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New Rules for Implementation of Fiscal Decentralization

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Abstract

This paper reviews how well fiscal decentralization has been implemented and how successful these projects have been in achieving a new level of local government financial capacity and service delivery. It reviews the research literature that has assessed the success and failure rates of fiscal decentralization in a global context. Overall, the levels of success have not been encouraging with fiscal decentralization having a positive impact. A case study of how fiscal decentralization has been implemented in Albania provides insights into the common mistakes that have been made in implementing fiscal decentralization projects. Professor Roy Bahl in a 1999 paper titled "*Implementation Rules for Fiscal Decentralization*" defined the basic approach to implementing fiscal decentralization and many of these rules have been the guiding principles for implementing fiscal decentralization. This paper addresses the deficiencies in these rules based on the experiences over the past decades and formulates new rules for implementing fiscal decentralization. It then assesses the old and new rules against the case study of Albania as a means of predicting if the fiscal decentralization will succeed. The paper concludes that new and original thinking about the implementation rules need to be formulated and encourages more dialogue and discussion among researchers and practitioners engaged in implementing fiscal decentralization.

Key Words: Decentralization, Fiscal Decentralization, Subnational government, Central and Eastern Europe, Albania

1. Introduction

Professor Roy Bahl provided in his 1999 paper "*Implementation Rules for Fiscal Decentralization*" twelve rules for implementing fiscal decentralization.[2] These have been referenced and perhaps even followed by the practitioners in implementing fiscal decentralization technical assistance in the transition and developing countries over the past 15 years.

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[2] Bahl, Roy W. 1999 *Implementation Rules for Fiscal Decentralization*, Georgia State University, International Studies Program: Working Paper 99-1.

Since Professor Bahl formulated these rules over 15 years ago there have been many fiscal decentralization programs implemented in both developing/transition countries. By this time these rules should have been fully tested in the actual implementation of fiscal decentralization. Unfortunately, there seems to have been no testing, examination or assessment of these rules and how they have been employed in actual fiscal decentralization efforts based on literature searches.

So, what should we make of these rules and how should we assess their relevance or practicality over these years. In this paper I want to challenge all of these rules and offer a new set that conforms with my experience to the reality and practicality of implementing fiscal decentralization. I take them one-by-one with some critique and offer an alternative rule.

It is the contention of this paper that these rules where not based on the realities of the political, economic, and social situation in which they were applied and following them, to the extent possible, probably contributed to the unintended consequence of the failures that are evident today.

Because of this failure there is a need for a new formulation of the rules of fiscal decentralization implementation that would provide a greater success rate and more beneficial impacts of fiscal decentralization in the future. The other alternative is to simply give up on fiscal decentralization as a good idea that could not be implemented.

2. A Failing Rate of Success

It seems fair to state that there have been few successes in implementing fiscal decentralization over this period, despite the millions and millions of funds spent by the donor community in these efforts. There are probably fewer objectively verifiable successes than the fingers on your hands. So, the question has to be, why have they not succeeded? Is it from not following these rules or that these rules where not realistic or practical to begin with when they were tried?

While there is no comprehensive evaluation across all the countries or fiscal decentralization projects that have been implemented over the past decades, there is an extensive number of studies that have attempted more limited assessments and evaluations of the success rates of decentralization and its components.

There is no intent here to make a literature review of all of these. However, several significant studies are cited herein to illustrate the main contention that decentralization on a comprehensive basis has had a failing rate of success.

An OECD Working Paper published in 2004 gave an early indication that decentralization and it components did not provide a significant level of success in improving the levels of poverty reduction in 19 countries studied. Of the 19 countries studied, the results showed that only three countries (Bolivia, Philippines, and India

(West Bengal) had positive results, four countries (China, South Africa, Mexico and Ghana) had somewhat positive results, nine countries (Paraguay, Brazil, Nepal, Vietnam, Egypt, Sri Lanka, Ethiopia, Burkina Faso, and Uganda) had somewhat negative results, and five countries (Guinea, Mozambique, Malawi, India (Andrah Pradesh and Madhya Pradesh) had negative impacts of decentralization.[3]

The World Bank has been one of the main proponents of decentralization and has provided probably the most significant level of funding through technical assistance programs. Consequently, some indication of the success rate of decentralization should be evident from the results of an evaluation of their programs. A 2008 report by the World Bank Independent Evaluation Group titled *Decentralization in Client Countries: An Evaluation of World Bank Support 1990-2007* provided an assessment of the successes and success rate of the WB sponsored projects.[4] The evaluation examined 20 countries with the intent to determine what had worked and what had not in support of these decentralization efforts.

The report indicated " the support for decentralization was of mixed quality, which nonetheless improved toward the end of the evaluation period, by which point it was rated high in about two-thirds of the focus countries. It was most successful in strengthening legal frameworks for decentralization and intergovernmental relations, improving public financial management at the local level, and helping central governments establish transparent fiscal transfer systems. It was much less successful in helping to enhance own-source revenue at the local levels, clarifying responsibilities of different levels of government, and strengthening citizen oversight."

It seems that while implementation improved over the course of the evaluation period covered, a two-thirds success rate is still of questionable value measured against the cost of providing the level of technical support and funding that went into these efforts.

In another well researched paper written by Jamie Boex titled *Fiscal Decentralization and Intergovernmental Finance Reform as an International Development Strategy* he states: "While there are some developing and transition countries where fiscal decentralization reforms have been relatively successful, it is indeed quite hard to come up with developing country examples where fiscal decentralization reforms have been an indisputable success story."[5] Boex identifies only three countries, Poland, Indonesia and South Africa, as being relatively successful.

Martinez, Lago-Penas and Saachi (2015) provide the most recent and comprehensive assessment of the impact of fiscal decentralization across the economic and political

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[3]Jutting, Johannes Celine Kauffman, Ida McDonnell, Holger Osterrieder, Nicolas Pinaud and Lucia Wegner. 2004 *Decentralisation and Poverty in Developing Countries: Exploring the Impact*, OECD Development Center, Working Paper No. 236.

[4] World Bank Independent Evaluation Group. 2008 *Decentralization in Client Countries: An Evaluation of World Bank Support 1990-2007*, World Bank

[5] Boex, Jamie. 2009 *Fiscal Decentralization and Intergovernmental Finance Reform as an International Development Strategy*, Urban Institute Center on International Development and Governance, IDG Working Paper No. 2009-06.

spectrum. They provide a survey of the research literature on the (1) economic and fiscal consequences (service delivery, economic growth, macroeconomic stability and fiscal sustainability, income inequality and poverty, geographical and interregional disparities) and (2) the political and policy consequences (government size and public policies, governance, governments' accountability and corruption, social capital and tax morale, voter turnout and nationalization of party systems and national unity). In each of these areas the authors survey the research as to whether the positive or negative impact of fiscal decentralization can, first, be ascertained, and, secondly, if there is a reasonable causal link among these factors and the implementation of fiscal decentralization. They conclude that while the results are rather mixed across these areas the research tends to indicate that fiscal decentralization has positive impacts only where the process is "well designed and implemented."[6]

While the global impacts assessed above present a rather ambiguous or negative result of fiscal decentralization implementation, a region where fiscal decentralization efforts should have shown some significant impacts would be the transition countries of Central and Eastern Europe following the fall of the communist regimes. This region, perhaps more than any other, served as a very good pilot and test case for fiscal decentralization. However, even here the implementation of fiscal decentralization seems not to have achieved a satisfactory level of results.

Rodriguez-Pose and Kroijer, in a paper in 2009 examined the relationship between decentralization and economic growth in the Central and Eastern European region. The findings indicated that the "expenditure assignments and dependence on transfers have negative implications for economic growth." [7] The only positive correlation was when the own source revenue was a significant share of the overall fiscal resources at the local level.

In a 2012 paper by Aristovnik the trends of fiscal decentralization in Eastern Europe were analytically examined. A fiscal decentralization index was utilized to examine the overall levels of fiscal decentralization among the countries of the region. According to Aristovnik there was an "alarming downward trend of the fiscal decentralization index (FDI) in most countries of the region over the past two decades."[8]

A report by the Network of Associations of Local Authorities of South East Europe (NALAS) in 2012 described "fiscal decentralization as a work in progress" and that the region was lagging behind in every aspect of revenue sources in comparison with the EU countries. The report cited the following critical features of the fiscal decentralization situation: (1) unconditional grants play a relatively small role in the financing of local governments, (2) revenue sources are largely based on real-estate transactions, new

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[6] Martinez-Vazquez, J. Santiago Lago-Penas and Agnese Saachi. 2015 *The Impact of Fiscal Decentralization: A Survey,* Georgia State University, Andrew Young School of Public Policy, International Center for Public Policy: Working Paper 15-02.

[7]Rodriguez-Pose, Andres and Anne Kroijer, 2009, *Fiscal Decentralization and Economic Growth in Central and Eastern Europe*, London School of Economics: LEQS Paper No 12/2009.

[8] Aristovnik, Alexander, 2012 *Fiscal Decentralization in Eastern Europe: Trends and Selected Issues* Transylvania Review of Administrative Sciences, No. 37, E2012, pp 5-22.

investment, and businesses, (3) the property tax collection is much less than 1% of GDP, which is the EU average, and (4) local borrowing is not adequately utilized. [9]

A later paper by Rodriguez-Pose and Ezcurra titled *Is fiscal decentralization harmful for economic growth? Evidence from the OECD countries*, published in the Journal of Economic Geography in 2011 provided the following conclusion based on their exhaustive research from 21 countries over the period 1990 to 2005. They concluded:

"Overall, the analysis shows that, at least in the case of OECD countries, the potential economic benefits of fiscal decentralization in terms of economic performance are more than counterweighed by the potential economic pitfalls of transferring ever greater resources to subnational tiers of government. Any potential benefits of fiscal decentralization in the form of greater territorial cohesion are thus counterbalanced by lower aggregate growth. And political and administrative measures of decentralization seem to be unable to offset this trend. Hence, in the case of the OECD, while fiscal decentralization may still be an adequate way to preserve and promote regional identity and culture, the claim that it will also bring about some sort of economic dividend can be considered as questionable."[10]

If the above cited works represent a fair assessment of the impact of decentralization and, specifically, fiscal decentralization, then there is a need to examine and redefine how these programs have been and should be implemented. Therefore, to the extent the rules of implementation formulated by Bahl have been implemented, or not implemented, a new formulation seems to be in order.

3. A Case Study Of Albania: How Not to Do Fiscal Decentralization

3.1 Political Background to Implementing Fiscal Decentralization

Many of the reasons for the failure of successfully implementing fiscal decentralization are illustrated by the case of Albania over the past four years. While it is impossible to get everything right in implementing the complex process of fiscal decentralization, Albania provides an example of the most common mistakes and how fiscal decentralization can go very wrong. The parliamentary elections of 2013 provided a basis for focusing on changing the local government system in Albania that had not been reformed over the previous decade. The opposing parties developed platforms emphasizing the changes they would make to the number of local government units, the increase of own source revenues to the local government, and improvement in the intergovernmental transfers to ensure a more objective based formula reflecting the differences among the local governments and eliminate widespread favoritism in the awarding of the infrastructure grants. Consequently, much was promised and hoped for by the citizens and the international donor community.

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[9] NALAS, 2012 *Fiscal Decentralization Indicators: South-East Europe,* Network of Associations of Local Authorities of South East Europe, March 2012.

[10] Andrés Rodríguez-Pose, Roberto Ezcurra; *Is fiscal decentralization harmful for economic growth? Evidence from the OECD countries. J Econ Geogr* 2011; 11 (4): 619-643. doi: 10.1093/jeg/lbq025

USAID and other donors (UNDP, SIDA, and EC) were heavily involved in supporting the fiscal decentralization effort. USAID supported the development of a *White Paper on Fiscal Decentralization* in 2012 to provide a strategy and roadmap for changing the local government system that addressed changes in the legal and regulatory framework, functional assignments, the own-revenue sources, intergovernmental transfers and borrowing authority of the local governments.[11] International experts (one being the author of this paper) along with some local experts developed this white paper.

3.2 Decentralization Began with Territorial-Administrative Restructuring

The Socialist Party with its coalition partners won the parliament elections in 2013 with a sufficient majority to rewrite the basic laws defining the local government system. The first action and primary focus of the new ruling coalition was to undertake a territorial-administrative reform (TAR) to reduce the number of local government units from 373 to 61. The Law on Territorial-Administrative Reform was enacted in July 2014. This law eliminated the communes and merged them into the larger municipality units.

This reduction would supposedly make the local governments more capable of providing services and achieve economies of scale in service delivery. The adoption of a decentralization strategy, revision of the legal frameworks, adoption of changes to the revenue sources and the intergovernmental transfers, along with implementation of other aspects of the program promised by the new ruling party were largely forgotten.

The new local government boundaries were drawn so that they favored the election of the new ruling party candidates in the local government elections for the following year. The 2015 local government election was held on a district wide party list basis and this favored the election of those from the largely urban areas in the newly formed units that were supporters of the new ruling party. As a result, the ruling coalition won 45 of the 61 local government units for the mayor and council positions in the local government elections.

In the previous local government elections held in 2011, the results were much more competitive. The Democratic Party had 30 municipalities to 35 for the Socialist Party. At the commune level, the Democratic Party had 173 communes, while the Socialist Party won 103 communes. The merging of the communes into the municipalities allowed for the Socialist Party to dissipate the rural area support for the Democratic Party in these new local government units.

3.3 Limited Developments After the Territorial-Administrative Reform

Once the territorial-administrative restructuring was completed, the ruling coalition lost any further interest in implementing the comprehensive fiscal decentralization strategy as was envisioned in the *White Paper on Fiscal Decentralization*. However, they decided they needed a strategy, so in February 2015, the Minister for Local Government Issues

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[11] USAID Albania Planning and Local Governance Project, 2012 *White Paper on Fiscal Decentralization*, October 2012.

that was responsible for the decentralization issued a *National Crosscutting Strategy for Decentralization and Local Governance 2015-2020.* This was largely a rework of the earlier *White Paper on Fiscal Decentralization*.

The government enacted a new Law on Local Self-Governance in December 2015 to be effective beginning 2016, which added 17 new functions to the local governments bringing the total number of functions to 56.[12] Many of the new functions were in the areas of infrastructure that the local governments had very little technical capacity to implement and no additional funding to provide the services.

There was no significant positive change to the revenue sources of the local governments, no change in the intergovernmental grants system or possibility for local government borrowing. In the end the local governments found themselves in even worse condition as the central government was not able to increase the levels of funds to the local units, a major source of local government revenue (the small business tax) was eliminated for the local governments, and no new law on local government finance was enacted. There was no major effort to implement a property tax or other enhanced revenue sources. It was not until April 2017 that a new Law on Local Government Finances was enacted.

3.4 Assessment of the Progress and Problems with the Decentralization Program

A mission from the Congress of Local and Regional Authorities of the Council of Europe did an assessment and provided a report on the progress of the territorial-administrative reform in March 2016. The report noted the following problems (1) confusion about the competencies among the local units, (2) lack of sufficient financial resources allocated to the local governments resulting in no net increase in financial resources, (3) lack of transparency in the grants process managed by the central government, and (4) concern over the drawing of the boundaries of the local units that seem distorted. The report concluded the following: "The delegation received reports on considerable transition problems in the newly formed municipalities—mainly due to a lack of information about the new competencies, considerable workforce reduction, budgetary uncertainties and inherited financial burdens at the local level."[13]

This concern about the progress of fiscal decentralization was also expressed by the USAID funded Planning and Local Governance Project (PLGP), which provided substantial support to the decentralization effort. In the PLGP newsletter of January 2016 it stated: "Yet, in spite of this substantive progress, the success of Albania's TAR is at risk and the local governance is being undermined: municipalities cannot be more

[12] The newly decentralized functions include: fire protection; supporting and educating staff in pre-schools; supporting staff in pre- university schools; environment protection; administration and maintenance of irrigation and drainage infrastructure; certain competencies in agriculture and forestry; and building and maintaining rural roads infrastructure, previously under the responsibility of the 12 second-tier local governments called Qarks (Regions)

[13] Fatjona Mejdini, 2016 "Albanian Territorial Reform Has Created Confusion, Report" Balkan Insight, March 24, 2016

effective without the financial support to do so. In 2016, a need exists for a heightened understanding that for territorial reform to be effective, it must be accompanied by fiscal decentralization. The historical underfunding of local government must end and municipalities must be provided both the resources and the authority to improve service delivery and fulfill their newly entrusted responsibilities. Only when responsibilities and finances are aligned will we be able to say that decentralization in Albania has been successful and the true and sustainable progress has been made."[14]

The USAID PLGP provided a substantial amount of support in the overall decentralization effort and, particularly, with regard to development of a new law on local government finance. In its report titled *Policy Brief: Key Recommendations for the Development and Discussion of the Law on Local Governance Finance* of May 2016 provided this assessment of the development toward fiscal decentralization. The report stated: "In Albania, the fiscal decentralization dimension remains particularly weak, local governments continue to be hampered by inadequate and unpredictable transfers from the central government and from restraints imposed by the central government on various municipal revenue-generating options."[15]

The progress of the territorial-administrative reform has been examined by a number of roundtables held by the donor community and research organizations in cooperation with the Government of Albania. A particular useful one was held by the Albanian School of Political Studies as reported by the Albanian Daily News of May 25, 2016. The school has conducted a research project titled "Local Administration Re-Organization Challenges." The results of the research study was that the reform will not necessarily lower the administrative cost and improve the efficiency of service delivery and that much depends on the improvements in the local government administrations through e-governance methods.

The most interesting comments on the progress of the territorial-administrative reform at this roundtable came from Artan Shkembi, the general director of the Territorial Reform Implementation Agency. He indicated that the TAR implementation have been misinterpreted by the majority of the mayors. The implementation was being disrupted by the creation of staffing structures that did not reflect the service needs of the communities and varied greatly from one local government to another.[16]

3.5 Sequencing of the Decentralization Process In Albania

Among the many contributions Professor Bahl has made to the implementation of fiscal decentralization is a seminal paper titled *Sequencing Fiscal Decentralization,* which

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[14] Clavelle, Peter. 2016 *Decentralization Progress In Albania?,* Newsletter Planning and Local Governance Project, USAID, Vol 3, No. 8, January 2016.

[15]USAID Planning and Local Governance Project, 2016 *Policy Brief: Key Recommendations for the Development and Discussion of the Law on Local Governance Finance*, May 2016, p. 6

[16] Albanian Daily News, 2016 *"Administrative Reform Misunderstood by the Majority of Mayors-Says Shkembi"* May 25, 2016.

examines the importance of the proper sequencing of fiscal decentralization programs and provides a normative based sequence that should be followed.[17] This normative approach to sequencing is presented below with the recommended actions to be undertaken in Albania for implementing the fiscal decentralization program.

Sequencing Fiscal Decentralization: A Normative Approach

Step 1: Carry out a National Debate on the Issues Related to Decentralization Policy

Step 2: Do the Policy Design and Develop a White Paper
Develop Sector Assessments for Functions
Complete the National Decentralization Strategy

Step 3: Pass the Decentralization Law (as Comprehensive Legislative Package)
Revise the Law on Organization and Functions of the Local Government
Revise election laws and basis for local councils functions
Adopt Law on Local Government Finance
Adopt Law on Administrative-Territorial Restructuring

Step 4: Develop the Implementing Regulations

Step 5: Implement the Decentralization Program

Step 6: Monitor, Evaluate and Retrofit

A comparison of the normative approach to what actually happened with the fiscal decentralization program in Albania is provided in the following table with comments as to what was done.

Step 1: Carry out a National Debate on the Issues Related to Decentralization Policy

The national debate was conducted as part of the parliamentary election campaign and then followed with the development of the territorial-administrative restructuring. There was no real debate about decentralization or what it would mean for local governments in the political campaign. Prior to the enactment of the new territorial-administrative reform law in 2015, the Minister of Local Issues did conduct a nation wide consultation process and a national survey was conducted which indicated that 67% supported the reform. There was a national consensus that territorial-administrative reform was needed. The options of 39, 47 and 61 units were presented. There was much political opposition to the boundaries, but with the ruling coalition having the necessary votes and the boundaries favoring them for the upcoming local government elections there was no real possibility of changing the boundaries. The new law passed with only the votes of the ruling coalition. There was no national referendum on the new boundaries as recommended in Council of Europe guidelines.

[17] Bahl, Roy and Jorge Martinez-Vazquez, 2006 *Sequencing of Fiscal Decentralization*, World Bank Policy Research Working Paper 3914, May 2006.

Step 2: Do the Policy Design and Develop a White Paper

Develop Sector Assessments for Functions

No formal sector assessments were done and this later created much confusion over the assignment of functions to the local government units.

Complete the National Decentralization Strategy

A national decentralization strategy was not completed until after the territorial-administrative units were reduced and changed. The strategy largely copied the White Paper on Fiscal Decentralization that had been prepared by the USAID.

Step 3: Pass the Decentralization Law (as Comprehensive Legislative Package)

Revise the Law on Organization and Functions of the Local Government

This was done effectively beginning in 2016 and was basically a revision of the previous law. It did assign 17 new functions to the local governments, but made no substantial improvements in the fiscal condition of the local governments with new revenue sources of increase in the grants and transfers.

Revise election laws and basis for local councils functions

Was incorporated into the new law on organization and functioning of the local governments. The election districts were created as at-large districts, which favored the urban areas and led to the rural areas that were incorporated into the new districts without adequate representation in the local councils.

Adopt Law on Local Government Finance

A new law was enacted in April 2017 with minimal impact on improving the local government finance situation. The law only provided for limited number of own source revenues as follows: (1) a tax on immovable property, (2) tax on infrastructure impact of new buildings, (3) hotel accommodation tax, (4) a tax on billboards, (5) temporary taxes, (6) taxes on economic activity of small businesses, and (7) taxes on personal income, taxes on revenues derived from donations, inheritances, testaments, and from local lotteries. The unconditional transfer is set at no less than 1% of GDP as the basis for determining the unconditional transfer pool (USAID experts had recommended at least 6.5% of national revenue from taxes and customs), while shared taxes are established as follows: (1) 97% of revenues from property tax transfer, (2) 18% of the used vehicle tax, (3) 5% from the mineral rent, (4) 2% of the personal income tax.

Adopt Law on Administrative-Territorial Restructuring

This law was enacted at the beginning of the process rather than at the end and was done without fully addressing the transfer of functions to the new local governments or changing the basic authorities and the revenue sources.

Step 4: Develop the Implementing Regulations

New regulations were mainly addressed at the merging of the local governments units rather than implementation of a comprehensive set of laws that would have formed the basis for the full implementation of a decentralization program.

Step 5: Implement the Decentralization Program
The implementation of decentralization has been a piecemeal process basically focused on attempting to successfully merge the local government units with the service delivery requirements that have now been placed on the local governments.

Step 6: Monitor, Evaluate and Retrofit
The monitoring and evaluation have largely been done externally through donor assessments and continued support to the territorial-administrative reform. A number of roundtables to discuss the progress of the territorial-administrative reform have served to assess the progress, but no clear changes in the process or adoption of new laws have been forthcoming.

This sequencing of fiscal decentralization in Albania is one of the main problems in the implementation of the decentralization program. The early emphasis on restructuring the local government units without a proper development of the overall decentralization strategy and legal frameworks in the sequencing of the process has led to the implementation problems identified above.

3.6 Costs and Benefits of the Reform

It is difficult to assess the overall costs and benefits of the reforms that have been undertaken over the past several years with the territorial-administrative reform. The main costs of implementing the reform program have been borne by the donor community through the UNDP administered Support to Territorial and Administrative Reforms (STAR). The STAR I was funded at USD 1.5m and the second phase STAR II is funded at an even higher level of USD 8m that will be contributed by various donors. The EC has committed 3.5m EUR, the Swiss $500,000, and the Government of Italy has committed USD 1.361m to the continuation of the project.

While these funding contributions are known and can be accounted for, the estimation of benefits of the territorial administrative reform may be more difficult to accurately quantify. The Minister of Local Issues, Bledi Cuci, at the signing ceremony for the funding to be provided by the Government of Italy, made the following statement of what the savings had been from the implementation of the territorial-administrative reform. Minister Cuci stated: "The impact of this key reform has started to show benefits. As such 12 million USD dollars have been saved by cutting administrative expenses and about 15 million USD dollars more, compared to last year, have been collected from local taxes." (UNDP Albania website: *Italian Government furthers its support to the Territorial and Administrative Reform: New Financial Agreement signed with UNDP)* Since there is no independent external monitoring and evaluation feature of the project these savings cannot be validated.

One has to wonder if there were other options that would have cost less and produced more benefits that were considered for implementing the territorial-administrative reform.

The Government of Albania did propose other combinations of numbers of local government units. There were proposals of 30, 39, 47, 57, 61 and 63 local government units examined and maps were drawn for these options. They finally settled on the 61unit option. All of these would have been as costly as the present approach.

There was an option for a more limited amalgamation of the local government units proposed as early as 2004. A Council of Europe report prepared by experts recommended that only those local government units below 3,000 population, spending more than 40% of their budget on administrative expenditures, and less than 4% on capital expenditures of the total expenditures. This was a more realistic criterion for the merging of the local government units than the larger merging of all local government units that has produced the results described above. A more incremental and limited approach to merging was also proposed in the *White Paper on Fiscal Decentralization* prepared by USAID.

A further study was done in 2012 for the Albanian Association of Communes by SKL International consultants.[18] This study provided a further in-depth analysis of the possibilities for merging the communes and municipalities. It recommended a target of 80 local government units based on their analysis and with some specific criteria for determining the basis for merging these units.

However, these approaches did not meet the overriding political objectives of the ruling coalition for the local government elections. Consequently, the Government of Albania chose the **high risk, high cost and low reward approach**.

3.7 Lessons Learned

The lessons to be learned from this experience in Albania are that (1) fiscal decentralization must be politically neutral and technically correct, (2) changing the number of local government units must be preceded by a defined functional assignment of responsibilities to ensure service delivery capabilities are matched with the new territorial structures, and (3) the legal framework and regulations must be in place before the fiscal decentralization can be properly implemented, and (4) the donor community has to play a more objective based role with definite expectations and objectives of what the donor community is paying for in the process.

The territorial-administrative reform did not achieve a political consensus across the political parties and was passed with only the votes of the ruling coalition. Whether this reform will continue should there be a change in the government following the parliament elections scheduled for June 2017 is problematic. Any reform of the local government structures needs to have broad based support from the political parties and the civil society. The political divisions are so deep in Albania that it is unlikely that any consensus could be achieved.

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[18] SKL International, 2012 *Territorial Reform in Albania-Study for the Albanian Association of Communes,* December 2012.

The criteria for determining the boundaries was very vague and appears to have been directed at achieving some political outcome based on the results of the local elections following the creation of the local government units. The boundaries were drawn without defining the functions of the local government units in a new law on local governance prior to drawing the boundaries. Consequently, it cannot be said that these boundaries conform to the areas of most efficient service delivery for these functions.

First level of local government: Municipalities and Communes

1. The Administrative Territorial Process will start from "districts" as base unit of local government, as stipulated in law no. 8653 dated 31.07.2000 "For the administrative territorial division of local government units in Republic of Albania"

2. New government units may be formed within district boundaries or from two or more districts if they fulfill the below criteria:

a. The new government unit is a functional zone by itself. "Functional Zone" constitutes of a territorial area with a dense and frequent interaction between the inhabitants and the institutions for economic, social, development and cultural purposes. The functional zone is organized around an urban center with the highest population number compared to other centers within the zone, able to provide the whole variety of public services that one government unit has to offer.

b. Territorial distance with the center unit provides all services to its inhabitants.

c. The new unit complies with the territorial continuity principle. "Territorial Continuity" means that a local government unit territory is continuous and there are no territorial "islands" that belong to another local unit.

d. There must be a considerable population number, supported by the geographic characteristics of the zone. A considerable population number is considered a population with an average of more than 30,000 inhabitants.

e. There is a historic tradition and is characterized with a traditional connection between inhabitants of all compounded territories.

f. By regulation, the boundaries of the communes joining the new units will not be divided but joined as a whole with the new unit.

3. Exclusive of the above criteria and as a separate exceptional criteria there could be taken into account cases that consider best international practices in safeguarding ethnic minorities, where these minorities make up the majority of the existing LGU population.

Ministry of Local Issues Website http://www.reformaterritoriale.al/

The reforms are struggling largely because the Government of Albania did not follow the sequencing of fiscal decentralization that would have led to a more effective management of the process. The election timetable largely drove the process; as it was desired that the new local governments be established for the scheduled local government elections in 2015. As often happens, the election cycle dramatically impacts the decentralization process and the level of interest in implementing reforms.

The donor community has played its usual role of financing the project without imposing some conditions or expectations of the results. The Government of Albania largely coopted the donor community into paying for this project and legitimatizing the process and results. The Government of Albania would indicate that all the policy decisions were made with the support of the international donor community and leaving the impression that there was consensus of the decisions. The donor community provided the funds and supported some international experts, but their influence on the policy decisions is problematic.

Further, the donor community seems to have been lured into an open-ended commitment to finance the further development of the territorial-administrative reform to support the implementation of the service delivery functions assigned under the new law on local governance. The support is largely directed to establishing one-stop citizen service centers and some e-governance features.

The STAR project, which provided the primary financial support to the Minister for Local Issues in the implementation of the reform, had the following objectives to be achieved in the period of mid-2013 to June 2015.[19] These are identified with comments on whether and to what extent they have been met.

- Revision of Law 8652 (Law on Local Government) with regard to the organization and functioning of first and second levels of local self-government. **(Law 8652 was revised beginning 2016 with additional functions to the local self-governments, with some transfer of functions from the region to the local governments to the second level (regions).**
- Revision of the intergovernmental transfers system and adoption of Law on Local Self Government Finance **(A new law on local government finance was enacted in April 2017)**
- Introduction of national/local standards for public services **(No progress on this)**
- Institutionalization of multi-level planning and coordination **(Some progress on revising the local development and physical plans in pilot local units)**
- Establishment of system for institutional capacity building at local levels **(Some progress through the implementing agency for the territorial reform, but no formalized and institutional capacity of a long term nature)**
- Implementation of Civil Service Law **(Not clear that the law was implemented according to its legal framework as following the local government elections many local government officials were dismissed without following appropriate procedures)**

For all of its support the donor community did not achieve many of the objectives that should have been achieved given the level of funding support that has been or will be provided. The donor community objectives were largely aspirations rather than specific

[19] United Nations Development Programme, 2103 *Country: Albania Project Document: Support to Territorial and Administrative Reform (STAR),* 2013, p. 4.

quantifiable objectives that would have measured the progress of achieving decentralization to an acceptable level.

This case study illustrates some of the problems encountered in implementing fiscal decentralization and forms the basis for defining the new rules for implementing fiscal decentralization in the next section.

4. New Rules of Fiscal Decentralization

With this background, we now turn to examining how the rules formulated by Bahl and new proposed rules relate to the case of Albania. In this section each of the rules promulgated by Professor Bahl are addressed with discussion of the problems with each of these and the formulation of new rules for implementation.

4.1 Rule 1: Fiscal Decentralization Should be Viewed as a Comprehensive System

Professor Bahl begins his list of rules for implementing fiscal decentralization with the view that fiscal decentralization should be part of a comprehensive system that must complement and be coordinated across a broad spectrum of the political, administrative, and fiscal decentralization efforts. Bahl indicates "Implementation should begin with a design of the comprehensive system, and should lay out the plan for each element."[20] This is a rather simplistic approach attempting to define a holistic strategy, which has been tried in other areas of development assistance with limited success.

This rule has largely been implemented through the development of some decentralization strategy that looks at the overall requirements of decentralized system and provides the objectives and approaches to meeting these objectives. Typically, a roadmap is provided providing a timeframe for the achievement of the specific steps.

In my own experience and having written a number of decentralization strategies I can say these tend to have a shelf life. That is they sit on the bookshelf for their whole life. There are a number of reasons for this, but chief among these can be reflected in the words of Machiavelli's *The Prince* who cautioned: *"It must be remembered that there is nothing more difficult to plan, more doubtful of success, nor more dangerous to manage than a new system. For the initiator has the enmity of all who would profit by the preservation of the old institution and merely lukewarm defenders in those who gain by the new ones. "*

There are many additional reasons for this failure to develop and implement a comprehensive decentralization system. These include:

1. Resistance from the central level ministries to transfer of funds and personnel

[20] Bahl, Roy W. 1999 *Implementation Rules for Fiscal Decentralization*, Georgia State University, International Studies Program: Working Paper 99-1 p. 5.

The central level ministries have the most to lose in the decentralization effort. Their interest is to maintain their personnel and funding position authority and not become relegated to a policy development or oversight function in the governmental scheme. The chief resistor is typically the Ministry of Finance that is uncomfortable with having their control over financial decisions limited. The other obstacle here is the perception that the local governments do not have the capacity or skills to handle the financing of services and pose a financial risk to the central government, particularly in areas of local government borrowing.

2. Weak support or even resistance from the local levels leaders who in some cases would rather complain about the problems of delivering services than have to accept the responsibility for solving them.

Some local leaders would rather be able to blame local service delivery problems on the lack of funds from the central level and their resistance to accept the responsibility for imposing local taxes and being accountable for the spending of these funds.

3. The election cycle is shorter than the time required to implement a comprehensive decentralization system and the whole process is viewed as a political ploy to win votes

Decentralization is too often utilized for political purposes and manipulation in the election cycle. Immediately preceding the elections, either at the national or local level, the central level politicians make a lot of promises on implementing decentralization. However, once the election is over the political will and the pressure to fulfill their promises fades very quickly.

4. External consultants too often develop these strategies without sufficient political or time commitment from the local stakeholders who view this as another donor community driven program.

External consultants, hired largely by the donor organizations, are often used to write these decentralization strategies and these are often done without full commitment or interest of the local stakeholders. A working group will often be formed, but the work will largely done by the external consultant, who writes the document, holds a workshop, and then leaves.

All of the above problems were evident in the Albania case and led to the results that were identified in the case study.

New Rule 1: Define a few strategic entry points (two to four) of least resistance and moderate consensus for fiscal decentralization and build from this base for success.

A more nuanced approach targeted toward some win-win solutions in the early stages of the decentralization and fiscal decentralization process would increase the probability of achieving some successes that would provide for further implementation of decentralization components. A large-scale comprehensive approach tends to only stiffen the resistance and opposition to implementing decentralization. The limitations of local capacity to accept and implement decentralization would be easily overcome through the more targeted technical assistance that could be provided. The success areas identified in the above cited World Bank report would provide some indication of these areas to target for more strategic entry points into the public finance system.

Some key entry points are likely to be in the revenue area, particularly in improving the collection of local taxes, providing for increased local authority to establish the base and rate of taxes, provide for local borrowing, and expanding the local own source revenues. Another area would be to make more transparent and objective the infrastructure grants system that would create incentives for local governments to increase their own local revenue sources to match the grants from the central government. A performance based grant system would be a basis for implementing a new approach to decentralized delivery of services.

In Albania, if a process of improving the local government revenues, particularly the property tax and shared taxes, had been pursued there would have likely been less political conflict among the major stakeholders, the political parties, the central ministries, and the local government associations.

4.2 Rule 2: Finance Follows Function

Finance follows function is the mantra of the fiscal decentralization movement. It rests on some fairly simple assumptions that are conceptually appealing, but are nearly impossible of applying. Bahl indicates this important rule requires: (1) the cost of the expenditures must be determined before (2) the appropriate mix of revenues can be assigned to the local governments. (Bahl, 1999)

In practice this has failed on both counts. First, costing public services is impractical as there is rarely a unit cost that can be applied to the diverse service requirements of a local government. The level of services across the whole country, especially if it is a large country will vary greatly, and the local costs could vary greatly from rural to urban areas. Finally, economy of scale is not applicable to most local public services, particularly health, education, welfare, etc. Fox and Gurley (2006) have provided a comprehensive review of the issue of economy of scale in the delivery of public services and its relationship to the size of local governments.[21] The results are very mixed and not always predictable and tend to be specific to service functions, such as infrastructure areas of water and transportation as opposed to health and education services.

The other practical problem is that it seems finance never follows the functional assignments. The unintended consequence of this approach is a lot of unfunded mandates that the local governments have neither the funding nor the capacity to deliver. The

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[21] Fox, William F and Tami Gurley, 2006 *Will Consolidation Improve Sub-National Governments?* The World Bank, Poverty Reduction and Economic Management Public Sector Governance Group: Policy Research Paper 3913.

central government simply off loaded functions they didn't or couldn't finance and fiscal decentralization is a good cover for doing that.

Professor Bahl in his paper admits that most countries do not follow this rule, as the practicalities of doing this are too difficult. So, a rule that isn't applied can hardly be a rule worth following.

New Rule 2: Function evolves from Finance

Since most central governments find the route of assigning revenues easier to implement, the rule should follow this more practical approach. There is no need to assign functions as a bulk transfer of functions in a law on local government. The increase in local government revenues or additional intergovernmental transfers to the local governments could be accompanied by specific functional assignments that could be directed to those functions. Over time the number of functions assigned could be increased along with the capacity of the local governments to assume these services.

The asymmetrical approach to functional assignments could also be applied and only those local governments with the capacities and willingness to assume these functions should be given the functions. The approach of Croatia in giving additional share of the income tax to local government units, which assume additional decentralized functions, such as elementary and secondary education, health care, fire protection and welfare, is one example of how this approach could be applied.

The use of earmarked transfers for certain functions, rather than just general unconditional grants, would provide some control and accountability in the use of funds. Rwanda is one example where the use of earmarked funds has been effectively utilized to ensure that the local units apply the funds properly. This also needs to be accompanied with an appropriate level of auditing of the use of these funds as well.

This approach would eliminate one of the main failures that have been identified in the development of fiscal decentralization efforts. It could overcome the tendency to dump functions on the local government without the necessary funding by a more stringent approach in assigning functions that can be more appropriately financed on the local governments without placing an excessive burden on them.

Bahl and Martinez-Vasquez (2006) strongly argue for keeping the finance follows function approach, but identify what is termed the "evolutionary" approach to the assignment of functions. (p. 19). Their main argument is that it will take decades or centuries based on past experience of developed countries to get to full implementation of decentralization under the evolutionary approach. While this maybe true, the policy makers have to determine whether it is better to make some "incremental mistakes" that can be repaired or make one "big mistake" that may not be repaired.

The Albania case illustrates the classic result of assigning functions to the local governments without the necessary financing methods. The 17 new functions assigned to the local governments in the new Law on Organization and Functioning of Local Governance were not supported with the necessary time for capacity building and mobilizing the financial resources to improve the service delivery of the functions.

4.3 Rule 3: There Must Be Strong Central Ability to Monitor and Evaluate Decentralization

Bahl in this rule is referring to monitoring the progress of decentralization through the changes in the financial condition of the local governments. He proposes that the solution is to (1) create a Fiscal Analysis Unit in the Ministry of Finance and (2) create an extensive financial reporting system that will provide the data for the monitoring and evaluation. Interestingly, Bahl goes on to indicate that neither of these is practical in the context of the developing and transition economies.

There have been some attempts to create these fiscal units within Ministries of Finance, but those that are known to this author have not really succeeded due to low level of expertise and competence available, the drain of the more talented and skilled to positions outside of government, and the low level of salaries for retention of the qualified staff.

The requirements for a large-scale implementation of a financial accounting system with the low level of availability of the technology and financing that is available make this particularly difficult. While this rule would provide for increased probability of decentralization succeeding, it actually needs to be developed prior to the introduction of the decentralization process.

In Albania, the Ministry of Finance is inadequately staffed to provide for the level of monitoring and evaluation that was needed. A fiscal analysis unit has recently been created, but this was delayed due to problems in recruiting qualified staff. The focus of this unit is more on monitoring the macroeconomic situations and improving the revenue forecasting of the national revenues.
There was only one budget person to oversee the local governments budgets and intergovernmental transfers in the ministry. There are serious questions about the accuracy and adequacy of the financial information system and additional international support is being provided to upgrade the financial management information system in the Ministry of Finance. The local government units are not integrated into this national level system.

New Rule 3: Establish External Institutional Monitoring and Evaluation Mechanism not influenced by governmental stakeholders

Given these internal capacity problems, the donor community would be more effective if they supported the development of external monitoring and evaluation mechanisms through non-governmental organizations that focus on analyzing governmental fiscal decentralization efforts and gathering the financial data to support the analysis. This would provide an opportunity for holding the government more accountable for the implementation of fiscal decentralization effort.

The donor community needs to build into the agreements for the funding of these projects some objective and specifically identifiable project milestones and accomplishments that are effectively monitored and evaluated as conditions for the technical support. Some of these could be specific requirements for changes in the legal framework, percentage objectives for improving local own source revenue capacity by identifying changes to the authority of the local governments to set the base and rate of certain taxes, targets for the allocation of funds to the local governments as percentage of GDP or total national revenues, implementation of performance based grants to the local governments, among others, as conditions for the donor to receive tranches of funding over the course of the project timeframe.

PEFA assessments, which are being adapted to the subnational level in some countries, could provide one source of independent monitoring and evaluation of the fiscal decentralization progress. These also provide a basis for assessing the full scope of the governmental financial system, without the financial data, that would serve to indicate the progress of achieving the requirements of a fiscally decentralized project.

Further support could be given to providing Parliamentary bodies with more analytical ability to examine the progress of fiscal decentralization. A Parliamentary Budget Office, appropriately staffed, could also support this monitoring and evaluation effort. Recently, there has been greater interest in establishing Parliamentary Budget Offices and these have been developed in such developing countries as Benin, Ghana, Kenya, Liberia, Morocco, Nigeria, the Philippines, and Uganda according to a World Bank Institute training module on Parliamentary Budget Offices.[22] However, these would be most effective in the situations where the Parliament has a budget making, rather than a budget-approving role.

The State Audit Offices might also be another possibility, but their independence from the government would need to be established and with appropriate means to sanction the government for its financial management failures.

On the international level, the International Budget Partnership has initiated the Open Budget Initiative that works with non-governmental and civil society organizations in many countries to provide an index of the transparency and impact of the national level budget process on improving the services to the people. These efforts can provide more opportunity to hold governments accountable for implementing decentralization.

The role played by the Congress on Local and Regional Authorities of the Council of Europe in the Albania case study described above also provides a model for assessing the progress of a fiscal decentralization project. Other regional based organizations in Africa or Asia that relate to local governance could play this role and their independent

[22] World Bank Institute, Module 02: *Fiscal Councils and Parliamentary Budget Offices.*

monitoring and evaluation could be built into the project by the donor organizations as part of the funding requirements.

The donors to the Albania decentralization project could have played a more objective evaluator role in this project and more directly influenced the direction of the program. The USAID funded project did several updates on the progress of fiscal decentralization, but these had limited impact on the outcome. The UNDP did a mid-term review of the their support project, but this only addressed their implementation support and not the progress of the decentralization program of the Government of Albania. The EC funding supporters largely served as cheerleaders rather than critical evaluators of the decentralization project.

4.4 Rule 4: One Intergovernmental System Does Not Fit the Urban and Rural Sector

This is quite an appropriate rule for beginning the development of the intergovernmental transfer system and Bahl indicates when he writes: "Subnational governments have very different capabilities to deliver and finance services, and certainly different capabilities to borrow. It may be necessary to set up a system where these differences are explicitly recognized, i.e., where different local governments are given different financing powers and expenditures responsibilities." (Bahl, 1999) The rule states that the differences between urban and rural areas should be recognized, but Bahl's discussion is more general and does directly relate to what the differences are between urban and rural areas. Bahl focuses on recognizing the asymmetric nature of the problem, but a fuller discussion of the differences between urban and rural, and within urban and rural areas is not further defined as elements of the intergovernmental transfer system.

There is, unfortunately, no established criteria or definition of what constitutes a rural and urban area. There are some measures based on population density, covered areas versus uncovered areas, proximity to urban clusters, but there is little agreement on an international standard that would provide how to define rural versus urban areas. In many countries, the local government law identifies a classification of local units based on population size and this may serve as a starting point for defining urban and rural areas.

In the Albania example cited above, prior to the administrative-territorial reform, there were two local governments unit designations: commune and municipality. However, there were some communes that had more population than municipalities and denser population. After the territorial-administrative reform, the commune level was eliminated as a designation and all local units became municipalities regardless of the population size or density.

The communes were, for the most part, situated in the rural and mountainous areas and their fiscal capacity and service needs were very different from those of the urban areas. The new territorial-administrative structure has incorporated these communes into the larger units and the disparity in service needs and fiscal capacity can only further compound the costs of the merging of these units. In addition, the political representation of these rural areas has been significantly decreased in the new councils as the urban areas dominated the elections.

New Rule 4: Treat Equals Equally and Unequals Unequally

If the intergovernmental transfer system is to really support the objective of equalization then it needs to identify more explicitly the characteristics and gradations among the subnational units. These can obviously be populations, population density, fiscal capacity, and assigned functions as basic characteristics. These can then be segmented in various gradations and appropriate formulas developed that would take into account these differences. The final result should be that those with equal characteristics are treated equally and those that are unequal across these characteristics are treated in a different manner.

It should be cautioned that identifying too many characteristics or specifying too fine a gradation of characteristics can be carried too far and make the whole process overly complex and difficult to understand. There tends to be a clustering of the characteristics across the whole ranges of local government units, so these clusters of population, density, and other factors many lead to a grouping of 3-5 gradations that would make a reasonable level of transfer factors. These gradations need to be incorporated into the legal framework and be the basis for defining some of the factors in the transfer formulas. Also, given that there is heavy migration from the rural to urban areas, these need to be reexamined periodically to see if changes need to be made to the classifications.

One particular problem arises when there is an outlier among the characteristics, particularly with regard to population size. The normal pattern is that there are many subnational units with small populations and then a decreasing number of large population units. The outlier among all of these tends to be the capital city of the country with a disproportionate amount of the population, sometimes as much as 25% of the total population and a very high density. This issue has been highlighted in a 2012 report by NALAS, which indicated that this high proportion of population concentrated in the capital city is a substantial political and economic obstacle to furthering decentralization.[23] What should be done when you have this situation?

Including this high population and high-density capital city will greatly distort the equalization formula and calculations that result. The recommended solution in this case to treat these outliers as special category and not be included in the general equalization pool with all the other subnational units. These capital cities can be treated as a special category in the transfer system and include more specific conditions on their revenue capacity and expenditure assignments.

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[23] NALAS, 2016 *Fiscal Decentralization Indicators for South-East Europe:2006-2014,* Network of Associations of Local Authorities of South East Europe, Fifth Edition, March 2016

In the Albania case, the consolidation of the local units into one designation and applying a transfer system that lumps all of them into one classification only serves to distort the requirements for making an equitable transfer based on the differences across these units. In addition, the capital, Tirana, is included in the number of local government units for the transfer pool, even though its population and other characteristics are significantly different for all the other local government units. The transfer system with its inclusion of Tirana distorts the revenue sources and the funding needs and makes the needed funding pool much higher than it otherwise would be.

However, Tirana actually loses even more in this transfer scheme as it based on taking funds from the local government units that exceed 100% of the national average per capita revenues and transfers 50% of the difference of that excess to the other units that are below the 75% of the national average per capita revenues. Those units are compensated up to 100% of that difference multiplied by the population of the local government unit.

But, more significantly, this approach to the intergovernmental transfers doesn't produce any incentives for the local governments to increase their revenue collections. The lower the average per capita revenue collected the more funds the local government unit will receive in the transfer. There are no carrot or sticks applied in the intergovernmental transfers. In fact, there is a disincentive for local governments to substantially increase their revenues above the threshold levels.

For the transfer model developed by USAID experts for the 2016 budget under this transfer scheme, the results would have been that six local governments (exceeded the 100%) would have 50% of their excess revenues transferred to 44 other local government units (less than the 75%) and 11 units would not have received any transfer (average revenues were between the 75% and 100%). Tirana was the big loser under this scheme as 75% of the funds transferred from the richest local governments to the poorest local governments came from Tirana. This transfer model was used for the 2016 budget, but the funding level was not at the level that was recommended by the USAID experts to adequately fund the local government units.

The problem with this "Robin Hood" approach is that there is no guarantee that funds transferred from the richest local governments will be more effectively or efficiently spent by those receiving the funds. Tirana has 25% of the population of Albania and given the pressure to provide urban services to those that have migrated to the urban area, these funds could have provided better housing and transportation facilities.

4.5 Rule 5: Fiscal Decentralization Requires Significant Local Government Taxing Power

This would be an excellent rule to follow if it were not so difficult to apply. The main problem with this rule is that the local tax base from which subnational governments could derive taxes is very limited. Also, the administrative and collection charges are often very high and negate the benefit of collecting the tax.

Bahl goes through a list of various taxes and whether they would be appropriate for subnational governments. He indicates that the VAT, corporate income tax and retail sales taxes are not appropriate or practical at the subnational level for mainly collection problems.

The individual income tax, excise taxes, motor vehicle taxes, property taxes and user charges are considered the best possibilities for the local governments to apply. But even these face some formidable obstacles in being applied at the subnational level. Overall, none of these provide a significant level of local taxing base or rates that could be applied.

Another significant constraint for the subnational units is the restrictions or limits placed by the national level on the tax rates for any of these taxes. The central level provides upper limits to the tax rates or parameters for the tax rates, which constrain local governments from exploiting any particular tax base.

Finally, local government officials would rather complain that the central government is not giving them enough money than to take the political heat associated with raising local government taxes. As long as they can place the blame for their limited resources on the central level without any incentive to increase their own revenues they will play this game.

If there is one rule that has been supremely violated in the case of Albania, it is with regard to providing the local governments with sufficient financial resources, both own source revenue and unconditional grants, that illustrates the almost impossibility of implementing fiscal decentralization in Albania. This issue has been amply analyzed in the reports prepared by the USAID PLGP project over the past several years. According to the report *Draft Policy Paper: Key Recommendations for Development and Discussion of the Law on Local Government Finances* states:

"The unpredictability and continuous decrease of local governments' financial resources has undermined local governments' ability to deliver services and has made effective budget planning and implementation a particularly difficult exercise. This unpredictability has played a major role in the accumulation of payment arrears. The other the key issue here is the continuous decline in fiscal autonomy - the control over sufficient resources to plan and manage the provision of local public services according to citizens' preferences without continuous interference from higher authorities."[24]

This decline and instability has occurred regardless of the political party in power in power over these years. The decline has continued under both Democratic Party and Socialist Party governments. While the present ruling Socialist Party had promised to greatly increase the level of local government funding and accelerate the reform of the local government system, the failure to provide the financial resources is greatly

[24] USAID Planning and Local Governance Project, 2016 *Policy Paper: Key Recommendations for the Development and Discussion of the Law on Local Government Finance*, May, 2016, p. 11.

inhibiting the local governments in meeting their new service requirements.

New Rule 5: Allow Local Governments Authority to Piggyback on National Level Taxes Applied by the Local Governments as Additions to the Taxpayers Bill

The intermediate term solution to the problem until such time as local governments have more economic base for their revenues sources is to allow for the local governments to apply surtax or to piggyback on the national level taxes, particularly the personal income tax and the corporate income tax. While there are some problems with attributing the income to the place of residence/business these could be overcome with clearer rules on where the tax base will be applied. Two countries in the Central and Eastern Europe region, Croatia and Montenegro, allow for this surtax application on the personal income tax (PIT). In both countries, the PIT has become a substantial source of their own source revenue.[25] While this is an encouraging development it needs further acceptance in the region.

A distinction between small businesses largely serving one local area as opposed to businesses with multiple locations and headquartered in the capital city could be made and the tax directed to a specific local government unit. Both of these could be applied on a derivation basis with some percentage being put into a national equalization pool for distribution across the local governments or at regional government level.

Shared taxes can be utilized, but since they are really a form of grant/transfer to the local governments and entirely under the control of the central level, these are not considered to be within the purview of local government taxing authority. However, the shared taxes are good candidates for a surtax or piggyback approach to enhancing local government revenues.

The property tax has the greatest potential as a local tax source and has not been fully exploited in the developing and transition countries. According to the NALAS 2016 report, only four countries (Montenegro, Slovakia, Romania, and Slovenia) of the South East European region had property taxes yielding more than 30% of their own source revenues. However, there are substantial differences in how property taxes are applied and how they are accounted for in the own source revenues that may distort these figures.[26]

The land registration, assessment and administrative problems, while formidable, can be overcome with the latest technology and innovations. This is a tax that would produce a more equitable and fairer tax system as it relates to the delivery of many of the services that are provide by the local governments. A comprehensive assessment of how to

[25] According to NALAS report 2016, in Montenegro the PIT surcharge has been between 12-14% of own source revenues since 2011 and in Croatia the PIT surcharge accounts for over 10% of the total PIT revenue and the total PIT revenues account for more than 50% of the local own source revenues since 2006.

[26] NALAS, 2016 *Fiscal Decentralization Indicators for South-East Europe:2006-2014,* Network of Associations of Local Authorities of South East Europe, Fifth Edition, March 2016

improve the property tax to be substantial own source revenue has been addressed by Kelly (2013).[27]

An interesting conclusion about property taxes as an incentive for greater fiscal discipline at the subnational level is referenced in the work of Presbitero, et. al., in the above cited paper by Martinez-Vazquez. The greater the use of the property tax the more fiscal discipline was evident at the subnational level. [28]

The Government of Albania has committed to implementing a valuation-based property tax by the end of 2017. The legislation for this will be approved by the Parliament by the end of 2016 and a pilot of the system will begin in Tirana in early 2017.

The new Law on Local Self Government Finance in Albania provides a very limited number of own source revenues and fixes the percentage of the shared taxes in the law. This will severely limit the potential of these revenues to adequately meet their growing service requirements and financial needs. The local governments will constrained in changing the rate or base of any taxes and, therefore, fiscal decentralization is not really achieved through the law. It does not allow for applying surtax or piggybacking on the national level taxes.

4.6 Rule 6: Central Governments Must Keep the Fiscal Decentralization Rules That They Made

This rule recognizes that many of the features of a decentralization strategy are not keep when the central government embarks on a fiscal decentralization process. Examples of these are (1) the promise by the central government to provide the funds sufficient to finance the functions assigned to the local governments, (2) providing for borrowing authority to local governments, but then issuing restrictions that effectively preclude local governments from borrowing, (3) maintaining control over the tax base and rates of the local governments, and (4) altering the transfer formulas and the shared taxes each fiscal year creating greater uncertainty in the local government budgets .

In many instances, the central government establishes the base and rates for local government units for certain local government taxes. This inhibits the local governments in establishing rates that are appropriate to the level of cost of the services provided. This desire for equity across the local government units inhibits the benefits that could accrue if the local governments had more flexible options for establishing these rates.

The implementation of restrictions is often true with regard to borrowing by local governments that could be used to finance infrastructure projects. The central government often establishes a limit on total national debt borrowing and this includes

[27]Kelly, Roy 2013 *Making the Property Tax Work* Georgia State University, Andrew Young School of Public Policy, International Center for Public Policy: Working Paper 13-11.
[28] Presbitero, A.F., A. Saachi, and A. Zazzaro. 2014 *Property tax and fiscal discipline in OECD countries,* Economics Letters 124 (3): 428-433.

local government debt within this limit. The central government then utilizes the full borrowing capacity with nothing left for the local government units within the overall limits. This situation is typical within the EU countries where there is debt limits imposed on the national governments for membership in the EU. The central government then imposes even further restrictions on the local governments through Ministry of Finance approval of any debt that effectively precludes the local government accessing even domestic debt markets.

New Rule 6: Central Government Fiscal Decentralization Rules Must be Kept to Minimum of Restriction on Local Government Authorities in areas of revenue sources and borrowing capacities

The central government should keep to an absolute minimum the restrictions on the local governments relating to revenues and borrowing capacities to ensure that the local governments can have the maximum flexibility to utilize these financial resources. Any restrictions should be provided for in a law on local government finance with only implementing instructions provided later to the local governments. Where the central government establishes such restrictions they should provide for a wide range of options available to the local governments and not narrow restrictions on the tax rates, tax base, and debt sources.

Albania in a new Law on Organization and Functioning of Local Governance adopted in 2015 addressed some of the restrictions that had inhibited local government borrowing through the following provisions in Article 39:

1. A certain percentage in the annual borrowing limit as approved in the annual budget law shall be reserved for local government units in conformity with the fiscal policy and discipline pursued by the central government. Access to foreign debt market shall be regulated in cooperation with the Ministry of Finance and other entities assigned by law.

2. Any and all regulations or restrictions imposed by central government on local borrowing that limit local governments' access to borrowing shall be provisional and shall not extend their effect beyond the fiscal year in which they were imposed, except for cases where these restrictions are adopted by the Parliament.

Article 39, paragraph 3 of the Law 8652 on Organization and Functioning of Local Governance, Republic of Albania, January 1, 2016

The above provides some opportunity for the local governments to have access to some borrowing capacity and limits the restrictions by the central government on this possibility. It will be interesting to see if the Government of Albania follows through on these provisions in the coming budgets.

4.7 Rule 7: Keep It Simple

There is no doubt that devising a simple formula based grant system would have substantial benefits. Bahl rightly points out four circumstances where a complicated allocation formula and applying restrictions on grants that distort the purpose of the transfer of funds are quite common problems within the intergovernmental transfer system. Interestingly, Bahl points out that these complicated formulas are the product of "well meaning policy analysts." (Bahl p. 16) It could be added that they are often the result of well meaning international consultants from developed countries who attempt to transplant their experiences and preferences into countries without any of the capabilities to implement them.

The most common problem with the transfer formulas is the inclusion of a multitude of factors with coefficients that require an advanced degree in mathematics to fully understand. In addition, the accuracy of the data is often questionable and the determination of the coefficients is manipulated to satisfy the funding constraints.

Just as there is a need to segment the transfer system based on the differences in the characteristics of the local governments, there is also a need to simplify the allocation formulas with more basic data that reflects the population and economic differentials among these subnational units. There may be an impression that the more factors that are included in the formula the more fair or equitable the transfer system will be. There is a tradeoff to be made between complexity and simplicity. However, the complexity can be reduced by further segmenting the subnational units based on basic data, rather than make a more complex formula based system that cannot be supported or maintained by the adequacy or accuracy of the data.

So, while keeping the transfer system simple is a laudable goal, in reality to make the transfer system more equitable and objective, there is a level of complexity that cannot be avoided. If there is a trade-off to be made between complexity of the formula and segmentation of the local government units, it is probably best to focus on the segmentation of the local government units and apply simple formulas to the segmented classifications.

New Rule 7: Keep It Transparent

A more appropriate rule would be to place transparency of the transfer system as a higher priority than simplicity. In many cases, the subnational units do not understand how the formula is derived and how the data is gathered that is included in the formula. They often see that other local government units with similar size and character often receive greater amounts of funds and this leads to suspicion that the formula is manipulated based on political affiliations. This is particularly true for infrastructure grants where there is considerable latitude in making the allocations among local governments.

Where the allocations are based on more simple formulas and the process is more transparent and the differences among the allocations can be more readily understood, the confidence the subnational units will have in the process will be greater and more politically acceptable.

Transparency can be enhanced when the determination of the transfer formulas are made by an independent fiscal commission that has representatives of the major stakeholder organizations and supported by technical experts. Fiscal commissions have proven effective in many cases, such as Poland, India, Pakistan, Australia, Canada, South Africa and other countries. These commissions not only provide for more technical input into the policy process, but also provide for a more objective and transparent decision-making process.

The new Law on Local Self Government Finance in Albania does simplify and make more transparent the factors to be considered in allocating the unconditional transfers. It provides the following transparent and objective factors to be utilized:

> 2. The formula allocating the unconditional grant to municipalities follows, but is not limited to the criteria below:
> a) Resident population, as measured by the last Census and corrected with the civil status register data, following a coefficient published in the annual budget law's annexes. Up to 80% of the total pool shall be allocated through this criterion;
> b) Population density, reflecting differences in service delivery costs among local self-government units; Up to 15 % of the total pool shall be allocated through this criterion;
> c) Number of pupils in the pre-university education system. No less than 5% of the total pool shall be allocated through this criterion;

Article 24 of the Law on Local Self Government Finance, 2017, Government of Albania

While this is an improvement over the previous complex formula, the ambiguity of the population data where there are substantial discrepancies between the census and civil registry data and how population density will be incorporated into the formula still continues the uncertainty, and potential instability, in the allocation formula. Interestingly, there is not a hold harmless clause which would mean that the local government transfer amounts cannot be less than in the previous year. However, the formula does account for analyzing the differences from the previous year and allows for changes to the allocation.

4.8 Rule 8: The Design of the Intergovernmental Transfer System Should Match the Objectives of the Decentralization Reform

Bahl provides another rule that on its face should be evident and applied. But at the end of his discussion on this he states: "As simple a rule as this seems, it is all too often violated." (Bahl, p 21.)

This discussion is rather complicated by Bahl through an examination of the different forms that the intergovernmental transfer system can take, but without relating these to any stated objectives of the decentralization reform. The objectives of the decentralization program are multiple and varied if you consider that it must address political, administrative, and fiscal decentralization within a very complicated political process and stakeholder resistance to any comprehensive change. Consequently, the objectives are generally too many and in practice often conflict across the decentralization reform effort.

New Rule 8: The Design of the Intergovernmental Transfer System should be based on a minimum of objective and verifiable criteria and apply both carrot and sticks to the transfers to the local governments

This new rule recognizes the difficulty of formulating specific objectives of a broad based and comprehensive decentralization reform, and instead focuses on the more narrow identification of what each element of the transfer system should achieve. Specific objectives of the intergovernmental transfer system should be the following or some variation of these:

1. The transfer should achieve an equalization of the overall financial resources within a lower limit of 75% across levels of government based on defining objective and accurate data reflecting the differences among the subnational units.

2. The transfer system should be based on incentivizing the local governments to increase their own revenue sources to within 75% of the national level average of local governments within the same characteristics.

3. Conditional grants for infrastructure should be based on subnational units achieving a performance level of own source revenues at the 75% national average level and performance factor of 80% of citizen satisfaction with local service delivery.

The main point here is that the design of the intergovernmental transfers cannot address the overall requirements of the decentralization reform, but a more limited and narrow focus on objective based equalization factors and performance incentives for improving their financial situation could provide a more successful fiscal decentralization outcome.

Four specific performance targets were established for measuring the improvement in fiscal decentralization of the Albanian local governments in the *National Cross Cutting Strategy for Decentralization and Local Governance 2015-2020*. These included:

- Ratio of local budget to GDP (%) by 2020: 6%
- Ratio of local revenues to GDP (5) by 2020: 3.9%
- Ratio of Unconditional Transfer to Local Revenues (%) by 2020: 35/65
- Ratio of local government borrowings as % of total government borrowing (%) by 2020: 0.2%

4.9 Rule 9: Fiscal Decentralization Should Consider All Three Levels of Government

This rule is rather impractical as most countries have a unitary form of government, rather than a federal system, which Bahl refers to in the discussion of this rule. He mainly refers to large countries and assumes that the provincial level has some role to play in the system of government. In most of the developing and transition countries, the middle level of government is largely just an extension of the central government and, generally, has little assigned role in delivery of services. There has been some debate over the years as to whether an intermediate level of government is needed in such small countries with a unitary structure of government.

New Rule 9: Fiscal Decentralization Should be Based on the Principle of Subsidiarity regardless of the levels of government

Whether there are two or three levels of government is rather inconsequential if the objective of the decentralization is to provide the services at the lowest level capable of delivering that service. The principle of subsidiarity, which is basic to determining the assignment of a function, is largely made without regard to whether a country has two or three or even four levels. The local level, if it properly receives the expenditure assignments and financial resources, could provide the basic services at this level. The intermediate levels would have the main function of coordinating some functional areas, such as some road networks, regional hospitals and universities whose services cross the local boundaries.

In some cases, the provincial, district or county levels, where they have been responsible for allocation of funds received from the central government, have imposed different allocations formulas and greatly distorted the equalization of funds across this intermediate level. Without some intervention or standardization of the allocation formula by the central government level, there could be greater inequality and levels of service per citizen due to the differences across this intermediate level of government. Consequently, the transfer of funds should be made directly to the unit delivering the service rather than a pass through approach. This would reinforce the principle of subsidiarity and more directly hold accountable the governmental unit receiving the funds.

While there are regional and local levels of government in Albania, the regional level has very limited responsibilities and resources. The regional level was addressed in the new Law on Organization and Functioning of Local Governance and some limited financial resources allocated to it in the new Law on Local Government Finance. There are some functions that have been assigned to the new municipal levels which could have been better delivered on a regional basis, such as transportation and health facilities that need a more service delivery coordination and funding support.

4.10 Rule 10: Impose a Hard Budget Constraint

This is a necessary rule for the long-term financial solvency of the local governments as well as the central governments. The national bankruptcy of some countries, such as occurred in Argentina, has been attributed to the level of debt that subnational units accrued over some years. Recently, the level of debt of the local governments in China that financed the infrastructure is causing considerable concern.

However, the reality is that for a good many reasons local governments in the transition and developing countries do run deficits, whether planned or not. Some of the reasons for this are due to the lack of economic base to provide sufficient revenues (which may be a result of the central government not giving them sufficient taxing authority), the unfunded mandates imposed on the local governments, the inability to borrow for cash flow purposes, and the delays in receiving their transfers from the central government as scheduled. In many of the transition countries of Central and Eastern Europe and the CIS, the local governments had substantial debts that were simply payment obligations (arrears) that could not be paid. While the local government may have complied with constitutional or legal requirements for a balanced budget at the beginning of the fiscal year, the deficits are realized during the year by constant changes to the local government budget by unforeseen circumstances.

In Albania there were a large amount of arrears being held by the local governments prior to the consolidation of the local government units. The Government of Albania was not willing to address this problem in the merging process and left it to be dealt with after the new territorial-administrative units were formed. The new units were to prepare a plan for eliminating these arrears by the end of September 2016 and clear these arrears from their own resources. The estimate of arrears among the local governments at the end of 2015 was 12billion LEK (about 95mUSD).[29]

New Rule 10: Local Governments should be allowed to have budget deficits to be financed within limits of their future intergovernmental transfers

Rather than try to impose a hard budget constraint that only proves to be impractical, the local governments should be allowed to budget for deficits by carry over of the deficit into the next year against a certain percentage of their transfer funds, such as 50% of the next year transfers. This deficit carryover can be budgeted for in the current local government budget. There is not doubt that there should be strict limits and justification for such an action or request by the local governments and have the approval of the Ministry of Finance.

Local governments could also be allowed to borrow from the central government a certain amount of the next year transfer and receive these in the current budget year to cover any deficits. This could be allowed in instances where local governments have a need to finance particular infrastructure projects, need funds for unexpected shortfalls or perhaps for emergencies, such as local natural disasters.

[29] International Monetary Fund, 2016 *Albania: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding*, August 15, 2016.

There should be strict limits on this deficit carrying capacity of the local governments to guard against financial bankruptcy. For example, once a local government has breached the deficit rules, they would be subject to bankruptcy procedures where the local council would be removed, the central government would appoint a financial administrator with the power to increase local taxes or other means to draw down the deficit within the limits.

In the new Law on Local Government Finance, there are several articles (55 to 61) that deal with the situation of local governments that cannot pay their obligations on time. It provides for a process of identifying the conditions under which the local governments are not meeting their payment obligations, dealing with this situation and the conditions under which the local units can bring their financial situation under control.

4.11 Rule 11: Recognize that Intergovernmental Systems Are Always in Transition and Plan for This

This rule is axiomatic in the world of governance. Governments, even the most authoritarian, are always saying they are in a state of reform or transition. It is not difficult to say governments are in transition, but the problem here is to plan for this. The balance between stability and flexibility is difficult to manage.

The central governments are always making some changes in their budget allocations from year to year as they rely basically on taxes that are driven by economic factors. They central level will transfer this uncertainty in their revenue sources to the local governments by either transferring functions they don't want to finance or changing the levels of shared taxes that finance many of the local government functions.

The more difficult problem for the local governments in the transition is that the constitution or the laws are not changed or easily changed as their circumstances change. The restrictions that are imposed on the local government authorities last longer than they should and no longer serve the purpose of improving the conditions of the local governments. So, the greater problem in planning for the transition of the intergovernmental system is to avoid the situation where changes cannot easily be made.

New Rule 11: No law, fiscal rule, expenditure assignment, revenue source, or borrowing limits should be allowed to exist longer than five years into the future without being renewed by national level policy and legislation

This new rule reflects the need to impose time limits on the decentralization policies and the local government system. These are generally referred to as "sunset laws or provisions" in that at the time they are enacted they have a time limit in which they are in effect. At the time of the expiration, the government must renew the law or authority.

Regulations issued by the central government ministries should have even shorter time frames, such as not beyond the present fiscal year without renewal by the central government.

Recently, Albania amended their local government law and included a provision that the regulations issued by the Ministry of Finance, which had effectively prevented local governments from borrowing over the past several years, could not extend beyond the fiscal year without approval by the Parliament.

> Any and all regulations or restrictions imposed by central government on local borrowing that limit local governments' access to borrowing shall be provisional and **shall not extend their effect beyond the fiscal year in which they were imposed**, except for cases where these restrictions are adopted by the Parliament.

Article 39, paragraph 3 of the Law on Organization and Functioning of Local Governance, Republic of Albania, January 1, 2016

4.12 Rule 12: There Must be a Champion for Fiscal Decentralization

Bahl presents a very comprehensive analysis of the main stakeholders in the decentralization reform and their potential to be the driving force behind decentralization. There is no question that there must be some political energy behind this effort because as previously stated for the criticism of Rule 1; there will be many who will oppose and very few who will support such a change.

Unfortunately, the support for fiscal decentralization tends to coincide with the political election process. Promising the people that more authority and resources will be given to them makes an attractive vote-gathering platform. However, once the election is over, as with most political promises, these are forgotten or other more pressing issues get the attention of the political leadership.

The external donors are identified as a potentially strong champion for decentralization, but perform more often the function of a cheerleader at a sporting event. They cheer the team on, but have no real influence on the outcome of the game. To they extent they get the crowd cheering for their teams and this cheering energizes the team to perform to a higher level; they can serve a useful purpose. This has been the main failure of the external donors. If they had energized the grassroots organizations, instead of focusing on technical assistance to the very institutions that have the most to lose from decentralization, the success of fiscal decentralization might be different that what the research shows cited earlier in this paper.

While Bahl identifies a number of what he terms potentially strong supporters, potentially weak supporters and ambivalent supporters, none of these have proven to be consistently champions of decentralization. The central level supporters are captives of the government policies and have little incentives to pursue decentralization. A natural champion would be the Ministry of Local Government, or its equivalent, in the central administration. But this ministry too often sees its role to be more of controlling the local governments than being an effective lobbyist for the local governments interests.

One potentially strong supporter not identified by Bahl is the local government association. Unfortunately, these have proven to be disappointing for several reasons. First, these associations are often very divided along political lines, with associations formed by the local governments and mayors pledged to support a particular political party of the national level.

Secondly, there are often multiple associations reflecting the different characteristics of the local governments. The rural communes will have their own association, while the larger urban cities will form their own association. Their interests greatly differ and finding common ground within a very politicized local government system limits their possibility to be effective champions of decentralization.

The champion of decentralization needs to be at the very senior level of the government structure and have the full support of the head of government, such as the prime minister or president. One example of where decentralization has found an effective champion is in Somaliland where the Vice President has been designated the champion of decentralization by the President and has proven to be capable of pushing the process forward against the bureaucratic inertia. The Vice President appointed an Inter-Ministerial Committee on Local Government composed of seven ministers representing the main sector ministries, particularly health, education, planning, etc. With the support of the international donor community supporting the decentralization program, this approach has worked much better than might be expected under the difficult circumstances.

In Albania, the Minister of Local Issues assumed the role of champion of decentralization, which was appointed to deal with the territorial-administrative reform and the merging of the units. This was an office created with minimal staffing level and primarily relied on the donor community to provide the financial and technical support for the implementation of the reforms.

New Rule 12: There must be organized a broad based grass roots political and civic organizational support for fiscal decentralization

An organized and broad based grass roots effort by local political and civic organizations that can be sustained through non-governmental financing holds the potential to keep the pressure on the central government and other reluctant stakeholders to implement decentralization. An external monitoring and evaluation of the progress of the government should accompany it to implementing decentralization and holding them accountable for the progress or lack of progress. (See New Rule 3)

The donor community can play a more decisive role as a champion by supporting these political and civic organizations as well as requiring specific decentralization reforms as conditions for their financial support.

This can be greatly enhanced where there are competitive political parties at the central and local level that must deliver on their promises or be swept from office in the next election cycle.

In Albania, while there was some level of public consultations as previously described, there was not sufficient time for many civil society or local civic organizations to develop their positions and assess the impact of the territorial-administrative reform. So, while there appears to be a sufficient level of public participation, it was actually limited to a small part of the affected populations.

4.13 New Rule 13: If at least 8 of the above 12 rules cannot be applied, do not undertake fiscal decentralization.

This is a conditional rule that hopefully would prevent the undertaking of fiscal decentralization projects that have little chance of success.

What is most unfortunate and probably leads to the low success rate of fiscal decentralization initiatives is that there is not sufficient attention given in the early formulation stage of the defining of the prerequisites for improving the chances for success. There are risk assessments done, although they always indicate that the risks are minimal or can be mitigated in the process, which never happens. There are too many stakeholders, particularly donors and the consultants, that have an interest in undertaking the work rather than making a realistic assessment of the costs/benefits for the funds expended.

There needs to be more assessment of the financial management system and the fiscal architecture of the central and local governments. Some assessments through the PEFA process both for the central and local governments would be helpful in assessing how well developed the financial management system is to support the project. A certain score needs to be achieved on the PEFA assessment as a qualification for further fiscal decentralization. In addition, the assessment of the introduction of budgeting methods, particularly the level of program budgeting and MTEF, would be useful to determine if the capacity exists to implement a fiscal decentralization project.

Further assessments need to be made of the organization capacity to deliver the baseline requirements for fiscal decentralization. The organizational capacity and informational base that needs to come from the state statistical services is a key requirement in supporting the data needs for an objective and verifiable transfer formula. Is the state statistical service capable of supporting these information requirements?

Is there willingness on the part of the main central ministries, particularly the Ministry of Finance and Ministry of Local Government, to support and are capable of supporting fiscal decentralization initiatives? Also, are training and technical assistance institutions available, other than the donor community, that can contribute to the development and implementation of fiscal decentralization activities at the local level?

Assessment of the political situation, in terms of the broad base of support for fiscal decentralization, from the government and parliamentary offices, the central ministries, and the support of civil society and non-governmental organizations needs to be assessed. The level of political competition from the central to local levels and the level of consensus or willingness to dialogue among the main political actors is a key factor to assess.

The application of this rule, along with a more thorough assessment of the existing conditions and situations, should provide a basis for assessing the probability, not the possibility, of succeeding in implementing fiscal decentralization. The risk assessment should examine what is available, required, and can be implemented in some strategic intervention approach based on an identified sequence of actions and broad based consensus to achieve these actions.

5. Applying the Rules to the Albania Case

The practical application of old and new rules is assessed in the following and leads to determination whether the fiscal decentralization project should have been undertaken in Albania. The test is whether the Albania case met a sufficient number of rules that were or could have been applied to increase the probability of success in implementing fiscal decentralization.

Rule 1: Fiscal Decentralization Should be viewed as a Comprehensive System

Albania did not view fiscal decentralization within an overall comprehensive system of local government reforms. It started the process without a national strategy that had been fully debated among the various stakeholders. The whole focus of the effort at the beginning was the territorial-administrative reforms without fully assessing the sequence or processes that would need to be put in place for a comprehensive reform of the local government.

Score: 0

New Rule 1: Define a few strategic entry points (two to four) of least resistance and moderate consensus for fiscal decentralization and build from this base for success.

This was achieved to a certain extent in an ad hoc process, but without a clear methodology or procedure to implement the reforms. The main entry point for the new system of local government was to realign the local government units into a much smaller number of units. On this issue, there was moderate to broad based consensus that some realignment was needed. However, there was not a broad based political support among the major parties and it was viewed with suspicion by the opposition.

Some reform of the local government finance system was also broadly agreed and was the main priority of the local government units. A much higher level of consensus could have been achieved had the Government of Albania focused on first reforming the local government finance system with greater fiscal resources and authority and improved the borrowing opportunities for the local governments.

Score: 1

Rule 2: Finance Follows Function

The Government of Albania adopted this approach by clarifying and adding additional functions in a new Law on Organization and Functioning of Local Governance. While a sector level analysis on a ministry-by-ministry basis was not developed, the result was to assign 17 more functions to the local governments. The weak point here, as with all efforts to follow this rule, is that the finance never follows the functional assignment to the level needed to support the functions to be delivered.

This was apparent from earlier experiences in Albania in decentralizing functions from the center to the local governments as detailed in the USAID report making recommendations for the new Law on Local Government Finance. It stated:

"There have been also cases where the decentralization of responsibilities has not been accompanied by the necessary financial resources. As an example, when in 2009 the GoA decentralized the administration of pre-university dormitories to LGUs, the latter received only 40% of (or 1 billion ALL less than) what the Ministry of Education was currently spending on the function. The same is true for water and sewerage systems. The general subsidy for water and sewerage systems when the function was performed by the central government itself was set at about 2 billion lek per year, whereas now that this is more of a local responsibility this subsidy has been reduced to just 400 million ALL. In other words, local governments receive only 20% of what the central government was spending in water and sewerage system subsidies when this was a central government function."[30]

Score: 1

New Rule 2: Function evolves from Finance

This was not followed as the process was devoted to implementing the decentralization as quickly as possible with the territorial-administrative reform without any consideration of the need for capacity building and supporting the local governments to implement the newly assigned functions. The result was much confusion over the functions assigned and inadequate preparation to assume the new functions. A new Law on Local Self

[30] USAID Planning and Local Governance Project, 2016 *Policy Brief: Key Recommendations for the Development and Discussion of the Law on Local Government Finances*, May 2016, pp. 14-15.

Government Finance was not adopted until 2017 and this law does not greatly increase the financial resources of the local governments.

Score: 0

Rule 3: There Must Be Strong Central Ability to Monitor and Evaluate Decentralization

This was lacking in the overall Government of Albania's approach to implementing the territorial-administrative reform and the subsequent functional assignments. The Minister of Local Issues was largely responsible for implementing the reforms and lacked the capacity to provide an independent monitoring and evaluation of the reforms. The Ministry of Finance played a minor role in monitoring the development and implementation of the TAR and the new law on local government.

Score: 0

New Rule 3: Establish External Institutional Monitoring and Evaluation Mechanism not influenced by governmental stakeholders

The Council of Local and Regional Authorities of the Council of Europe through their monitoring of the progress toward meeting the European Union requirements for accession and the compatibility with the European Charter of Local Self-Governments provided some external institutional monitoring. It provided the only outside and objective assessment of the progress and implementation of the local government reforms. Some monitoring and evaluation has occurred through the research and academic community that has investigated the outcomes and supported roundtable discussions on the decentralization reforms. The donor community largely failed to effectively provide this monitoring and continued to support the activities without much influence over the process or the outcomes.

Score: 1

Rule 4: One Intergovernmental System Does Not Fit the Urban and Rural Sector

This was a major violation of the rules of implementing fiscal decentralization and will have long term consequences for achieving a stable and predictable intergovernmental transfer system. The territorial-administrative reform merged many of the smaller rural communes into larger urban areas. The intergovernmental system now has to deal with merged units, which vary greatly in terms of population and the population density of the new units. All 61 of the new local governments are included in the one transfer pool that will be distributed among these varied units. The merging of the rural and urban local government units based on their population and geographic characteristic will likely increase the amount of funds that are needed to equalize the financial resources. Also, the rural areas are likely to suffer in terms of the allocation of the local financial resources due to the dominance of the urban areas on the local councils.

Score: 0

New Rule 4: Treat Equals Equally and Unequals Unequally

Under the new transfer system adopted in the Law on Local Self Government Finance, all units are lumped into the same pool even though there are great variations in the population size, population density, and local financial resources. The result is that under the new transfer system, the larger units with more fiscal resources will provide the funding for about 44 of the local government units. This will depend on the threshold levels that are to be established, but there is no incentive for the local government units to increase their own source revenues. The fiscal capacity under the new Law on Local Self Government Finance will only use the shared taxes collected from the previous year as the test of fiscal capacity.

Score: 0

Rule 5: Fiscal Decentralization Requires Significant Local Government Taxing Power

The new Law on Local Self Government Finance does not provide a significant level of local taxing power to meet the financial needs of the new units. The number of local taxes is severely constrained in the new law and these are not taxes with adequate tax base or potential growth to insure that local governments will be able to increase their own source revenue. The implementation of a property tax is still hindered by central authorities and the lack of capacity at the local level. While this could be a major source and provide more equity in the local tax base, it has not received the political support necessary to make it successful.

Albania has the lowest level of financial resources of the local government units in the region. In the past several years, the local government revenues have been about 2.2% of GDP and local revenues only about 9% of the total public revenues. Nothing in the new Law on Local Government Finance will dramatically change this level of local revenue.

It is interesting that the recommendations of the USAID experts to provide more funding to the local governments were largely ignored. For example, the USAID experts recommended that 6.5% of the national revenue from taxes and customs be allocated in the unconditional grant, the Government of Albania has only provided for about 4.7% over the past several years. In addition, the USAID experts recommended that the shared tax on vehicles be 30%, but in the new Law on Local Government Finance it remains at the 18% it has been for the past several years. The USAID experts recommended that the allocation of the unconditional grants be based on percentage of the national revenues from taxes and customs, but in the new Law on Local Government Finance, the share is based on minimum of 1% of GDP to be allocated to the local governments.

Score: 0

New Rule 5: Allow Local Governments Authority to Piggyback on National Level Taxes Applied by the Local Governments as Additions to the Taxpayers Bill

The new Law on Local Self Government Finance does not allow for the provision of local governments to apply surtax or piggyback on to the national level taxes. There is only the reliance on limited number of shared taxes with the percentage to be shared with the local units specified in the new law at very low levels of tax sharing. The Personal Income Tax is only shared at a 2% level to the local governments. There is no provision for sharing of corporate profits tax, which was included in the prior law, and this will not only further limit the financial resources of the local governments, but, also, produce more inequality in the tax system.

Score: 0

Rule 6: Central Governments Must Keep the Fiscal Decentralization Rules That They Made

There are a number of examples where the Government of Albania, including both the present and previous governments, that have violated this rule. One prime example is that the prior law governing local government finance had allowed for shared taxes of the personal income tax and the corporate profits tax. However, these were never shared with the local governments.

Another example is that the property registration information was never provided by the central Immovable Property Registration Office to the local governments, despite the fact this was required by the law.

A Law on Local Borrowing that would have facilitated the local governments to obtain credit and other borrowings was severely constrained and made impossible by regulations imposed by the Ministry of Finance. These rules were to expire at the end of a fiscal year unless renewed by Parliament.

There is a further conflict in the laws regarding the determination of the amount of funds to be allocated to the unconditional transfers. In the Law on Organization and Functioning of Local Governance, Article 37.1.b) indicates that “the unconditional transfer is set as fixed ratio of public revenues in the law that regulates local government finances”, while the new Law on Local Self Government Finance in Article 23.2 states that “The annual size of the unconditional grant to be allocated to local self-government units shall be no less than 1% of the Gross Domestic Product, as projected in the Report on Macroeconomic Forecasts and Estimations adopted by the Council of Ministers…” It is not clear whether these are reconcilable in determining the amount of the unconditional transfers and leaves room for a great deal of ambiguity in the amount to be allocated.

Score: 0

New Rule 6: Central Government Fiscal Decentralization Rules Must be Kept to Minimum of Restriction on Local Government Authorities in areas of revenue sources and borrowing capacities

The new Law on Local Self Government Finance specifies the local government revenue sources and does not specify limitations on local government borrowing. The regulations and restrictions have not been issued that would limit the authorities specified in the law. There is provision in the new Law on Organization and Functioning of Local Governance to overcome some of the restrictions on local borrowing, but must wait to see if this is implemented.

Score: 1

Rule 7: Keep It Simple

The factors identified in the new Law on Local Self Government Finance greatly simplify the intergovernmental transfers and makes them more objective and verifiable. There are still a number of problems related to the population and population density data. The new criteria reflect the problem with the differences in the range of populations among the 61 new units. There are three new local government units with less than 4,000 populations and the highest population is Tirana with over 500,000. The proposed formula does segment the population range with some coefficients applied to the four segments.

A more difficult problem is the large differences between the census data from the 2011 census and the civil registry data. The difference ranges from 15% to as high as 545%. The final population data used for the formula will provide for an adjustment factor, but the differences caused by attempting to incorporate the civil registry data will further distort the allocations to the local units.

The population density calculations also complicate the allocation amounts. The lowest population density is 16 per sq. kilometer to as high as 2,082. This disparity across the local government units indicates that the consolidation did not achieve a more uniform local governments units with similar characteristics. There was as much disparity under the previous local governments. This only reduced the number of units, but did not produce more uniformity among the units to support a more equitable distribution of resources.

Score: 1

New Rule 7: Keep It Transparent

The new allocation formula does provide more transparency in the determination of the allocation formulas as the data is more easily verified and provided by the State Statistical Agency. The allocation model developed by the USAID project is available to be checked and tested with various alternative data and coefficients that provide more transparency in the process. While the model is rather large with the data utilized the calculations made are easily understood and verified.

Score: 1

Rule 8: The Design of the Intergovernmental Transfer System Should Match the Objectives of the Decentralization Reform

While the new transfer system is more simple and transparent, there is no indication that it was developed to match the decentralization reforms. Since the decentralization reforms were never clearly identified at the beginning of the process, the later objectives as presented in the *National Crosscutting Strategy for Decentralization and Local Governance 2015-2020* do not provide a rationale for much that occurred before this strategy was formulated. The objectives in the Crosscutting Strategy are very general and not verifiable and seem to be made to justify what had already been done in changing the intergovernmental system.

Score: 0

New Rule 8: The Design of the Intergovernmental Transfer System should be based on a minimum of objective and verifiable criteria and apply both carrot and sticks to the transfers to the local governments

The design of the new intergovernmental transfer system, at least for the unconditional grants, does provide for a minimum of objective and verifiable criteria as discussed above. The conditional grants are not fully defined with a criteria or performance based approach in the new Law on Local Self Government Finance. This is left to the annual budget process to define these on a project basis. The conditional transfers have been the source of much controversy as they have been done a partisan political basis to those local government units of the same party as the ruling coalition. While there is much that could be accomplished to improve the basis of the conditional transfers, the overall transfer system has not significantly improved.

Score: 1

Rule 9: Fiscal Decentralization Should Consider All Three Levels of Government

Both the new Laws on Organization and Functioning of Local Governance and Law on Local Self Government Finance do provide for the regional and local levels of government. While the functions assigned and the revenue sources for the regional level or not particularly clear and do not provide for a strong level of service delivery and financial capacity, the regions have some possibility to play a coordination role among the local governments within the regions. However, some of the functions previously performed by the regions, such as rural roads, have been transferred to the new local government units and the funding of the regions has been dramatically reduced under the new unconditional grant formula devised by the USAID experts.

The new laws do also provide for a clearer delineation of responsibilities between the three levels and how consultation among the levels will be achieved. The new Law on Local Self Government Finance provides for a Consultative Council that will function as the main communication and coordination mechanism among the levels of government of issues related to the lower levels. The Consultative Council has no powers to develop and implement any changes in the new local government system.

Score: 1

New Rule 9: Fiscal Decentralization Should be Based on the Principle of Subsidiarity regardless of the levels of government

The principle of subsidiarity was not the basis for determining the functional assignments to the local governments in the territorial-administrative reform. The Government of Albania utilized what was termed functional areas that relied more on the economic interaction between the main urban center and the outlying areas as a basis for saying these areas should be incorporated into the new municipal unit. The only services considered in this functional areas concept were health and education, which do not constitute the main services that are provided at the local level by their own capacity. Consequently, the previous functional assignments and the 17 new functional assignments were not based on an analysis that would determine they could best be delivered at the local level. The failure to do a sector analysis and the little input from the central ministries prevented a more detailed examination of what services could have fit to the subsidiarity principle.

Score: 0

Rule 10: Impose a Hard Budget Constraint

While there is no specific provision in either the Law on Organization and Functioning of Local Governance or the Law on Local Government Finances that the local government must adopt a balanced budget, there are provisions relating to the control of the adopted budget within the financial resources of the local government unit. A medium term budget framework is part of the budget process to forecast revenues and expenditures for three years into the future and is submitted for review by the Ministry of Finance. The Ministry of Finance reviews the medium term budget submission and provides recommendations that are to be incorporated into the final draft of the medium term budget. The annual budget is also prepared based on specific guidance from the Ministry of Finance through the medium term budget review and these are incorporated into the final adopted local annual budget with a copy being sent to the Ministry of Finance. This seems to be a great improvement over the previous local government finance system where many local governments had substantial budget arrears carried from one year to the next.

Score: 1

New Rule 10: Local Governments should be allowed to have budget deficits to be financed within limits of their future intergovernmental transfers

There is no provision for local governments to fund any annual budget deficits from future intergovernmental transfers. While there are provisions for situations where the local government is not able to pay its obligations and have to undertake a process of revising their budget, the new Law on Local Government Finance does not identify or prescribe any options or means for meeting these obligations other than through increasing revenues or cutting expenditures.

Score: 0

Rule 11: Recognize that Intergovernmental Systems Are Always in Transition and Plan for This

There is no provision for limiting the timeframe of the Law on Organization and Functioning of Local Governance or the Law on Local Self Government Finance. This will obviously be subject to changes in the political situation and due to the lack of political consensus among the major parties and coalitions. A change in government following the June 2017 elections might well lead to changes in the territorial-administrative reform and the laws that have been enacted by the present Socialist Party coalition.

Score: 0

New Rule 11: No law, fiscal rule, expenditure assignment, revenue source, or borrowing limits should be allowed to exist longer than five years into the future without being renewed by national level policy and legislation

The only provision for limiting the time frame of regulations was the provision in the Law on Organization and Functioning of Local Governance concerning the continuation of the Ministry of Finance regulations, which inhibited the local governments to borrow. The government authorities did not implement this provision. The newly enacted laws did not provide for any time limits for expiration of the articles within the laws.

Score: 0

Rule 12: There Must be a Champion for Fiscal Decentralization

The newly created position of Minister of Local Issues was the de facto champion of the reforms and the fiscal decentralization effort. This office lacked any substantial staffing levels and was mainly supported by the donor community for its financial and technical support. The Minister, being part of the government, tended to support the central government policies toward the territorial-administrative reform and the reform laws that followed. Additional, this position was not at a level that it could effectively overcome resistance from the other ministries and, particularly, the Ministry of Finance.

If ever there were a situation where the highest officials of the government would have thought to be champions of fiscal decentralization, it would have been the position of Prime Minister and Deputy Prime Minister in the Socialist Party government. The Prime Minister, Edi Rama, had been Mayor of Tirana for eleven years and the Deputy Prime Minister, Niko Peleshi, had been the Mayor of Korca for two terms. So, one would have thought they would have been particularly supportive of a comprehensive change in the conditions of the local government situation. However, it appears they were more interested to change the number of local units and create opportunities for the Socialist Party to win the elections at the local level, which provided to be true.

Score: 1

New Rule 12: There must be organized a broad based grass roots political and civic organizational support for fiscal decentralization

The changes in the local government system, particularly the territorial-administrative reform and the laws affecting local governments, have been driven by a top-down approach to enacting these changes. While there has been a series of public consultations organized by the Minister of Local Issues and the donor supporters, the time frame of a few months for these reforms was not sufficient for many grass roots political and civil organizations to assess or mobilize support or opposition for these changes. The impact of any grass roots organizations, other than those representing some ethnic concerns, appears negligible.

Score: 0

New Rule 13: If at least 8 of the above 12 rules cannot be applied, do not undertake fiscal decentralization.

If we count the number of rules that have been adhered to under either the old or new rules we see that there were only 5 in each category that can reasonably be said to have been part of the fiscal decentralization process in Albania. This would indicate that fiscal decentralization in Albania is unlikely to be successful and, possibly, have negative consequences. If this assessment had been made of the rules and potential for their implementation had been performed prior to the start of the project, it would have indicated that fiscal decentralization faced substantial challenges to be implemented and should have not been undertaken. If the Government of Albania had focused on complying with the rules there would have been a greater probability of success.

This has proven to be the case in Albania. The implementation of fiscal decentralization has been undertaken in spite of obvious obstacles and mistakes by the government authorities. The lack of a comprehensive strategy could have been overcome if the authorities had chosen a more strategic approach and built the civil society and political support that would have made the process more consensual. The authorities chose an approach based more on political considerations and forced by the election cycle to implement a rather complex process that was not fully thought through. The large scale merging of the units only made the process more complex and complicated to coordinate. The assignment of functions without subsequent fiscal capacity changes now places the local governments in more fiscal jeopardy.

The emphasis on just implementing the territorial-administrative reform without providing the necessary financial resources is the most obvious strategic mistake and overshadowed the necessary elements of a fiscal decentralization effort. So, Albania now faces a situation where the new system of local government will fail. This seems to be prophesied in the USAID report when it stated:

"However, TAR will fail unless commitments are made to strengthen the fiscal dimension of decentralization in Albania. TAR will fail unless the transfer of responsibilities for newly-consolidated Municipalities is accompanied with the transfer of adequate resources and the empowerment of local governments' to raise own-source revenues. In the absence of definitive action in the area of fiscal decentralization, the opportunity will be lost for TAR to: improve services, maximize good governance and efficiency, and empower local governments and their citizens."[31]

The long-term costs of this implementation will very likely out weight what ever benefits might have been achieved in the process. There is no end in sight in terms of the donor financial and technical support that will be needed to implement some features of the project. Additionally, if there is a change in the government, it is highly likely that what has been done will be undone by a new government that felt the merging of the local government units was biased against their supporters.

6. Conclusion: New and Original Thinking Needed on Implementing Fiscal Decentralization

Professor Bahl's contribution to the thinking and research in the field of fiscal decentralization is unquestionable and inestimable over the past decades. His formulation of the rules provided a starting point for improving the quality of the thinking on the difficult path to implementing fiscal decentralization.

The level of knowledge and experience has greatly increased in the intervening 15 plus years since Professor Bahl formulated these rules. In this interim period much should and could have been done to improve the successful implementation of fiscal decentralization. Fiscal decentralization was a pivotal feature of the reforms in the transition and developing countries over these years; but, unfortunately, the impact is still difficult to ascertain in most cases.

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[31] USAID Planning and Local Governance Project, 2016 *Policy Brief: Recommendations for the Development and Discussion of the Law on Local Government Finances*, May 2106, pp.7-8.

Therefore, it seems time to incorporate this increased level of knowledge and experience and develop some new rules for implementation of fiscal decentralization. There is a need for new and original thinking. While the rules formulated here rely greatly on the experience of this author in supporting fiscal decentralization in several countries, others with equal or greater experience are welcomed and encouraged to contribute their own experience to the improvement of these rules.

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