities and expertise can get more competencies than those that don't. It is emergent to discuss and approve the space developing law.

### 5.3 *Competencies and functions of the Council of Region*

This second level of local government (Regions) was created with the reform after the year 2000 (the new organic law). However the role and functions of council of regions are not clear yet. The organic law mentions as their primary function that of regional planning. In fact the role of this level of government is still vague. Region councils are not directly elected by citizens and as such they do not have anybody to be accountable to. Region councils do not have any. A step forward is the specification of the role and competencies of the Regions for Education, Health Care, Social Issues and local and regional developing.

### 5.4 *Fragmentation*

Albanian territory is divided in 373 local units (65 Municipalities and 308 communes). 47% of Albanian Population lives in

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<sup>6</sup> Law No. 9869, date 4.2.2008 "On Local Borrowing"

local government units smaller than 10 000 inhabitants. The internal migration has created a situation where some local units are experiencing increase of their number of inhabitants (and as a results that resources to provide adequate public services are insufficient), while other local units are experiencing reduction of their number. This affects also the technical capacities of these units to implement their competencies and deliver the public services. Out of 308 communes, in 2007, 60 communes collected local taxes in the amount from 200 000 leks to 300 000 leks. (2000 USD – 3000 USD)<sup>7</sup>. What can a local unit do with such an income from its own resources? On one hand the smaller units bring the government closer to citizens (and that is the purpose of the decentralization) but on the other they lack the capacities to deliver these citizens the services they need. A dilemma that should be faced and resolved by the process of decentralization in the coming years.

### 5.5 Fiscal Decentralization

This is the vital part of the reform. It should be said that during the last four years there is improvement in the increase of the local own revenues as well as in the ratio between local taxes and tariffs and unconditional transfers<sup>8</sup>. However there are still issues that under the effective implementation of fiscal decentralization as well as the progress of the reform in this area:

- There is still insufficient local expenditure autonomy. There is progress in this area but a lot remains to be done.
- Local Revenue autonomy remains low. Although the fiscal reform of 2002 marked, a very important step forward for local government they still cannot set the tax rates for vehicle tax and property transfer tax. In addition, the local governments are not allowed to assess the tax base.
- Property tax which elsewhere in the developed world is one of the most important taxes for local government faces a big challenge in Albania. The challenge is related with property evaluation. Albania has still not finished the registration process of properties.
- Lack of capacities for tax administration. Many local government units have suffered from this "disease" and this has had direct impacts on the revenue collection for these units.
- To clarify the fiscal relationship between center government and local government is necessary to have a special local finance law.
- According the organic law for local government defines the income tax and profit tax of corporate as share taxes, but up to now, didn't do anything. It is necessary to have the rule how is the part of these taxes that should go to center government (state budget) and which part goes to local government.

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<sup>7</sup> According to the data Ministry of Finance

<sup>8</sup> Data from Ministry of Finance