

Fiscal Decentralization and Intergovernmental Finances in the Republic of Albania

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Central budget transfers to local governments will remain the dominant source of financing for many functions, but Albania is on the path toward autonomous, responsive local governance. Local governments can already deliver some infrastructure services, but for some — especially education and health — it is important to ensure national service standards.

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Summary findings

Economic decentralization emerged as an issue in Albania following the first election of a noncommunist government in Albania in 1992. It is one of many challenges in creating a fiscal system that supports reform.

Decentralization has begun with the central government's transferring spending responsibilities primarily for some local infrastructure services to local governments. But, given Albania's small size, it is unclear whether "people" services such as education and health care need to be delegated to local governments. Although the destruction of local health and education facilities accompanying the demise of the old regime argues for giving communities a greater sense of ownership of these facilities, they should not be handed down without mechanisms to ensure uniform service standards.

Draft laws focus on the transfer of assets (schools and clinics) to local jurisdictions but are vague about responsibilities for recurrent spending. And because local spending responsibilities are expanding, local governments need increased revenues to finance them. Providing an adequate social safety net is vital in Albania — the poorest of the economies in transition — and the

government has taken steps to ensure that parts of it are locally administered, though centrally funded.

The key to a well-designed intergovernmental financial system is to clearly define spending responsibilities so that a revenue system can be designed to accommodate them. Such a system would combine revenue-sharing, own-source revenues, and intergovernmental transfers.

Tax-sharing of central government revenues based on district of origin cannot be the only means of local finance in Albania, as most revenues are collected in only a few districts. To meet financial needs, local governments need some authority over significant own-source revenues (such as user charges and property and vehicle taxes). Privatization revenues can also help local governments but only in the short run, as they are nonrecurrent.

Matching grants with spillover effects may be appropriate. And for low-income regions incapable of meeting their spending needs alone, a transparent, equalizing transfer system should be developed. Albania's draft laws allow for this possibility, having established constituent and independent budgets for the local level.

This paper — a product of the Infrastructure Team, Europe and Central Asia, and Middle East and North Africa regions' Technical Department, and the Office of the Director, Europe and Central Asia, Country Department II — is part of a larger effort in the Bank to study the problems of the development of local and subnational governments and issues of intergovernmental finance in the economies in transition. Copies of this paper are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Gemma Langton, room H11-075, extension 38392 (57 pages). November 1994.

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by

David Sewell and Christine I. Wallich

World Bank

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**FISCAL DECENTRALIZATION AND INTERGOVERNMENTAL
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I. INTRODUCTION

1. Albania was the last of the countries in Central and Eastern Europe to begin the process of political and fiscal decentralization and is still in the early stages of this process. Decentralization has, nevertheless, been a priority of the current government of Albania, which is also the first democratically elected non-communist government in the country's history. The government was elected in March, 1992, passed legislation setting up local governments in June 1992 and held the first elections for these local governments in July, 1992. The Council of Ministers subsequently held a colloquium on public administration reform and decentralization in March 1993.¹ At that time, Albania was just emerging from some of the most difficult macroeconomic circumstances encountered by any of the former command economies of Central and Eastern Europe in their transition to market economies. Recent successes in macroeconomic policy -- a substantial amount of price stability was attained by mid-1993 -- have given the government some much needed breathing room. This gives it the opportunity to consider construction of a fiscal framework that will allow central and local governments to be established on a sound long-run basis.

2. The emergence of greater interest in decentralization of government in Albania is to be expected. In part, the desire for current empowerment by local governments represents a reaction to the

overcentralization, rigid party control and tightly regimented behavior that formerly characterized Albanian government and society. In part, decentralization represents the public sector equivalent of privatization of the production of private goods and services. Another practical reason for interest in decentralization and deconcentration in Albania results from the emphasis, in a post-socialist market economy, on increasing efficiency in service provision. Problems in transportation and communications, outlined below, also make it difficult (indeed, always made it difficult) to operate a highly centralized government efficiently. For all these reasons, some deconcentration of power to local officials has already taken place within the government of Albania although the center is proceeding very cautiously (the terminology of the decentralization debate is discussed in box 1).

3. With a population of under 3.5 million, Albania is a small country and questions might well be raised as to how much decentralization of government is appropriate in these circumstances. It is clear that we should not be considering the type of extensive decentralization that might be appropriate in a federal state such as Russia with its many constituent republics, nationalities, language and ethnic groupings and huge expanse of territory covering 11 time zones. However, the efficiency argument for local responsibilities for service provision as distinct from national provision also applies in Albania's circumstances in some sectors (section V). Indeed, all continents have examples of democratic countries with populations in the range of 3-5 million which have well developed local government sectors based on a commonsense division of powers. These countries – Costa Rica is an example – provide possible models for future development of the relationships between Albania's local and central governments.

Box 1: Transfers of Power from Central Government Administration

Four types of transfer of power from central government administration can be distinguished on the basis of the organization to which power is transferred. The following terms are widely used in the literature to identify these four power transfers.

Deconcentration implies a shift in the authority of national government officials away from those working in the capital to those working in more dispersed locations. Some 9.1 million lek out of a total annual budget for the government of Albania in 1993 of 49.9 million lek, or slightly more than 18%, is delivered in such a deconcentrated manner. Seven ministries deliver services on a deconcentrated basis; the major ministries involved being those for Agriculture, Construction, Transport, Education and Health.

Delegation of powers means that local governments undertake certain functions on behalf of the central government. In such delegated fields of authority, local governments are still subject to the control of the central government and are responsible to the latter for their actions. The government of Albania has recently begun to delegate some important powers and responsibilities to the newly elected local governments. Thus, municipalities and communes have been given grants to distribute social assistance in 1993. While the guidelines for social assistance payments have been developed by central government ministries and each municipality and commune has a fixed sum to distribute, the municipalities and communes will themselves decide which families will receive this aid and how much each family will receive.

Decentralization means that full authority to make and carry out decisions is transferred to local governments, which are solely responsible to their own electors for these decisions.

Devolution is a closely related term often used to describe the situation where significant amounts of legislative and fiscal authority are transferred from central to subnational governments.

Both decentralization and devolution of powers are under active consideration by the government of Albania at the present time.

4. After giving some background data on Albania and its recent legislation concerning local government, the following sections of this chapter will examine the assignment of functions between central and local governments (section V) and their financing (section VI). The system of transfers (section VII) and the ongoing process of intergovernmental relations (section VIII) will then be examined. A final section provides a summary and concluding thoughts.

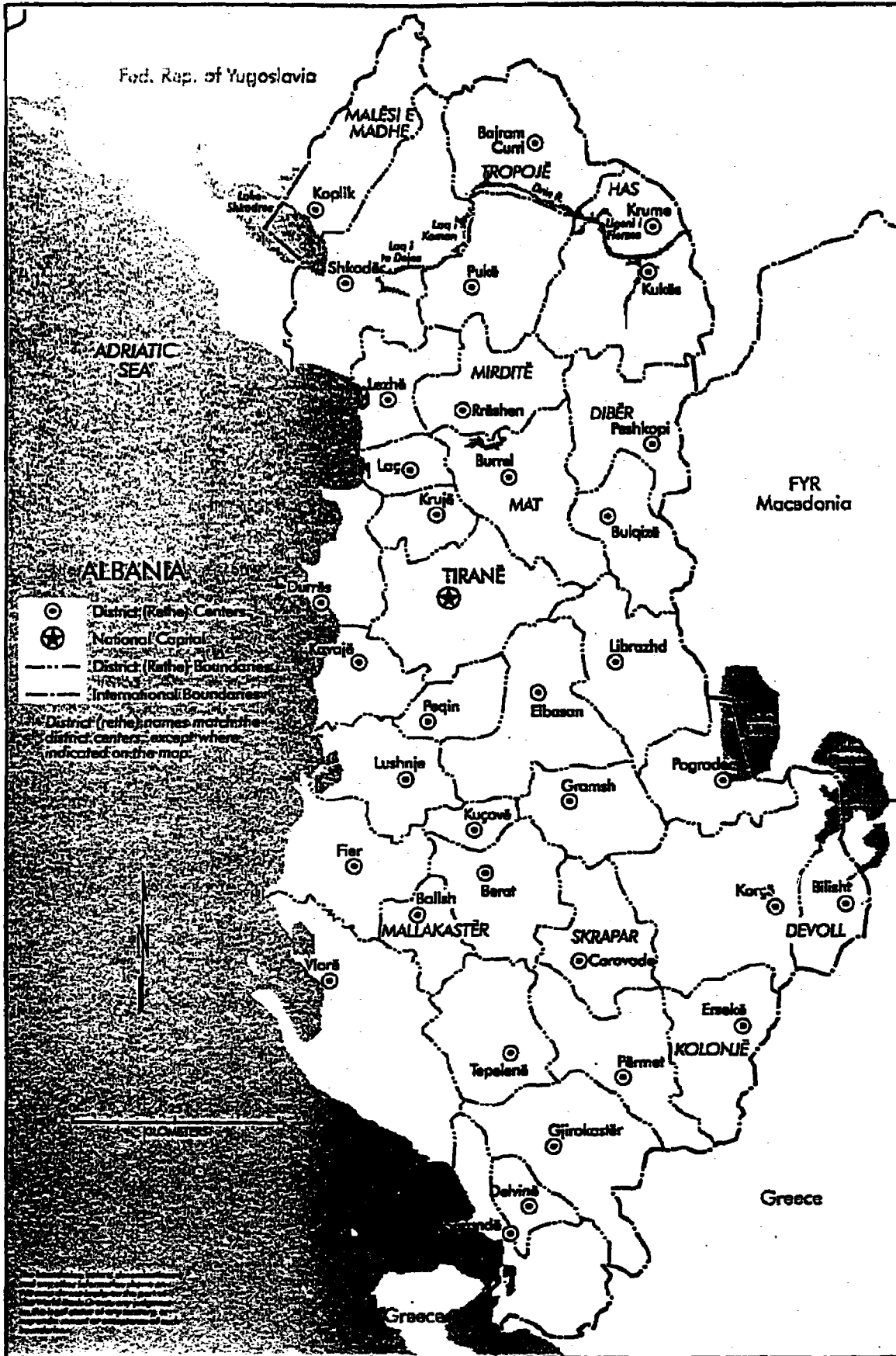
II. ALBANIA: EUROPE'S MOST RECENT REFORMER

5. Albania is among the smallest of the Balkan states, with a population of roughly 3.4 million in 1992 and a land area of nearly 29,000 square kilometers. About 70% of the territory of Albania is mountainous and the population predominantly lives in rural areas and is engaged in agriculture. The largest city is the capital, Tirana, with a population of some 270,000, and the average size of its 47 cities is 28,000. Some 65% of the population lives outside urban areas, and in 1992 agriculture employed half of the labor force and accounted for half of total output (See Map).

6. Of all the former command economies in Europe, Albania was the poorest, and the most rigidly controlled. In emerging from the totalitarian period, from 1992 to the present, Albania has implemented one of the more successful stabilization programs in the region, and has liberalized the major part of its economy. In 1993, Albania manifested one of the highest growth rates in Europe (11 percent), and has reduced inflation to less than two percent a month since mid-1993. Virtually all agricultural land has been privatized, state farms disbanded, and most small and medium size enterprises privatized. This section briefly describes Albania's troubled earlier history and subsequent macroeconomic and structural achievements, as background to the discussion of decentralization that follows.

The Legacy of the Past

7. Until comparatively recently, Albania was ruled by a vicious and paranoid dictatorship. Under the regime set up by Enver Hoxha, as many as three out of four families were touched by police repression, according to some estimates -- with family members being jailed, exiled or otherwise harassed for political reasons. The number of ex-political prisoners of the regime is so large that they now constitute a major political force, and a separate Ministry is devoted to their welfare. The extent to which



the regime was concerned about threats from abroad is shown by the pillboxes that are in almost every field. They are rarely out of sight in the countryside and will be one reminder of the Hoxha regime that may be evident for centuries. An indication of the extent of the intrusion of the Hoxha regime into the affairs of individuals and families is that it made family planning illegal. The extent of collectivisation and associated prohibitions on ownership of private property is illustrated by the fact that private automobile ownership was banned until 1991. In 1976, private ownership of productive assets was formally prohibited in the Constitution.

8. The Hoxha regime also imposed complete central control over the economy and kept its people isolated from the rest of the world to an extent unparalleled in any of the former command economies. The policy the regime followed from 1975 to the death of Hoxha in 1985 was one of total autarky. Indeed, the principle of autarky -- called self-reliance -- was written into the 1976 Constitution. The latter prohibited any foreign credit, aid or investment.

9. The demise of communism in 1991-92 led to economic chaos. For 45 years, central planning had decided, allocated and distributed everything in all sectors. When it was abolished, no alternative allocation mechanism was in place and the result was a freefall in economic output. In this respect, the process of transition was not too different in Albania than from that in many other former command economies.

10. What did distinguish Albania from other Central and East European economies where communism also collapsed in this period, however, was the breakdown in public order and the physical destruction of social capital that accompanied the fall of the old regime. Some of this might seem to be the

equivalent of the population shooting itself in the foot. Thus, slightly more than a third of the schools in Albania were badly damaged or destroyed in the process. The majority of local health centers were also badly damaged, with 24% of these centers and a further 65% of local health posts being either completely destroyed or occupied by squatters. The destruction of cooperative and state farm buildings also destroyed administrative centers and offices for many rural local governments. There was also significant destruction of some goods-producing capital, such as the irrigation network on the former cooperative farms which accounted for three quarters of land under irrigation. Much of the property that was destroyed would be identified as belonging to the local community in many western states, and its destruction speaks eloquently about the alienation of the population from the former regime, the extent to which public services were previously delivered together with a hated ideology, and the absence of a feeling of local ownership or community commitment with respect to the activities using these facilities.

11. Although Albania was already one of the poorest countries in Europe before these events, the collapse of central planning and the breakdown in public order led to a decline of slightly more than 40% in output in 1990-1992. The distress of the population was shown to the West in stark fashion in March 1992, when television recorded the arrival in Italy of some 20,000 youths and men who had seized ships in the Durrës area. A recent estimate is that out of 3.4 million Albanians, nearly half a million are now illegal emigrants in neighboring countries — including a quarter of a million who left Albania in the year following the March 1992 elections which led to the installation of the first elected non-Communist government.

12. The decline in economic output of more than 40% in 1991-1992 had other macroeconomic consequences. When output fell, so too did the principal source of government revenues, from state-

owned enterprises. Further, control over most categories of government expenditures almost disappeared. As a result, the fiscal deficit exploded to about 42% of GDP in the first six months of 1992. Money was printed to finance the deficit and the resulting inflation rate in early 1992 was 14% on a monthly basis. Actual inflation for all of 1992 was 237%.

	1989	1990	1991	1992	1993
GDP Growth (Percent Change)	10	-10	-28	-10	11
Revenues % GDP	48	47	31	25	28
Expenditures % GDP	57	61	62	47	45
Deficit % GDP	-9	-15	44 ^a	-22	-16
Inflation (Percent Change)	0	0	104	237	31

^aIncludes spending arrears from 1990.

The Restoration of Growth and Stability

13. As noted, the first non-communist government in Albania was elected in March 1992. Its priorities were to launch structural reforms to establish a market economy and to introduce a comprehensive program of stabilization measures. Its success in the latter respect, coupled with high per capita foreign aid flows and remittances from the large numbers of Albanians who have moved abroad to get work, have contributed to a remarkably rapid economic turnaround in inflation and output. Mainly through reductions in expenditures, the budget deficit was reduced to 16% of GDP in 1993 by the new government, of which two-thirds was financed by concessional foreign aid. Remittances from those working abroad also contributed \$200 million, and substantially eased the balance of payments. As a result of the stabilization program, the lek -- which had been allowed to

float – was stable by the beginning of 1993 and inflation in 1993 of 31% was a far cry from the 237% level of the previous year. As of mid-1994, there was evidence of an appreciation of the real exchange rate in the freely floating market, and inflation had fallen further, to 18 percent, on an annualized basis.

14. Although admittedly it started from a low economic base, Albania's GDP growth of 11% in 1993 was one of the greatest of all the former command economies, and the highest in Europe, east or west. In 1994, growth performance has been similarly robust. While the recovery primarily had its origin in agriculture, construction and other private services also expanded substantially. The adjustment process was, of course, not without costs, particularly for those in the public sector. Unemployment rose to about 26% of the labor force as a result of layoffs in the state-owned industrial enterprises and real wages have fallen. Nonetheless, in the recent Eurostat survey, the overwhelming majority of Albanians agreed that they were "better off than before the reforms", a result which contrasted strikingly with the generally pessimistic evaluation registered in other Eastern European countries.

15. The sustainability of the macroeconomic achievements to date and their conversion into long term growth will depend on further far-reaching structural reforms. Thus far, Albania has privatized virtually all agricultural land, and the output response has been substantial. Privatization of trucking and the retail sector has been followed by privatization of small and medium term enterprises. Remaining challenges include the building of infrastructure required by the private sector, privatization and/or restructuring of the remaining state enterprises, and the creation of a banking system so that credit can start flowing to new activities.

16. With its location close to EU markets, and its low labor costs, Albania should be able to expand trade and attract some foreign investment enabling the country to better exploit its natural endowments, especially in natural resources, tourism, water resources and agriculture.

Some Challenges for Decentralization Policies

17. Albania remains the poorest state in Central and Eastern Europe, with per capita GDP of roughly \$340 in 1993. There are perhaps more graphic indicators of the country's standard of living than even these rather bleak income statistics. For instance, it is estimated that there are only 7.5 square meters of housing per person in Albania, and the country with the next lowest housing stock in Central and Eastern Europe is Romania which has 15 square meters per person. By way of contrast, Hungary has the largest stock of housing in Central and Eastern Europe with 26 square meters per person.

18. Difficulties in transportation and communications were alluded to above as making it difficult for a highly centralized form of government to be efficient. The country is mountainous and many villages are inaccessible by motor vehicle. About 400 villages with an estimated population of 1.5 million people are not accessible by motor vehicle for part of the year. In addition, there is no telephone service to many municipalities. Thus, not only is Albania poor, but there are significant *regional disparities* within the country, with some areas served much better than others.

19. The poverty of this country, and its previous mismanagement by the former communist regime, are reflected in other statistics for local infrastructure. For instance, of the 250 water supply systems in Albania, only one provides 24 hour service to its customers. In Durres, which is

Albania's second largest city and principal port, about 30% of households with a tap get no water at all and the remainder get service for an average of 3 hours a day. In the past 10 years, the origin of 4 typhoid epidemics has been traced to contamination of its water supply. Indeed, it is estimated that from 50 to 75% of all drinking water sources in both rural and urban areas in Albania are contaminated. Further, only 60% of primary health care centers have any source of heating, while only 40% have running water and 14% have basic laboratory equipment.

Comparative Sizes of Local Governments in Albania

20. Table 2 presents some information on the sizes of local government units in Albania – districts, municipalities, and rural communes – at the time of the first local elections in July 1992. While the 37 districts have an average size of close to 100,000, there is considerable dispersion in their size. The addition of 10 new districts between 1991 and 1992—six of which had an urban population of less than 10,000—contributed to this dispersion in size. The 47 municipalities also show considerable deviation around their average size of roughly 28,000. The average size of the 309 rural communes is close to 7,000, and it can be seen that the communes are much more homogeneous in size than the other units of local government. While not shown in the table, the rural communes comprise up to 24 villages, with the average number of villages per commune being slightly over 9. Average village size, in turn, is 764 and is relatively homogeneous.

<p style="text-align: center;">Table 2 Size of Local Government Units in Albania: July 1992</p>			
	Districts	Municipalities	Communes
Number	37	47	309
Size Range	23,789-414,367	2,534-270,000	1,292-18,791
Average Size	96,118	27,801	6,963
Standard Deviation	79,434	49,622	1,723

Source: Department of Statistics, Government of Albania

21. The size of local governments and the degree of urbanization of a country influence the costs of local governments and the extent to which the latter can capture economies of scale and be viable as independent units. Table 3 presents some comparative statistics in this respect for Albania and other Central and Eastern European countries. It is evident that Albania is by far the least urban of these countries, using the *World Development Report's* definition of urban as being the percent of the population living in cities of more than 10,000. At the most aggregate level of local government, the rethe or district level, Albania's local government units are smaller in size than those of most of its neighbors in Central and Eastern Europe. On the other hand, Table 3 indicates that the lowest level of local government in Albania, comprising the municipalities and rural communes, has a larger average size than that in other Central and East European countries with the exception of Poland and Bulgaria.²

III. WHETHER AND HOW TO DECENTRALIZE: WHAT ARE ALBANIA'S OBJECTIVES?

22. There is no single "right" system of local government finances: much depends on what a country wants to achieve (see Box 2). Balancing objectives—efficiency, revenue adequacy, equity, local government autonomy, and the like—can be difficult. For instance, too generous support for local governments may discourage their own revenue effort and hence autonomy and undercut central stabilization policy. Different countries also attach different priorities to each of these objectives, and these priorities may change over time. Not all these objectives can be achieved simultaneously, and choices need to be made. In Albania today, the overriding objectives in the intergovernmental system would seem to be: (i) consistency with macroeconomic stabilization policy; (ii) administrative simplicity; and (iii) sufficient equalization to avoid the emergence or worsening of service differentials if key areas such as education and health are handed over to local governments, where the nation as a whole stands to lose if poor areas underspend. In addition, a means of financing local infrastructure development is also a priority.

23. Given the above discussion of Albania's macroeconomic situation, Albania's administrative and revenue constraints, and the need for greater efficiency in service provision, the following general objectives should be taken into account in designing its intergovernmental system: First, administrative constraints, the need for continued macroeconomic controls and the superior taxing power of the central governments (as in most countries) suggest that local governments will thus remain transfer-dependent for some time to come. Second, Albania should more clearly assign spending responsibilities and give expenditure discretion to subnational governments in appropriate areas to increase the efficiency of public

Box 2: Objectives of Local Government Financing Systems

An ideal system of local government financing would:

- try to ensure correspondence between subnational expenditure responsibilities of local governments and their financial resources (including transfers from the central government) so that functions assigned to local governments can be effectively carried out;
- increase the autonomy of local governments by incorporating incentives for them to mobilize revenues of their own;
- support (and not undermine) the center's macroeconomic management policies;
- give expenditure discretion to subnational governments in appropriate areas to increase the efficiency of public spending, and to improve the accountability of local officials to their local constituents for provision of local services;
- incorporate intergovernmental transfers that are transparent and based on objective, stable, nonnegotiated criteria;
- minimize administrative costs and thereby economize on scarce administrative resources;
- provide "equalization" payments to offset differences in fiscal capacity among localities and so ensure that poorer localities can offer sufficient amounts of key public services;
- incorporate mechanisms to support public infrastructure development and its appropriate financing;
- support the emergence of a local government role consistent with market-oriented reforms.

spending, and to improve the accountability of local officials to their local constituents for provision of local services. Third, clarity and a full understanding of the budgetary implications of the expenditures assigned to subnational governments is needed to design the intergovernmental system and to determine both the level of revenue and the revenue-elasticity local governments will need. Fourth, since economic efficiency is an important goal, the central government should encourage local government revenue mobilization. For efficient local government operations, some autonomous taxing power must therefore be assigned to subnational governments. Fifth, for the above reasons and since equity may well be a dominant goal given regional disparities, a formula grant should weigh heavily in the system, and a

premium should be placed on developing transparent formula indicators to support some equalization of per capita local government fiscal capacity. Sixth, since many functions suitably delivered by local governments are most appropriately financed by user fees and are not at present so financed, or have uniform national prices which are set without regard to local cost conditions, greater local pricing discretion will also be desirable. Finally, given the infrastructure backlog, the system should incorporate mechanisms to support public infrastructure development and its appropriate financing by central or local governments.

IV. THE LEGISLATIVE AND REGULATORY FRAMEWORK FOR DECENTRALIZATION

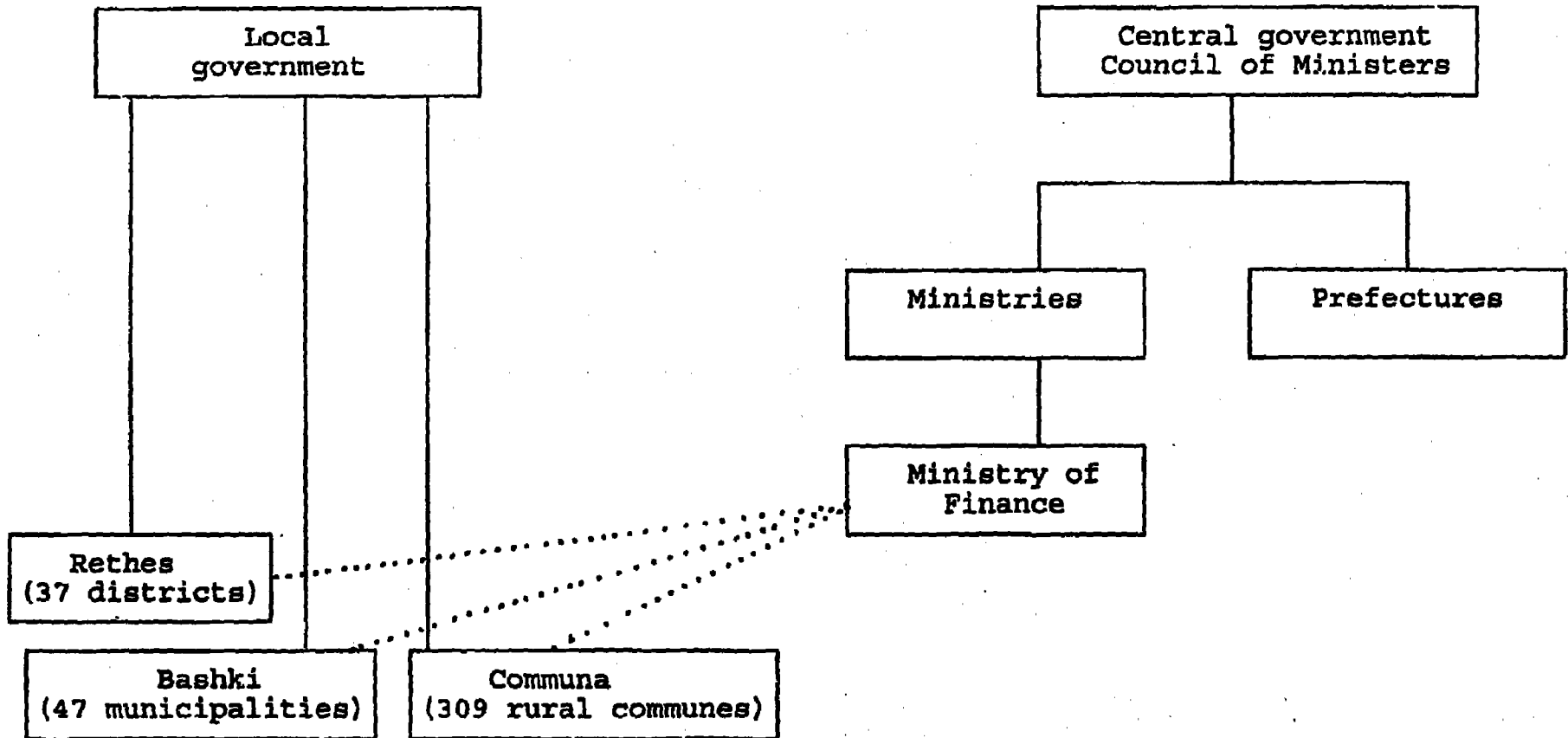
The Constitutional Framework

24. Three layers of government are specified in the draft constitution now being considered by the Constitutional Commission of the Albanian Parliament: the communes and municipalities, the 37 district governments (the higher level of local government), and the central government. The draft constitution defines the relationship between these layers of government and the issue of the role of the judiciary in adjudicating disputes between layers of government in general terms. (chart 1)

Recent Legislation Affecting Local Government

25. Albania has taken a number of steps towards decentralizing and deconcentrating government functions. Most importantly, *The Law on the Organization and Functioning of Local Government* (Law No. 7572) was passed on June 10, 1992 and was immediately followed by the first local elections of district, commune and municipal officials in July 1992.

Figure 1 Government structure



Note: According to the draft Constitution, local governments and the central government have equal power. Dotted lines indicate the Ministry of Finance is the principal source of funding for local governments.

26. The problems that have emerged since the local elections have their origin primarily in vagueness in this Law, which gave local governments an impressive number of responsibilities but did not specify either how these responsibilities were to be financed, or the division of labor where local and national governments share responsibilities.

27. The division of powers and the fiscal capacity to carry out these powers need to be clarified to promote accountability of both levels of government. Until these problems are resolved, there is also likely to be considerable frustration of central and local government officials leading to a corresponding amount of intergovernmental tension. In addition, lapses in service provision may occur if responsibilities remain unclear.

28. The government of Albania moved to address these outstanding issues in mid-1993 by establishing an intergovernmental Task Force on decentralization charged with preparing legislation on the functional responsibilities and financing of local government. This legislation consists of: (i) a Law on *Local Budgets*; (ii) amendments to the Law on *The Tax System in the Republic of Albania* and a Law on *Asset Ownership of Local Government*. The first two address the financing of local government and deal with both transfers from the central government and revenue sources that the local governments have the power to tap themselves. The Law on *The Asset Ownership of Local Government* is an indirect attempt to assign spending responsibilities to local governments by allocating ownership of governmental assets between central and local governments. The status of this legislation as of the first quarter of 1994 is that the *Law on Local Budgets* was passed by Parliament on December 22, 1993 (Law No. 7776), while the other legislation is in draft form and is still being considered within the government. These laws address the key dimensions of designing an intergovernmental system: the allocation of functions and their

financing.

Prefectures

29. Another interesting development in the process of decentralization and deconcentration in Albania has been the introduction of a prefecture system. The prefecture system in other countries which have such an institution is the regional arm of the central government, although the importance of the prefects has greatly diminished with the rise of elected subnational governments in countries such as France.

30. *The Law of Prefectures* (Law No.7608) was passed on September 22, 1992. The introduction of this Law closely followed the first local government elections, in which the opposition parties in Parliament did much better than they had in the previous national elections in March 1992. The primary objective of the prefectures is stated in the *Law of the Prefectures* as being "to coordinate the activity of the ministries and other central institutions in the administrative territorial units". Article 5 of the Law indicates that the prefectures are not to have supervisory powers over departments of the central government, however: any disputes between the prefectures and the departments are to be settled by the Council of Ministers.

31. Article 4 of the *Law of Prefectures* is careful to specify that the Prefectures and elected local governments are to be totally independent institutions. The prefectures are, however, given the right to stay local government by-laws or legislation while the courts decide whether this legislation is constitutional. The *Law on Local Budgets* indicates that the Prefectures are to have no responsibilities with respect to local government budgets; the Law specifies that a copy of these local budgets are simply to be forwarded to the relevant Prefectures for information.

32. The functions of the Prefectures therefore remain somewhat of a mystery at the present. In July 1993, however, the government approved the formation of 12 Prefectures with a total establishment of 180 positions. It may be that the prefects will have potential significance. *The Law of the Prefectures* emphasizes a substantial role for them in internal security: they are to be responsible for civil defence, for example, and to "supervise" the police.

V. ASSIGNING EXPENDITURES

Principles of Expenditure Assignment

33. What are the respective roles of central and subnational governments? Typical functions of both levels of government are indicated in Box 3. Traditional public finance theory suggests that an "efficient" expenditure assignment between levels of government is based on the geographic dimensions of benefits. That means, ideally, that each locality should provide, and pay for, services whose benefits accrue within its boundaries, and, to the extent possible, spending responsibilities should be given to the *lowest* level of government *consistent with the efficient performance of that service*. The reasoning is that local populations with differing tastes and preferences will receive those public services which they want—not what is centrally determined. Thus, the center will be responsible for functions with national benefits while local governments will provide services to benefit local residents.

34. This decentralization principle has important corollaries. Where there are important economies of scale, for instance, it may make sense to centralize provision of such services. In addition, a case is often made for central government involvement in sectors such as health and education on the grounds of "spillover effects", or "externalities." Spending in these sectors is important for national economic

Box 3: Who Does What? Functions of Central and Local Governments

Typical Central Functions. Among the functions commonly assigned to the central level of government are: defense, post, and telecommunications; national roads and highways, ports and civil aviation (if these are in government hands at all). These services provide benefits beyond any one local jurisdiction and are typically the responsibility of the national budget. The courts, enforcement of national laws, foreign affairs and diplomacy, industrial and environmental legislation and interregional commerce are also usually seen as "national level" functions of government.

Typical Local Functions. Among the public services best delivered at the local level (with local decision-makers deciding what services are provided, to whom, and in what quantity and quality) are: transportation services such as construction and maintenance of local roads and provision of public transit; security services such as fire protection and enforcement of local laws; public utilities such as those for water, sewage and various forms of energy distribution; general urban services such as provision of parks, recreation facilities, markets and slaughter-houses. These are all examples of services whose benefits favor the local area, and which are often provided by local governments.

Spillovers. In between are expenditures on education and health and social welfare. On the one hand local schools and clinics clearly benefit residents of the local area; on the other, a well-educated and healthy population has national benefits also. Because of these benefit "spill-overs", the responsibility for education and health is often a national one, or when it is local, the central government may assist local governments in providing services to a certain standard. In the latter instance, the service is delegated, but not fully decentralized.

Shared Responsibilities. Sometimes both levels of government share spending responsibility within a sector: local governments may provide kindergarten and primary education with the central government providing higher education, for instance. In practice, there is much variability in spending responsibilities and while the allocation of functions described here provides a guide, the decisions as to which level of government provides a service are as much a function of a country's historical and political heritage and tradition of local autonomy as of the economic efficiency principles we have outlined.

Government Provision versus Privatization. The assignment of functions between the levels of government might seem to be complicated in the economics in transition by the fact that provision of many goods and services previously supplied by governments are now being privatized. In fact, the extent to which goods and services now supplied by governments are public rather than private goods is debatable even in the market economies. Many market economies are currently privatizing functions such as utilities in transportation and communications; even entire postal systems are being considered for privatization in some countries.

Responsibility versus Delivery. Finally, governments need not always themselves directly provide services for which they are responsible. In market economies, many local governments contract for services to be delivered by the private sector: garbage collection is a typical example. Local governments can even contract with *higher* levels of government: Canada's Royal Canadian Mounted Police supplies services under contract to many provinces and municipalities. Equally, even if the central government is responsible for functions such as poverty relief, it does not need to deliver the required services itself and can delegate these functions to local governments. For instance, the Albanian social assistance program, *ndihme ekonomike*, is centrally funded but managed by local governments.

development and national welfare and income distribution, and if left to local governments alone, they may not provide enough of these services because only some of the benefits will accrue to their local

residents. Commonly, the central government may delegate responsibility for functions with such external benefits to local governments but also provide transfers to increase their supply. In transition economies, it is also often argued that responsibility for the social safety net should not be left to local governments. If one believes that the provision of a safety net is a national priority during the difficult transition ahead, then the center should have a predominant role in its financing (as it does in Albania).

Who Does What in Albania?

35. The traditional "benefit area" division of responsibilities between central and local governments, based on public finance theory, holds that local governments should provide services that benefit the local jurisdiction while the central government provides those with a national benefit area (Musgrave 1983). How Albania's assignments square with these principles is described below.

Responsibilities for Local Infrastructure Services

36. Current thinking concerning the allocation of responsibilities to local governments in Albania seems to parallel the assignment of such responsibilities in theory and in many market economies. The draft *Law on Asset Ownership of Local Government* proposes to transfer to local governments significant responsibilities for local infrastructure, including facilities and equipment for streets and streetlighting, water and sewerage systems, urban transit, firefighting, garbage collection and local recreational and cultural facilities such as museums, sports stadiums and parks. Local police powers are the only function often undertaken by local governments in market economies that do not appear to be under consideration for transfer to local governments in Albania. The proposals also include transfer of all local

"hard" infrastructure services with the exception of electricity reticulation. Most of these services are now provided by state enterprises reporting to the Ministry of Construction.

37. As noted above, assigning responsibility for provision of infrastructure services to local government does not mean that this level of government has to provide these services. For instance, the central government is interested in privatizing solid waste management services even before transferring responsibility for them to local governments -- including streetcleaning, solid waste collection from households and maintenance of public parks. These services are presently provided by 64 state enterprises. It is anticipated that these services can be provided by performance contracting with the private sector, as in many OECD economies.

38. **Water and Sewerage Systems.** Some responsibilities for these functions have already been transferred to local governments. For instance, there are 75 water borne sewerage systems serving some 30% of the population in Albania and 250 water systems serving 80% of the population. The central government continues to maintain jurisdiction over all of the 75 sewerage works but only 6 water works which rely on the same water source. The remaining 244 water works are the responsibility of the municipalities and districts they serve, in the limited sense that these local governments are responsible for paying for their operation and maintenance costs from tariff revenues. Such investments as there are in these water systems are still controlled centrally, however, with investment priorities being determined at the national level as part of the public investment program. This may be all that can be done for the time being, but over time, and as fiscal accountability increases, greater decentralization will be appropriate. Further, the water tariffs that local governments can charge are subject to a price ceiling set by the central government without regard to cost differences between areas or any particular level of

cost recovery. This kind of central pricing mandate prevents localities from moving towards cost recovery (section VI).

39. **Irrigation.** The development of local authority for irrigation systems in agriculture is an example of the development of local government which is comparable to the formation of the many special purpose districts in OECD countries. Although Albania is rich in water supplies, seasonal irrigation and drainage are necessary for adequate crop growth, especially in the country's fertile coastal plain. Some 417,000 hectares, or roughly 60% of all arable land, were serviced by irrigation systems before 1991. Unfortunately, this irrigation system was one of the principal pieces of social capital which suffered extensive destruction in the jacqueries accompanying the fall of the old communist regime in 1991-1992. Destruction and theft was confined mostly to the former cooperative farms which accounted for 74% of the total area under irrigation, and extended from pumping stations to high voltage electricity lines and even to the concrete linings of irrigation canals. In addition, the operation and maintenance of the irrigation system was previously based on the old cooperative and state farms. Privatization of the latter posed institutional problems in undertaking maintenance and collecting user fees from the multitude of newly-created small holdings -- some 400,000 farms averaging about 1.4 hectares have been created as a result of privatization by the end of 1993. These factors, along with restrictions on system maintenance because of central budget constraints, reduced irrigation to 31% of the irrigation "command" area in 1992 and 19% in 1993. These were dramatic developments in a poor economy where agriculture is the main employment for 50% of the labor force.

40. Rehabilitation of the most cost-effective parts of the irrigation system has accordingly been a priority for the government and international lending institutions. (The first World Bank operation in

Albania -- the Critical Imports Project in 1992 -- included an irrigation component for the most urgent repairs to infrastructure and also provided funds to prepare a Water Code and legislation for Water Users' Associations). A proposed \$10 million International Development Association credit is presently being appraised by the Bank for rehabilitation of irrigation and drainage systems serving some 57,000 farm families in 7 districts in the coastal plains.

41. At present there are 37 district-based Water Enterprises, although it is suggested that these Enterprises might eventually be merged into larger organizations covering the main river basins in the country. The Water Enterprises in turn sell water on a wholesale basis to emerging Water Users' Associations, which are based on villages. Although the irrigation system was previously based on cooperatives and state farms whose boundaries did not necessarily coincide with those of villages, after the privatization of agriculture, the villages were found to be the only well-functioning local social unit in the countryside. The Water Users' Associations are comprised of elected village representatives who consolidate water purchases from individual farmers, collect water fees and enter into contracts with the Water Enterprises for scheduled deliveries.

42. **Transport.** Of the various means of transport, local governments have no responsibility for marine transport, ports and railroads, but they do have responsibility for local roads. Roughly 8,200 km of the total national road network of 18,000 km. are classified as "local" roads connecting small urban centers with rural communities. A further 7,800 km. of "main" roads connect main cities with each other, and the 1,800 km. of "economic" roads serve industrial and mining centers. Excluding the economic road network, local roads constitute 51% of the road network but are allocated roughly 30% of total road expenditures in the national Budget. Owing to economic stringency, most road expenditures have been

restricted to basic maintenance in recent years. Recommendations as to total expenditures in the National Budget, as well as the allocation of expenditures between main and local roads, are made by the National Roads Department. This Department also provides technical assistance to local governments and supervises road works that local governments undertake.

Responsibilities for Non-Infrastructure Services

43. The draft *Law on Asset Ownership of Local Government* also indicates a willingness to have a considerable local government presence in the delivery of "people" services. Social insurance (*ndihme ekonomike*), is now a centrally funded program that is managed by local government. Also under consideration is the transfer to the communes and municipalities of all facilities for *kindergarten, primary and secondary schooling* as well as *vocational schools* and schools for the *handicapped*. In the health sector, the draft *Law on Asset Ownership of Local Government* proposes a transfer of facilities such as *ambulances, pediatric clinics, health centers and local clinics* to communes and municipalities. *Hospitals* and other health facilities would be devolved to the district level of local government. It is recognized, however, that efficiency in the health system could be improved through establishment of catchment areas for secondary health facilities which are larger than the existing districts. For this reason, most district hospitals are being downgraded so that they offer only the most basic inpatient care while a small group will be upgraded to offer comprehensive care to larger multi-district catchment areas. Responsibility for *public welfare institutions* such as *orphanages* and *old-age homes* are covered by the new *Social Assistance Law* (Law No. 7710, adopted by the Albanian Parliament on May 18, 1993). Institutions with district, commune or municipal responsibilities are transferred to those levels of government while institutions dealing with multiple districts are administered directly by the Ministry of Labor and Social

Protection. Each of these assignments of responsibilities raises issues which are discussed further below.

Issues Raised by Present Expenditure Assignments

44. **Capital vs. Recurrent Spending.** Some concerns about the proposed transfers should be flagged. First, it is not clear if *operating responsibility* comparable to responsibilities for facilities will be transferred to local governments: the draft *Law on Asset Ownership of Local Government* only deals with facilities. It might seem commonsense that capital and operating responsibilities for these functions should go together, but no proposals have yet been made public concerning future operating responsibilities for local infrastructure. Local governments should be assigned responsibility for capital expenditures in sectors for which they also have recurrent responsibility. Substantial problems would arise if operating and capital responsibilities were separated for the same functions.

45. **Quality Standards.** Second, the proposed transfer of responsibility in education and health raise questions as to whether *national standards* will be attained by local governments; for instance, in adherence to national curricula or in hiring suitably credentialed teachers and medical personnel. Since the responsibilities for health and education under consideration for transfer to local governments can realistically only be financed by transfers from the central government, requirements concerning standards *should be a condition of such grants*. The *Law on Local Budgets* has provisions for such conditional grants in its "constituent" budget section (see Section VI below).

46. **Maintenance and New Investment.** Nor does the draft *Law on Asset Ownership of Local Government* indicate who will be responsible for *incremental capital expenditures* in these areas. Who

will build new schools or new hospitals or maintain existing ones? If local governments are to have responsibilities for infrastructure, they need to be able to finance them. But perhaps the center plans to retain this responsibility. Some possible capital and infrastructure financing mechanisms are outlined in section VI below.

47. **Social Assistance.** Social assistance in Albania is at present centrally funded but locally managed, and provides benefits for families whose incomes fall below subsistence levels. The program is funded by a quarterly grant to communes and municipalities from the Ministry of Labor and Social Protection. Funds are allocated on the basis of indicators of need such as the number of disabled, the number of unemployed whose entitlement to benefits will expire in the forthcoming quarter, etc.

48. While the Ministry of Labor and Social Protection determines these guidelines, communes and municipalities themselves decide which families receive aid and how much each family will get. Further, the scheme is administered at the local level by administrators who are hired and employed by the local governments, but have been trained in part by the Ministry of Labor and Social Protection and are paid for by the grant to local governments.

49. In many ways, the new *Social Assistance Law* is a model for *delegation* of responsibilities and financing of functions from central to local governments. The conditional grants for this purpose are easily included in the "constituent" budgets of local governments as specified in the proposed *Law on Local Budgets*.

50. **Education.** As can be seen in Table 4, Education is presently the second most deconcentrated

ministry after Construction. Only a third of the ministry's budget is being supervised directly from Tirana, while two-thirds is managed by employees of the Ministry at the local level. The draft *Law on Asset Ownership of Local Government* would imply a transfer of responsibility to the *elected local governments* for physical *facilities* in education.

51. No proposals have been made public for comparable *operating* responsibilities to be transferred to these local governments, however. Will local governments be given full responsibility for primary and secondary education? This could very adversely affect educational quality, if underfinanced localities cannot afford to hire qualified teachers or maintain full curricula. It would certainly lead to emerging differentials in service provision unless the center requires standardization of teacher quality and curricula or other conditions, as appropriate.

52. Any transfer of educational responsibilities to local governments should be financed by transfers through the "constituent" sections of local budgets (see Section VI below). Such transfers are strictly conditional grants. The Ministry of Education should require quality assurances as conditions for such grants—such as that only nationally credentialed teachers be hired or that a national curriculum be adhered to.

53. **Health.** Health spending authority has also been substantially deconcentrated in the past: sixty-one percent of the Ministry's budget for 1993 being under the authority of Ministry officials working at the District level. New national health strategies currently being presented and discussed would appear to call for even more emphasis on such deconcentrated management. The government's strategy paper of April 1993, "A New Policy for Health", calls for substantial rationalization of health care delivery,

including substantial reductions in facilities, bringing the remainder up to a fully operational state, and appointment of District Health Directors who will be responsible for all public health activities in their respective districts.

54. The proposed transfer of capital responsibilities in health to local governments in the draft *Law on Asset Ownership of Local Government* appears to conflict with the emphasis on deconcentration in the emerging national health strategies. For instance, as in the case of education, it is proposed in the *Law on Asset Ownership of Local Government* that capital responsibilities in health will be transferred to local governments. If so, who will cover recurrent costs? Again, it would seem to be a mistake to separate operating and capital responsibilities.

55. As a final comment, developments in the field of health illustrate that uncertainty about the extent of deconcentration and decentralization poses problems for planning by local governments. This uncertainty is best removed. Further, quality control and coordination issues remain.

VI. REVENUE ASSIGNMENT AND DESIGN-FINANCING

MODALITIES

56. The key challenge in financing local governments in transition economies is to determine the actual costs of providing the services they are expected to provide, and design a system for tax assignments, shared taxes, transfers and fees that provide sufficient revenues to meet the assigned expenditures. General principles of financing local governments are set out in box 4. Box 5 considers other sources of local government revenues such as user charges. Table 5 suggests possible financing

vehicles for the various functions to be assigned to local governments in Albania.

Box 4: Financing Local Government: Taxes and Transfers

Where it is impractical to impose fees or levy user charges, services should be financed principally by taxes levied on local residents. In many market economies, local governments rely principally on the property tax, but revenues can, in principle, come from many sources, and there are several models for providing local governments with revenues. For example, taxes can be "assigned" to different levels of government or shared between levels of government. Some countries allow "joint" tax powers (sharing the tax base) by allowing local surcharges on federal taxes, such as the personal income tax.

Redirection of a large share of revenues to local governments can restrict the center's macro-economic flexibility, however, and care needs to be taken in deciding which taxes to assign to local governments. There are obvious advantages to assignments of particular taxes such as the property tax to the exclusive use of local governments and "piggybacking" or surcharge schemes which allow localities to set their own tax rates on tax bases shared with higher levels of government. Such exclusive assignment of tax bases and piggybacking arrangements increase the accountability of local governments and render them less vulnerable to unilateral withdrawal of support from higher levels of government.

In most countries, subnational revenues are supplemented by transfers, since the central government typically takes the highest yield taxes for itself, and subnational governments are assigned more expenditure functions than can be financed by their own revenue sources. In addition, services provided by local governments acting as the agent of the central government should be financed by appropriate transfer payments from the national budget.

The first step in designing a transfer system is to determine the aggregate volume of the transfer; the second is to determine its distribution across governments. Transfers can be negotiated on an *ad hoc* basis or, preferably, set according to some clear and agreed criteria—often a formula is used to provide budgetary certainty. This transfer formula will typically: (i) estimate minimum or "normed" subnational expenditure "needs" (based on assigned expenditures and often related to population, per capita income, social indicators or the actual cost of delivering services); and (ii) assess the local government revenues ("own", assigned or shared) available to finance these needs. In designing the transfer, central governments are often concerned that local government's "revenue effort" will decline if they become too dependent on transfers. Depending on how much interregional equalization of expenditures is desired, transfers will fill all or part of the expenditure/revenue "gap".

To encourage or require spending in specific areas, "matching" or conditional grants may be used. Matching grants augment local spending for a specific purpose by prescribed amounts of support by higher level governments (e.g., dollar for dollar). A problem with most (but not all) matching grants is that they may provide greater benefits to wealthier local governments that can afford greater discretionary expenditures. Conditional grants are the usual form of support where higher levels of government are delegating functions to lower levels. For instance, support for health services may be conditional on residents from other localities having access to treatment; support for education may be conditional upon adoption of a prescribed curriculum. A block grant is a conditional grant restricted to a specific set of expenditures, or one that may be used for a broad category of expenditures and which has only general conditions attached.

57. The new local financing system under consideration in Albania envisages two sources of funding: the taxes and fees that the local governments can raise for themselves (described in the proposed changes to the law on *The Tax System in Albania*), and transfers from the central government (described in the *Law on Local Budgets*).

Constituent and Independent Local Budgets

58. The *Law on Local Budgets* envisages local budgetary discretion in funding and providing some local services. According to the Law, each local government will have two parallel budgets. First, the *constituent* local budgets will be comprised of funds from the central government for "delegated" programs supervised by the central government ministries, but carried out at the local level. These are strictly conditional grants for performing specific functions and funds are not transferable between programs.

59. The second component of local government budgets is to be called the *independent local budget* section and funds here may be used for any purpose specified by local governments. Revenues in the independent budgets are to be derived from local taxes, fees, income from revenues and asset sales of enterprises owned by local governments, and funding from the budget of the central government. Revenues in this independent local budget can be transferred between uses. In effect, the central government contribution to this component of local government budgets amounts to an unconditional block grant.

60. The *Law on Local Budgets* came into effect in December 1993. It represents an imaginative

approach to financing local governments. It should increase accountability and transparency with respect to intergovernmental financial relations and represents a marked contrast with the individually negotiated transfers that were characteristic of the previous regime.

Local Own Source Taxes

61. Most of the 22 revenue instruments now proposed for local governments in draft amendments to the Law on the *Tax System in the Republic of Albania* are very minor "service fees". These are charges for services such as fees for registering mortgages and other legal documents. The objective of these service fees is simply to recover costs incurred in their provision; they are not true general revenue-raising instruments. Albania has not yet decided how much additional revenue will be given to local governments over and above that arising from taxes assigned to them in the draft law on taxes. Almost certainly the required revenues will be substantial because the assigned taxes will not likely yield very much --in many countries they would be considered "nuisance taxes" --complicated to administer and generating very little revenue.

62. The objective of local autonomy involves local governments having the power to raise their own revenues, being able to set their own tax rates and being answerable to their electors for these taxing decisions and the level of services they finance. In this respect, there is a very positive feature of the draft amendments to the Law on the *Tax System in the Republic of Albania* which are being proposed to accommodate local government taxes. In many instances, local governments are given a range of rates that can be applied for a particular tax. This element of discretion in local setting of tax rates is to be welcomed. Indeed, as we shall see it might be emulated in other areas where price or rate fixing by the

central government considerably detracts from local government fiscal flexibility and discretion. As we saw in box 3, there is wide agreement on the principles that should determine the selection of local taxes. Most notably, it is recommended that local government should levy taxes on immobile bases and preferably bases that reflect benefits received from local government services. Other characteristics of a good local tax are that it be visible, have a stable and predictable yield, be relatively easy to administer and not be "exportable"

63. **Property Taxes.** Most of these criteria of a good local tax support the use of a tax on immobile property and there is also considerable intuitive appeal to the use of property taxes. Local property values are closely linked to the extent of the infrastructure services that support them, such as street construction, maintenance and lighting. Property taxes are therefore attractive on "benefit" grounds.

64. The use of property taxes is widespread. Out of 24 OECD countries for which data are available, for instance, 20 levy some form of property taxation. Property taxation has been a mainstay of local governments in English-speaking countries, but is not restricted to them. The property tax is the main source of local government taxation in Holland, and has also been introduced in recent years in Mediterranean countries such as Portugal, Spain and Italy. The case of Italy is perhaps most interesting, because it is Albania's neighbor and the principal national donor of aid to Albania. It has long been recognized in Italy that the country's local governments have been overly dependent on transfers and need to acquire their own sources of revenues to increase their autonomy. A national property tax has been introduced in Italy and is to become a local property tax with locally established rates in 1994.

65. In these circumstances, it is natural that the government of Albania has been interested in introducing a property tax, primarily to support local government. The government has sought advice from the U.S. Treasury and the Harvard Institute for International Development on the formation of such a tax.⁷ Some preliminary steps would be necessary to implement a conventional property tax, including the introduction of a cadastre, or land ownership register. The government has not, however, been able to attract the international assistance necessary to introduce such a full-blown property tax and has decided to introduce a more limited version. The *Property Tax Law* passed in mid-March 1994 requires the central government to undertake property valuation, to set the rates and to administer the tax, but for 60% of the revenues to be distributed to local governments according to the source of the revenues. In rural areas, the tax would be assessed on the fertility of land, like the presumptive taxes assessed on agriculture in many developing countries. In urban areas, the tax would be restricted initially to the value of buildings.

66. Some comments on the proposed Albanian property tax are called for. First, there is little sense in which the tax is now a *local* property tax, since neither the assessments of property values, nor the tax rates nor the administration of the tax are to be performed by local government. The assessment of property tax values and perhaps even administration of the tax are not essential to its character as a local tax. Higher levels of government commonly intervene in or even determine assessments of property values in many countries for various reasons. One reason that might alone justify central government determination of assessments in Albania would be to have comparable property values for calculation of equalization of local government fiscal capacities.

67. The freedom of local governments to set local tax rates is, however, essential to the property tax

being a true local tax. If local governments do not determine the tax rates, the property tax is merely another source of revenue to local governments and does not contribute to their accountability to local taxpayers nor to their autonomy.

Equalization

68. Property taxes will obviously yield greater revenues to some municipalities and communes than others. Not all municipalities will have as valuable a property tax base as Tirana, where rents of \$1,000 a month were paid for prime retail locations in early 1993 at a time when annual GDP per capita was much less than \$300. Equally, communes with prime agricultural land will obtain greater revenues than others from the property tax. "Equalization" grants from the central to local governments may be desirable to assist local governments with such lower yielding tax bases.

69. Many industrial states such as Canada and Germany and some developing countries such as Morocco have the goal of equalizing revenues of subnational governments. The objective of these revenue equalization programs is not to provide some form of guaranteed income for local governments but to attain goals which directly benefit *individual citizens*—goals such as treating citizens equitably no matter where they live in the country and increasing efficiency in the allocation of resources and hence the standard of living. The equity goal is an adaptation of the rule that likes should be treated alike by government. In a regional context, this means that individuals who are equally well-off should be treated the same no matter where they reside in Albania.

70. Equalization is necessary to attain these equity and efficiency goals because the "fiscal capacities"

of local governments differ. Thus, the fact that rental values are higher in Tirana than in less well-off localities would be reflected in higher per capita realizations of a property tax levied at the same rates throughout Albania. The result would be the residents of Tirana would benefit from greater "net fiscal benefits" because the city would be able to finance its municipal services with less fiscal effort than other cities.

71. Equalization compensates for such difference in fiscal capacities between local governments by redistributing income to the less well-off local governments. Not only will this increase equity but it will also efficiency in the allocation of resources. Without equalization, people will eventually migrate to capture such net fiscal benefits and such migration is inefficient. To attain efficiency in the allocation of resources, the productivity of workers (and for that matter, capital), has to be the same in all areas of the country. Otherwise, national output could be increased by moving labor and capital around until productivity is equalized. This is exactly what normal migration to get better jobs achieves, but productivity is not increased if migration occurs to capture the fiscal benefits described above. Equalization payments to local governments with below-average fiscal capacities will allow them to increase their services or lower their tax rates. This will, in turn, reduce fiscally-induced migration.

Other Possible Local Taxes

72. Local income taxes are the principal source of tax revenue in about half of the OECD countries. They are particularly important in the Scandinavian countries (Sweden, Denmark and Norway), where local governments have been assigned significant roles in the delivery of the "people" services of health, education and social welfare services and are, as a result, relatively large in relation to central

governments. The local governments in these Scandinavian countries determine their own tax rates as a share of the national government's income tax base. The larger subnational governments in some other countries, such as the provinces in Canada, also apply surcharges on income tax bases determined by central governments. In the opinion of many experts, such surcharges or piggy-backing arrangements should be used more widely, since they preserve a common tax base, maintain the autonomy of local governments and make them accountable to local taxpayers.

73. It is generally agreed, however, that piggy-backing by subnational governments on a multilevel consumption tax such as the VAT would be very difficult if not impossible. Albania's proposed reliance on a value-added tax as the principal national source of tax revenue, as well as the prospective unimportance of income taxes for the immediate future, suggest that local government surcharges on a central government tax base are therefore not a practical possibility in Albania.

Business Taxes

74. There is also general agreement that local governments should be restricted from tapping some forms of revenue in order to perform their important role in efficient allocation of resources. The principles that should be observed are that local government taxes should not distort the location of factors and that local governments should not have a claim on taxes generated in their localities that are borne by *nonresidents*. Natural resource revenues are a case in point that are of some significance, given that Albania is one of the largest producers of chromium in the world and is an exporter of other minerals as well. Higher property tax rates for businesses than housing which are not justified by differences in service levels are another example,⁸ as are sales taxes applied at other than the retail level such as the

present turnover tax in Albania.

75. While it may be attractive for local politicians to try to shift the burden of taxes to nonresidents, such tax exporting artificially cheapens and inflates local provision of services and thereby erodes the efficiency benefits contributed by local governments. To prevent the "exporting" of such taxes to nonresidents, the central government should restrict their use by local government.

76. Business taxes used to raise revenues (and not charge for services rendered) are considered undesirable for the above reasons. Business taxes in France and Canada are cases in point. The tax professionnelle raises 40% of local taxes in France and it is estimated that from 42% to 73% of this tax is exported beyond the taxing locality.⁹ Business taxes account for about one-tenth of local taxes in Canada and it is estimated that from 16% to 100% of such nonresidential local taxes are exported from the locality levying the tax.¹⁰

Revenue Sufficiency

77. What other revenue options are there? The center could simply share some of the revenues it collects with local governments. Simple revenue-sharing according to the area of origin of central government taxes -- the "derivation" principle -- could be problematical, however, since it could be severely "counter-equalizing". As shown in Table 6, most revenues are collected in only a few districts -- Tirana and Durres collect almost 50% of all revenues, but have less than 20% of Albania's population. Thus, the simplest scheme of sharing revenues according to the district of their origin (or collection) would not be adequate to support maintenance of national standards in services such as health, education

and social assistance. Put another way, the poorer districts would not be able to provide adequate levels of services, including those that are commonly thought to have large spill-overs, if central revenues were shared by district of origin. Revenue-sharing also suffers from other problems, in that it decreases the accountability of local governments. As U.S. experience under the Reagan administration also indicates, revenue-sharing can be altered unilaterally by higher level governments and consequently decreases the autonomy of local governments. Some other sharing basis than this derivation principle, probably a formula based on expenditure needs and/or other indicators, would be appropriate (see Section VI).

78. **Local vehicle taxes could also be used with profit in Albania. Private ownership of automobiles was banned in Albania until early 1991, but there is evidence of impressive growth in their ownership since then -- and in the private and social costs of such growth. For instance, in 1993 Albania had the highest road accident rate in Europe, leading to a death rate per vehicle-kilometer about 20 times that in Italy. A *local* tax on moveable property -- automobiles and other vehicles -- would be a useful proxy for a tax on local road use. Those fortunate enough to own cars in Albania are much better off than the rest of the population and can well afford to pay this and other taxes on road use (such as import duties for automobiles, licensing fees and excise taxes on automotive fuels imposed by the central government.)**

User Charges, Local Pricing Discretion and Central Pricing Mandates

79. **In addition to revenues from taxes (for the independent budgets), and block grants (for constituent budgets), local governments in Albania also derive income from enterprises that now fall or will fall under their responsibility, including *local utilities*. At present, the central government maintains**

jurisdiction over all 75 of the water borne sewerage works and for 6 of the nation's 250 water systems. Sewerage service, where provided, is at no charge to the consumer with costs of provision being assumed in the national budget. In the case of the water works, investment priorities, funding for investment and prices or tariffs to consumers for all 250 systems have been set by the central government. The local governments which have responsibility for operation and maintenance of 244 of the water systems are expected to finance the service with revenues from tariffs. However, the tariff has been set by the central government at a uniform nation-wide level that ignores local cost differences in supply of these services and has not covered operating and maintenance costs except for a few works. Not unnaturally, the result has been a lack of commitment to the service by the local authorities and deferred maintenance. Further, customers are billed at a flat rate that gives them no incentive to conserve. Local authority to set tariffs and an appropriate pricing policy is essential to improve service and promote full cost recovery for these utilities.

80. Concerning irrigation pricing in agriculture, Albania is credited by international specialists with having established a simple and effective user-pay system which could provide efficient water pricing on a per-unit basis. Current pricing levels, however, are insufficient to cover overall costs of system operation and maintenance and to pay for investments required for system rehabilitation. In addition, and as for other utilities, fees are centrally fixed and do not make allowance for different levels of costs for providing water or artificial drainage in different areas. It will therefore be necessary to revise the current level of water charges to attain full cost recovery and reflect actual district-based expenditures incurred by the respective Water Enterprises and allow greater local pricing discretion and cost recovery. In these and other examples of utility pricing, an appropriate role for the central government would be to set framework policies to guide local tariff determination and to abstain from micromanagement of

local utility pricing.

Box 5: User Charges and Fees as "Own Source" Revenue for Local Governments

The principal "own source" revenues of local governments, or revenues that they themselves levy, are fees or charges and taxes. The distinction between the two revenue categories is that taxes are compulsory payments for public services which do not vary with the level of consumption of specific goods and services, whereas charges and fees are collected from the recipients of specific services and often vary with the extent of consumption of the service. Charges and fees therefore represent a specific attempt to link the benefits and costs of local government services and are often referred to as user fees.

Three types of fees or charges have been distinguished: public prices, specific benefit charges and service fees.³ Public prices consist of direct charges for services consumed, such as bus fares or public utility rates for water reticulation or entrance fees for public recreational facilities such as swimming pools. Specific benefit charges are more indirect in nature, such as "development charges" or "local improvement charges" levied to cover the costs of local improvements such as sewer extension, streetlighting or other infrastructure costs associated with the development of new housing subdivisions or estates. Finally, service fees are charges for bureaucratic services such as provision of marriage licences or other mandatory legal documents.

It is not often appreciated how important user fees and charges are as a source of local government revenue in developed countries. For instance, they account for as much of 40% of revenues raised by local taxes in OECD countries.⁴ The feeling that beneficiaries of many local government services should pay their own way is also strong in some countries. Thus, the U.S. Advisory Committee on Intergovernmental Relations has found that Americans express a strong preference for user charges as opposed to other means of raising government revenues.⁵

Many experts think that even more use might be made of user fees than at present by local governments; their motto is "wherever possible, charge".⁶ The case for using user charges to pay for services is in fact an important corollary of the principal rationale for local government, which is its efficiency role. As in private markets, users of local government services have the choice of buying or not buying services and their actions indicate whether provision of services is efficient *if fees cover costs of provision*.

It is also relevant to consider the conditions under which the use of fees and charges are inappropriate. First, distributional effects should not be important considerations where user fees are contemplated; here there is a feeling that beneficiaries should not be required to pay their own way. In addition, it must be possible to identify beneficiaries so that those who are not willing to pay for the service can be excluded. Nor should externalities be significant. Thus, local government health clinics in OECD countries often choose not to impose user fees for immunization against contagious diseases, for example.

We conclude that there is a strong case for user fees as a principal source of local government revenue and we suggest that more use might be made in Albania of such fees.

A Smaller Role for Social Pricing?

81. As is well-known, the former command economies used pricing policies as a tool for redistributing income. Albania provides a number of examples of pricing policies, often involving local utilities or affecting local governments, that have been apparently undertaken either for distributional reasons or in the belief that price ceilings imposed would contribute to macroeconomic stability. What is interesting is that such policies often have perverse or questionable distributional effects. The cross-subsidies involved in the present uniform national pricing policy for water services to households are a case in point, since costs of supply vary by locality in a way that is not obviously correlated with the need for income support. Nor is it obvious why the 30% of the population which receives sewerage services at no cost are more deserving than those who receive no government-provided sanitation service at all.

82. There are, in fact, more obvious examples of mischievous effects of misguided pricing policies for infrastructure and other utilities than those mentioned. For instance, automobile owners are among the better off in Albania, and until recently they have also benefited from subsidized fuel prices. These subsidies, indeed, were large enough so that foreign vehicles entered Albania to buy fuel. In addition, large numbers of electric appliances have been imported into Albania in 1992-1994 by its more fortunate citizens, who have also benefited by the fact that electricity has also been supplied to households at one-tenth of its cost of production.

83. Indeed, underpricing (or cross-subsidizing) local services rarely leads to the desired result of helping the poor more than those with higher incomes. Consumption of most goods normally rises with income, and subsidies for these "normal" goods therefore give the least help to the poorest. In fact,

it is now a common finding that subsidies for infrastructure benefit the better off much more than those with lower incomes. This finding is frequently trumpeted with respect to subsidies for electricity, but appears also to apply even to household water supply and sewerage systems.¹¹ The point is simply that the poorest often do not have access to these services. Such subsidies and cross-subsidies also violate principles of good governance in that they are not transparent and their effects, as we have seen, may not be self-evident. In Albania, it is almost certainly the case with respect to cross-subsidies that as "in most countries, more efficient and effective instruments should be used to help the poor."¹²

84. These policies with respect to subsidies and cross-subsidies are now changing. For some of the fuels mentioned above, the government has moved to adopt market prices and for others prices close to cost recovery levels have been imposed. Thus, automotive fuel prices were raised to European levels in 1993. Most recently, in a decision of 31 March, 1994, the government raised tariffs for household electricity usage sixfold, raised kerosene prices fourfold and raised tariffs for gas and steam heating four- to sixfold. Prices for wood and coal for heating were freed to find their market levels.

85. The government has followed an interesting strategy in raising some of these prices, by adjusting public sector wages and transfers to households to compensate for overall loss of purchasing power. While this strategy does leave the newly emerging private sector to fend for itself (as perhaps it should), it affects just over half of total budget expenditures.¹³ This strategy was first adopted in raising the price of bread, and its success appears to have convinced the government to move towards market prices for many other goods that have a less dramatic impact on consumer budgets. Another apparent motive in raising these prices is to get them to cost recovery levels so that the services concerned can then be successfully privatized. In this connection, it is of interest that the government

has expressed an interest in privatizing services such as solid waste collection and streetcleaning which are presently provided by state enterprises reporting to the Ministry of Construction.

VII. TRANSFERS, INTERGOVERNMENTAL GRANTS AND OTHER SOURCES OF LOCAL GOVERNMENT FINANCE

Transfers

86. Finally, the precise nature of central government transfers to the constituent and independent local budgets are not fully spelled out in the *Law on Local Budgets*. Ideally, these should be determined in a transparent fashion and be stable and predictable over time. The "negotiated" or "bargained" transfers between levels of government typical of the old command economy are not compatible with local autonomy and accountability. In addition, the transfer system should provide for some equalization. It is likely that local governments in Albania will be highly "transfer dependent" for a long time. The design of these transfers is thus an important consideration.

87. The government of Albania could perform an equalization function when it provides, as is planned, some unconditional transfers to local governments. Equalization of per capita revenue capacities of local governments might be adopted as an explicit objective of central government contributions to the "independent" sections of these local budgets. The extent to which the transfers to "constituent budgets" are equalizing will depend on how the underlying central services (education, health, etc.) are themselves distributed.

Privatization Revenues

88. Local governments in Albania have recently been given control of some small and medium enterprises. Given the inadequacy of other revenue sources to local governments in many countries in transition, local governments may be tempted to augment their small revenues by extracting monopoly rents from enterprises under their direct control and by becoming "entrepreneurial" with their newly acquired assets.

89. Albania appears to have found the means to avoid this problem in Decree No. 248 of 1993 on *Measures for the Acceleration of Privatization of Small and Medium Enterprises*. All of the properties concerned are to be sold by public auction within a relatively short time period, and there is some evidence that the small and medium private enterprises that are the subject of Decree No. 248 appear to be moving expeditiously into private hands. The decree also specifies that local governments are to receive 28 percent of the net proceeds of privatization of small and medium enterprises.

90. More generally, it is important to ensure that local governments have adequate revenues to finance their functions, so that they do not see enterprise ownership as a necessary source of finance, as has happened in many other transition economies. "Entrepreneurialism" in local government and ownership of enterprises by local government is not to be encouraged.

Local Government Borrowing?

91. The *Law for Local Budgets* (Article 6c) indicates that local governments can only borrow

for investment. This is fully appropriate. Investment in infrastructure such as local road construction or sewer extensions leads to future benefits and is most appropriately financed by long-term borrowing. It would obviously not be desirable to require that these investments be financed out of current local government revenues.

92. Albania has greater needs for rehabilitation and replacement of public sector capital than most of the economies in transition. Recall that in the breakdown of public order accompanying the fall of the old regime in 1991-92, more than a third of the schools and roughly a quarter of all local health centers were either badly damaged or destroyed. If responsibility for many of these public facilities is to be devolved to local governments, as is proposed, some method of long-term financing for construction and repair of these structures will have to be devised.

93. The development of capital markets in Albania will satisfy these local government borrowing needs only in the long run. In the short run, much capital expenditure on local infrastructure is being financed by foreign grants or loans at concessional terms.¹⁴ In the transition period, however, alternative arrangements need to be developed to permit capital expenditures to be financed—by central or local governments or their utilities. Other countries that have faced thin or nonexistent capital markets for local infrastructure have dealt with this problem (or are proposing to deal with it) by creating municipal credit agencies for local governments. In these arrangements, loans are supposed to be made only to creditworthy local governments: creditworthiness being assessed on the basis of plans for cost-recovery or on the promise of future streams of transfer payments from central governments. Loans are usually for capital spending on health, education, utilities and transport and are not extended for capital formation in other commercial enterprises that may be owned by municipalities.

94. Experience in the establishment of such municipal credit agencies has frequently been disappointing.¹⁵ Accordingly, direct involvement by the Ministry of Finance and Economy may be necessary both in approving and supplying funds for local government capital projects in the near future in Albania, in the context of a formal public investment program that includes local investments.

VIII. THE CONTINUING PROCESS OF INTERGOVERNMENTAL RELATIONS

95. The process of managing intergovernmental relations will not cease after the present legislation has been adopted and implemented. There will be a continuing need to perform technical and nonpolitical functions concerning intergovernmental relations in the Government of Albania. Because of the role currently being played by the Council of Ministers coupled with the short term desire to limit bureaucracy, this is likely to be an effective location for an *intergovernmental coordination function*.

96. An important role for such a coordinating body arises from the fact that central government contributions to each local government budget are to be presented for approval to Parliament each year under the *Law for Local Budgets*. The intergovernmental coordinating body might be given the task of analyzing local government submissions and preparing recommendations on these budgets. Parliamentary deliberations might also benefit from preparation of an annual report to Parliament by the Minister for Local Governments, which would be prepared by the coordinating body. Such a report would present social, economic and financial data relating to the revenues and responsibilities of local governments.

97. Finally, the body might provide technical assistance for local governments to build up financial and other management skills. The body might also assist local governments in making formal cooperative arrangements where they have common interests, such as to provide services where cost savings are possible or, to give an actual example, 6 local governments obtain their water supplies from a common source. On the other hand, the suggested body could also play the role of an arbiter where the interests of local governments conflict.

IX. SUMMARY AND CONCLUSIONS

98. Several conclusions emerge from this examination of decentralization initiatives in Albania. Albania's small size is obviously one of the factors that must be taken into account in assessing present proposals for and progress in decentralization. Functions that might be undertaken by local governments in other countries may well be appropriate for the central government in Albania. But while Albania may be small, this does not detract from the traditional economic argument for local government where public services are of purely local interest and their benefits are confined to restricted geographic areas. The central government of Albania should not be responsible for activities such as local rat catching or filling in potholes in village streets. These tasks can be left to local governments so that the government of Albania can devote itself to appropriate national concerns such as defence.

99. The wisdom of decentralizing non-infrastructure "social" services such as education or health is another matter. What may distinguish Albania from other former command economies, however, is the ferocity with which the population detested the former highly centralized communist regime, and this may account for some of the fervor with which the prospect of decentralized government is viewed. This

background needs to be taken into account when one wonders whether Albania can "afford" some decentralization in provision, for instance, of services such as education. The severe damage or outright destruction of a third of the schools and a quarter of all local health centers which accompanied the demise of the old regime is a very good argument for attempting to get local communities more involved in the operation of these facilities and in giving the communities some sense of ownership of these facilities. As is well-known in OECD states, local governments are usually willing to contribute to the financing of facilities such as local schools, even if provision of this and similar "people" services is the primary responsibility of higher levels of government. Of course, central quality control through conditionality of transfers remains appropriate to ensure service provision levels do not diverge across localities in these key sectors.

100. Indeed, Albania's experiences under the Hoxha regime provide many good illustrations of the validity of arguments for decentralized management of the economic system. They also serve as a potent reminder that externality arguments for involving higher levels of government do not mean that functions can be safely left to the latter and are not a magic wand that will make problems go away. Thus, the citizens of Albania's second largest city, Durrës, who have had to suffer through four typhoid epidemics in the last ten years because of contamination of the water supply furnished by the central government, can attest to the fact that central provision of services does not necessarily take care of externalities. Of course, for efficient local provision, adequate revenue efforts, appropriate pricing, and a well-designed transfer system will be needed -- each of which will take major efforts.

101. *Lack of clarity* in draft legislation with respect to responsibility of the two levels of government for major functions -- particularly for health and education -- remains a concern.

Accountability requires clear lines of responsibility. The draft *Law on Asset Ownership of Local Government* does not indicate which level of government would be responsible for incremental capital costs and recurrent costs in education and health. There is already an example of the consequences of such muddled lines of responsibility in the provision of city water supplies where the local authorities are responsible for operations and maintenance and the central authorities are responsible for investment and set water rates or tariffs for users. The latter have frequently not been sufficient to cover operating and maintenance costs. The result has been a lack of commitment by the local authorities to provision of water service, deferred maintenance and underinvestment. One should likewise be concerned that continued uncertainty about the possible extent of fiscal and administrative decentralization in Albania poses problems for forward planning in many fields such as health. This uncertainty is best removed as expeditiously as possible.

102. As regards *the organization of governmental services*, the appropriate spatial units for decentralization and deconcentration need not be regarded as fixed in stone and need not coincide with the present structure of local government. The creation of 11 new districts since 1991 appears to have been a response to political pressures from local interests who thought their constituencies were being ignored. It would be somewhat surprising if the results of such redistricting coincided with the optimal size of units for many administrative purposes and, in any event, the size of the latter may well fluctuate over time. For many functions, what may be needed is the equivalent of the "special purpose" districts that have been created in many OECD states. For instance, appropriate "hydraulic" units for the irrigation network in agriculture would be more logically based on the main river basins in Albania than on the existing 37 districts. Such a reorganization of areas for irrigation provision would be quite compatible with decentralized responsibility for demand management among users' associations of

farmers. Similarly, the Ministry of Health is presently considering the creation of what are in effect "full-service" hospitals for catchment areas that exceed the size of present districts and limiting the services provided in existing district hospitals.

103. Turning to the *financing of local government services*, the traditional sources of "own" revenues of local governments in many OECD countries are user fees and property taxes and both can be applied in Albania. Albania's determination to install a property tax with most revenues from the tax being assigned to municipalities is noteworthy in this regard. While central government administration of assessment is acceptable and even recommended for purposes of establishing equalization payments, local freedom to set property tax rates is an essential feature of eventual local government autonomy.

104. With respect to *fees for the services of local utilities*, it would be best to avoid using pricing or tariff-setting as a means of income redistribution, as appears to have been the objective in the past. Holding to the existing pattern of utility prices with the goal of restraining inflation is also a questionable use of public policy. There is little doubt that the better off have benefited disproportionately from some of these policies in Albania, whether they have involved subsidies for automotive fuel or household electricity, the provision without charge of sewerage services to the 30% of Albanians who can benefit from this service, or to the 80% of the population who are provided with household water supplies. The government has already increased automotive fuel prices to European levels and on March 31 1994 increased household electricity prices roughly sixfold. Sewer and water charges should similarly be moved to levels which permit full cost recovery as soon as possible.

105. The past and present practice of imposing uniform nationwide prices for local utilities also

involves cross-subsidies of dubious distributional merit. More particularly, however, in fields such as household water reticulation and irrigation in agriculture it ignores underlying cost differences between locations which are appropriately reflected in prices. The practice of pricing below cost recovery levels is a hangover from central planning and the antithesis of the decentralized management that many of these services need. There are many instances in both infrastructure and "people" services where efficiency and responsiveness to demand could be improved through decentralized or deconcentrated but in any event more autonomous management. Much effort is now being devoted to building up such decentralized and deconcentrated management capacity in particular areas so that it can better respond to the need of local populations. This, for instance, is a principal thrust of the National Primary Health Care Plan that the Ministry of Health has drafted.

106. The practice of imposing uniform national prices for local public utilities, even where local costs of supply differ, may be a throwback to old habits of highly centralized government. Similarly, we noted that the property tax, which is to be the principal revenue source for local government, will have rates specified by the central government. We recognized, however, that although local governments have been given some flexibility in choosing rates for other local taxes. A desire for local government may be meaningless if this level of government is not given sufficient power to raise its own revenues, set its own tax and user fee levels and be responsible to its own electors for these taxing decisions and the level of services it provides. At some point, local government in Albania means cutting the apron strings to Tirana.

107. Finally, whether government is moving towards greater decentralization or deconcentration of programs, it is clear that central budget *transfers* will remain the dominant source of financing for

many of these functions for the foreseeable future. It is quite feasible for some of these services to be delivered by local governments but for central government interests in having national standards in provision of these services to be attained by appropriate design of conditional grants or transfer payments. The accountability of both local and central governments will be enhanced by such transparent transfers, as opposed to the individually negotiated transfers that have been common in the past. In the "constituent" and "local" budgets adopted under the *Law on Local Budgets*, Albania has developed a novel intergovernmental financing vehicle which increases transparency of and accountability for intergovernmental fiscal flows and which should be of some interest in the rest of the world. Finally, if more reliance is to be placed on local "own" revenue sources for local governments, we noted the need for consideration of "equalization" payments to those local governments that will inevitably have lesser fiscal capacity per capita.

108. Albania took a radical step away from the past and towards joining the family of democratic nations when it introduced elected local governments in July of 1992. The promise of better governance associated with autonomous local governments which are responsive and responsible to local electorates for the pricing and provision of local services still lies largely ahead. Despite the difficult conditions associated with the birth of one of the world's newest democracies, however, there is little doubt that Albania is on the path to this goal.

Table 3
Urbanization and Number and Size of Local Government Units: Selected Central and Eastern European Countries and Albania

Country	Size of Local Government					Urbanization	
	Type of Local Government	Name	Number	Average Population	Range minimum maximum	Percent of Population Living in Urban Areas (Towns > 10,000) 2/	
Albania	Districts Municipalities/ Communes	<i>rethe</i> <i>bashki/comuna</i>	37	96,118	23,800	414,350	35
			352	6,936	1,300		
Bulgaria	Counties Municipalities	<i>oblast</i> <i>obshchina</i>	9	941,413	630,500	1,218,600	68
			255	33,226	1,650		
Czech Republic 1/	Districts Municipalities	<i>okres</i> <i>mestsky urat</i>	75	133,300	50,000	230,000	78
			5,768	1,735	50		
Hungary	Counties Municipalities	<i>megye</i> <i>onkormanyzat</i>	19	557,447	212,000	1,956,800	61
			3,070	3,450	200 <		
Poland	Municipalities	<i>gmina</i>	2,383	16,050	858	848,514	62
Romania	Counties Municipalities	<i>judet</i> <i>municipi/oras/</i> <i>commune</i>	41	564,672	237,900	2,318,900	53
			2,948	7,853	500 <		
The Slovak Republic	Districts Municipalities	<i>okres</i> <i>okresni urat</i>	37	140,540	44,000	441,000	78
			2,834	1,834	50 <		

1/ Excluding Prague which is both district and municipality.

2/ Data are for Czechoslovakia before its separation into the Czech and Slovak Republics

Source: Department of Statistics, Government of Albania: data for other countries supplied by Felix Jakob; data on population in urban areas from *World Development Report, 1992* (Washington, D. C.: World Bank, 1992), Table 31, p. 278.

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Table 4
 Government of Albania
 1991 Budget: Spending by Ministries in Administrative Units at Subnational Levels

MINISTRIES WHICH SPEND AT SUBNATIONAL LEVEL	Lek					Percent				
	Districts	Municipalities	Communes	National	TOTAL	Districts	Municipalities	Communes	National	TOTAL
Ministry of Agriculture & Food	133,700	-	-	976,300	1,110,000	12	-	-	88	100
Ministry of Construction	112,232	2,925,620	-	216,470	3,254,322	3	90	-	7	100
Ministry of Transport	677,445	188,300	-	1,525,255	2,391,000	28	8	-	64	100
Ministry of Education	169,132	882,541	1,444,552	1,259,645	3,755,870	5	23	38	34	100
Ministry of Health	2,058,000	-	-	1,338,000	3,396,000	61	-	-	39	100
Others 1/	118,101	383,004	13,398	233,621	748,124	16	51	2	31	
TOTAL	3,268,610	4,379,465	1,457,950	5,549,291	14,655,316	22	30	10	38	100

Source: Ministry of Finance and Economy, Government of Albania

1/ Ministry of Culture, Youth and Sport; Ministry of Trade and Foreign Economic Relations.

Table 5
Functions Presently under Consideration for Transfer to Local Governments in Albania and Efficient Financing of these Functions 1/

SERVICES	Sources of Finance			
	Local Taxes	User Charges	Central Transfers	Loans
Public Utilities (a)				
Water supply	S	P		A
Sewerage	S	P		A
Drainage	P	P(b)		A
Markets and abattoirs	S	P		(A)
Transportation				
Highways and streets	P	P(b)		A
Public transit	S	P		(A)
General Urban Services (c)				
Refuse collection	P			(A)
Parks and recreation	P			(A)
Fire protection	P			(A)
General administration	P			
Social Services (d)				
Education (other than universities)			P	(A)
Health (other than national facilities)			P	(A)
Social Assistance			P	

Notes:
 P = Primary source of finance
 S = Secondary source of finance
 A = Borrowing is appropriate for major capital expenditures
 (A) = Borrowing is appropriate, but likely to account for a small share of total costs.

Source: Adapted from Roy W. Bahl and Johannes F. Linn, "The Assignment of Local Government Revenues in Developing Countries" in *Tax Assignment in Federal Countries*, ed. Charles E. McLure, Jr. (Canberra: Australian National University Press, 1983), p. 179.

1/ Under the previous socialist system only a few of the functions in the table (such as utilities for water supply, electricity, public transit) were supported by user fees and the latter fell far short of cost recovery.
 (a) Utilities not being considered for transfer to local governments include electricity and telecommunications.
 (b) Development charges (i.e., special assessments, valorization charges, etc.) are appropriate for drainage, highways and streets especially where their benefits are spatially well defined within a jurisdiction.
 (c) Local law enforcement is the principal general urban service not being considered for transfer to local governments. (d) It is assumed that user charges and local taxes will play a lesser role in financing social services for the foreseeable future.

Table 6
Government Revenue and Population by Major Districts, Albania

District	Proportion of Revenues January-November 1992	Proportion of Population 1990
Tirana	24.2	11.5
Durres	22.7	7.7
Fier	10.9	7.7
Elbasan	5.9	7.6
Korce	5.7	6.7
Others	30.6	58.8
TOTAL	100.0	100.0

Source: Ministry of Finance, Government of Albania.

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1. David Sewell, *Fiscal Issues in Decentralization in Albania*, A Discussion Paper prepared for the Council of Ministers, Republic of Albania. World Bank, Europe and Central Asia, Middle East and North Africa Regions Technical Department, Feb. 19 1993.
2. Small sizes of local governments are not confined to central and eastern Europe, of course. Thus, Kincaid reports that "72 percent of all general-purpose governments in the United States have fewer than 3,000 residents, and more than half (55.4 percent) have populations under 1,000." John Kincaid, "Financing Local Government in the United States," *Local Government: An International Perspective*, eds., J. Owens and G. Panella (Amsterdam: North-holland, 1991), p. 142.
3. Richard M. Bird and Enid Slack, *Urban Public Finance in Canada* (Toronto, Ont.,: John Wiley and Sons, 1993), p. 69.
4. See Melville L. McMillan, "A Local Perspective on Fiscal Federalism: Practices, Experiences and Lessons from Developed Countries", (World Bank Working Paper, forthcoming 1994), p. S-1.
5. *Ibid.*, p. 36.
6. See in particular, Richard M. Bird, *Charging for Public Services*, (Toronto: Canadian Tax Foundation, 1986).
7. See Roy Kelly, "Implementing Property Tax Reform in Transitional Countries: the Experience of Albania and Poland", *Journal of Environment and Planning*, (forthcoming 1994).
8. See Wayne R. Thirsk, "Political Sensitivity versus Economic Sensibility: A Tale of Two Property Taxes," in Wayne R. Thirsk and John Whalley ed., *Tax Policy Options in the 1980's*, Canadian Tax Paper No. 66, (Toronto, Canada: Canadian Tax Foundation, 1982), pp. 384-401.
9. See Remy Prud'homme, "Decentralization of Expenditures or Taxes: The Case of France" in R.J. Bennett (ed.), *Decentralization, Local Governments and Markets*, (Oxford: Clarendon Press, 1990).
10. See McMillan, 1994, p.33.
11. See World Development Report 1994, *Infrastructure for Development*, (Washington, D.C., The World Bank, 1994), Chapter 4, pp. 80-81.
12. Bruce Fitzgerald, *Cross-Subsidies: There Should be Better Ways to Help the Poor*, HRO Dissemination Notes, No. 26, April 11, 1994, (Washington, D.C., The World Bank, 1994), p. 1.
13. In 1993, wages and salaries accounted for 16.3% and transfers to households 34.5% of public expenditures.
14. While many examples could be given, the rehabilitation of urban water supplies provides a good illustration. The Italian government has committed resources to improving the water supply and sewerage system in Tirana, the capital and largest city in Albania. The World Bank Group is addressing improvement of the water and sewerage systems in Durres, the next largest city in Albania. The neighboring Kavaja District has also received a grant from the German government to upgrade the distribution system of its Water Works.
15. William Dillinger, *Decentralization and its Implications for Urban Service Delivery*, Washington, D.C., The World Bank, Urban Management Programme Discussion Paper No.16, 1993), pp. 32-34.

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