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Too Much of a Good Thing? Own Revenues and the Political Economy of Intergovernmental Finance Reform: The Albanian Case

Tony Levitas

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Abstract

Decentralization projects in developing and transitional countries are typically accompanied by efforts to increase the own-revenue powers of local governments. Both the literature of fiscal federalism and the practices of donors and domestic reformers often see the strengthening these powers as critically important to the success of local government reform initiatives. The recent history of Albanian intergovernmental finance reform, however, suggests that there can be too much of a good thing: Placing the enhancement of local government tax powers at the center of decentralization projects can not only crowd out—theoretically and practically—critically important efforts to develop stable, predictable, and adequate transfer systems, but can also be politically self-blocking. In this paper, we use the Albanian case to illustrate why in developing countries with highly skewed tax bases there are good reasons to focus first on stabilizing transfer systems, and only secondarily on expanding local government own-revenue powers.

* Tony Levitas is a Senior Research Associate at the Urban Institute Center on International Development and Governance in Washington, D.C. The empirical research upon which this paper is based was carried out under contract from the Swedish Association of Regional and Local Governments (SKL) on funding from the Swedish International Development Agency (SIDA). This research also resulted in policy paper for the Albanian Association of Communes that contains, in a different form, many of the arguments around which this paper is focused. I am grateful to Ryan Knox of SKL, and Chas Cadwell, Jamie Boex, Olga Kaganova and Juliana Pigey of the Urban Institute, for comments on earlier drafts of the work. Both papers, however, would have been inconceivable without the knowledge, guidance, and the previous investigations into Albanian intergovernmental finance of Ornela Shapo.

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1. Introduction

Decentralization projects are typically accompanied by efforts to increase the own-revenue powers of local governments. Both the fiscal federalism literature and donor practices place own-revenue enhancement at the center of such projects. The recent history of intergovernmental finance reform in Albania, however, suggests that there can be too much of a good thing: that efforts to rapidly expand local government tax powers can be politically counterproductive, and can even crowd out—theoretically and practically—critically important efforts to develop predictable, equitable, and adequate transfer systems.

In this paper, we argue that there are good reasons to be cautious about pushing the devolution of own-revenue raising powers to local governments too fast and too far. Instead, we suggest that in developing countries with highly skewed tax bases, focusing on stabilizing transfer systems is the more important task. We make this argument by telling a cautionary tale about the recent unraveling of what seemed to be a stunningly successful decentralization effort in Albania, and by tying this story to the standard policy preferences of the literature on fiscal federalism and of donors.

We elaborate this argument in four steps. In section 2, we briefly review the literature that links local government own revenues with the normative promise of decentralization. Next, we present a thumbnail sketch of decentralization in Albania that illustrates the political and economic liabilities of overemphasizing efforts to increase in local government own-revenue powers. In section 4, we lay out what we think are the most important take-home messages of this cautionary tale in Albania for decentralization initiatives in the developing world. Finally, we return to Albania with some policy recommendations which may put the country's efforts back on track.

2. Own Revenues and the Virtuous Circle of Decentralization

Own-revenues occupy a loaded and fraught space in the literature on fiscal federalism and decentralization. The space is loaded because the literature typically presents own-revenues as being central to the idea of decentralization as a virtuous circle. It is fraught because the literature reluctantly recognizes that local government own-revenues are harder to come by in the real world than the proponents of fiscal decentralization would like.

Two arguments are typically made for the importance of own-revenues to "good" decentralization. The first argument is practical: giving local governments revenue-raising powers is the best way to reduce their dependence on the national government in general and on grants and transfers in particular (Paugam 1999; Rodden, Eskelen, and Litvack 2003). The second is theoretical: giving local governments substantial powers to tax the citizens they serve is the best way of ensuring that local political accountability is accompanied by serious efforts to improve the effectiveness and efficiency of public services (Musgrave 1983, Olson 1969, Oates 1991). Here, the argument is that citizens, as voters, will have a strong incentive to hold their elected officials accountable for the quality of public services only when those officials are directly responsible for determining a palpable proportion of their tax bills. This argument makes local government taxation the engine that drives the virtuous circle of decentralization forward.

In the real world, however, local governments inevitably need national government grants and transfers to make ends meet, a fact that the fiscal federalism literature always finds uncomfortable but which it has reluctantly come to accept (Shah 1994, Bird 1999). There are at least three reasons for this situation. The first is simply that relatively few robust taxes can be reasonably assigned to local governments. Indeed, the literature recognizes only two: the market-based (or *ad valorem*) property tax and local surcharges on a nationally administered personal income tax (PIT) (Norregaard 1997). The *ad valorem* property tax is generally considered the ideal local tax because its base is impossible or difficult to move (e.g., land, buildings) and thus hard for taxpayers to game, because there are no significant administrative efficiencies to be gained by having the national government administer it, and because a positive link should connect better public services and property values.

Meanwhile, PIT surcharges are considered good local government taxes because people move only infrequently, because political decisions on local PIT rates are extremely transparent, and because it costs next to nothing to let local governments piggy-back on the national government's tax administration. We will discuss these taxes in greater detail in the next section. For the moment, let us stipulate that in most developing countries these taxes either do not exist or do not yield anything like the revenues local governments need to pay for the services they have been assigned.

At the same time, the literature explicitly recommends against giving local governments the power to tax businesses. In developed contexts, the argument is that such taxation encourages business to relocate in response to different local government tax policies. As such local government business taxes are considered to both distort economic behavior at the micro level while being largely self-defeating at the macro level. In less developed contexts, and where businesses may have less mobility, the argument runs in the other direction, with much of the literature stressing that here, local governments tend to abuse these powers because taxing businesses, which do not vote, is easier than taxing voters who do. Similarly, over the past 30 years the literature on tax reform, and indeed worldwide practice, has seen a progressive movement away from local sales taxes and toward nationally administered value-added taxes (VATs) (Norregaard 1997).[1]

The second reason that grants and transfers typically play a larger role in the real world than proponents of decentralization generally would like is because local governments are frequently assigned public sector responsibilities whose costs far exceed any conceivable local tax stream. For example, in the vast majority of countries that have decentralized education functions to local governments—including responsibility for paying teachers' wages—a huge gap exists between what local governments can be reasonably expected to raise in own-revenues and the basic cost of running primary and secondary schools. The literature calls this sort of difference a *vertical gap,* and explicitly legitimizes the use of central government grants to fill it, even if this weakens the link between political accountability and public sector performance created by local government own-revenues (Ahmad and Craig 1997, Ahmad 1996, Shah 2003, Bird and Smart 2001).[2]

Finally, the literature allows for grants to be used to fill *horizontal gaps*. Horizontal gaps are like vertical gaps, but are particular to poorer jurisdictions. The literature recognizes that local governments with weak tax bases will require more national government grant support than the "average" jurisdiction because the own-revenues of the poorer ones will not permit them to provide public services at a reasonably similar standard. Thus, to prevent radical disparities in the provision of basic public services, the literature allows not only for grants to fill vertical gaps but also for so-called equalization grants to fill horizontal ones.

Indeed, the amount of the fiscal federalism literature devoted to the design of grants and transfers probably dwarfs all the rest by at least a few library stacks. Nonetheless, our central point remains the same: The normative goals of the literature gives conceptual pride of place to local government own-revenues, with grants and transfers appearing as a necessary evil arising from a variety of inevitable real-world problems. It is to a closer examination of these real-world problems in Albania that we now turn.

3. Decentralization in Albania

When communism collapsed in Albania in 1991, the country was the poorest in Europe and had no pre-communist history of independent local governments. Nonetheless, Albanian reformers put decentralization high on their agenda. As in the rest of post-communist Europe, this goal was set less because reformers had a clear idea of the functions they wanted local governments to

[1] National VATs are considered more effective consumption taxes than sales taxes because they produce less distortion in the behavior of economic agents. Over the past 30 years, most of the world has adopted VAT systems, with the notable exception of the United States. (Bird and Smart 2003, Bird 1999).
[2] It is important to acknowledge that decentralizing expenditure functions to local governments without decentralizing the corresponding revenue raising powers can still be justified within fiscal federalism's normative framework, so long as the resulting vertical (and horizontal) gaps are filled by appropriate grants.

perform and more because they saw democratic local elections as fundamental to the larger project of turning passive subjects into active citizens.

As a result, the hastily prepared interim constitution of 1991 required the creation of independent local governments. A mere 18 months after the transition began, Albania held its first democratic elections in 310 communes and 65 municipalities. Figuring out what these local governments were supposed to do, and with what resources, proved vastly more difficult, and over the next few years only limited progress was made in clarifying these issues. Worse, decentralization efforts came to an abrupt halt in 1996 when the collapse of a number of large Ponzi schemes pushed the country to the brink of civil war.

The crisis waned following the 1998 elections, and the prospects for decentralization brightened when the newly elected socialist government ratified the European Charter of Local Self-Government and constituted a National Decentralization Committee. The committee included representatives from both the national government and local governments, and from all major political parties. It was tasked with developing a comprehensive decentralization strategy and received substantial technical support from the U.S. Agency for International Development (USAID) and other donors (Banks and Pigey, 1998). The committee's work made decentralization a front-page issue. It also generated a small cadre of domestic municipal finance experts who began to focus on the issue full time. Perhaps most important, the committee managed to bridge the otherwise vicious political divide between the predominately urban, post-communist Socialist Party, and the more provincial coalition of democratic parties that had governed the country until the Ponzi schemes discredited them among voters.

In January 2000, the government adopted the committee's "Decentralization Strategy," and later that year passed landmark legislation on the Organization and Functioning of Local Governments and on Territorial-Administrative Division. This was followed by a package of milestone legislation that strengthened local government property rights and allowed them to assume ownership of select state assets. Finally, in 2002, the government overhauled the transfer system and gave local governments substantial new revenue-raising powers with the passage of a package of laws, including the Law on Local Government Tax Systems (IDRA 2006, Hoxa 2001).

These reforms make 2002 something of "year zero" for decentralization in Albania. The reform of the transfer system consolidated a large number of earmarked grants into a single, larger general grant that improved the financial position of all local governments and which they were free to spend as they saw fit. Moreover, the allocation of the general grant was put on a formula basis that distributed funds to local government on the basis of their populations and their area in square kilometers. The area component of the formula served as a proxy for "rurality" and by extension a blunt but still reasonable measure of (relative) poverty that helped improve the financial position of poorer jurisdictions. In short, the new transfer system substantially increased the financial independence of local governments by slashing earmarked grants, expanding their expenditure authority, raising their revenues, and improving equalization (Ministry of Interior 2006).

Meanwhile, the Law on Local Government Tax Systems significantly increased the own-revenue powers of municipalities and communes. The law expanded the base and raised the rates of the existing small business tax (SBT). It introduced a new area-based property tax on urban buildings and agricultural land, a new infrastructure impact fee, and a new hotel tax. It also gave local governments the right to impose “temporary (seasonal) taxes,” as well as to collect user fees and charges for the use of public space and for services like water supply, sewage, and solid waste collection.

Taken together, the reforms radically improved the financial position of Albanian local governments, and between 2002 and 2005 their total revenues increased 1.5 times. More remarkably, their own-revenues almost tripled. Their investment rates shot up and they began to repair long neglected roads, schools, and lighting systems and to build new infrastructure. Some also began to take over local public utilities, principally water and sewage facilities, which had previously been run by the state.

By 2005 it seemed not only that a remarkable process of intergovernmental dialogue had produced new legislation, but also that this legislation had tangibly increased the importance of local governments in the polity. Moreover, it appeared that the reforms had succeeded by making local governments work for their money, thus strengthening the link between local public officials and their electorates and bolstering democracy. In fact, the reform was so successful that by 2006 Albania had become a poster child for successful decentralization in a poor and messy country, with the World Bank taking Albanian ministers and local government officials on road shows around the region. Meanwhile, USAID and other donors shifted their efforts away from intergovernmental finance reform and toward issues of capacity building and local economic development, because it looked like the heavy lifting on fiscal decentralization had been done.

But no sooner had victory been declared than things began to unravel. In 2005, the Democratic Coalition won back control of the national government and immediately made good on campaign promises to promote economic growth by slashing the base of the SBT. Equally important, they shifted the bulk of the transfer system back toward earmarked grants. Indeed, by 2008, these new “competitive” grants had come to constitute almost of third of local government budgets—the same share as in 2001, before the reforms began. In short, the national government had started to undermine the financial independence of local governments by cutting both own-revenues and the general grant.

In 2009, this was followed by a broader assault on local government own-revenue powers. Amendments to the Law on Local Government Tax Systems again reduced the base of the SBT, but now also lowered the base of the property tax for small businesses. Most important, the government limited the total amount of the property tax and *all user charges* that local governments could impose on small businesses to 10 percent of SBT. These amendments not only significantly reduced both local government own-revenues and own-revenue powers, but by capping *user charges* at 10 percent of the SBT they also effectively eliminated the distinction between user charges and taxes (Levitas 2010a).

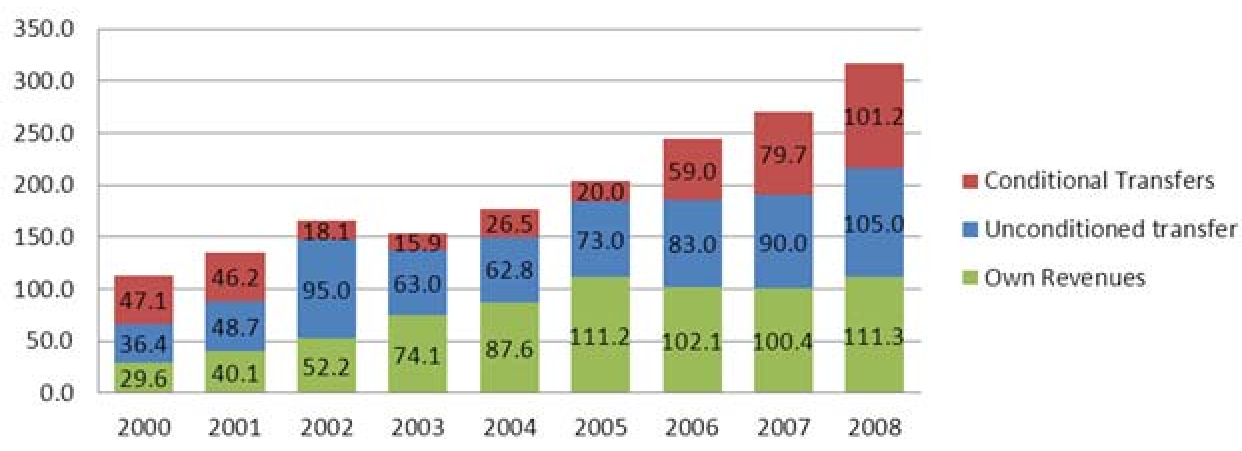
Perhaps most costly of all, the intergovernmental dialogue about decentralization that had been such a prominent feature of the previous period ground to a halt. Bipartisan cooperation within both the Albanian Association of Communes and the Albanian Association of Municipalities broke down. And in 2010, the larger socialist-led jurisdictions broke away to form their own municipal association.

What Went Wrong?

One explanation is simply that the new government decided to settle old scores, and went at Socialist policies wherever it could. Seen in this way, the attack on local government independence is the by-product of a more general political struggle that had little to do with decentralization. The argument has a fair amount of truth, in as much as that after the 2005 elections it is hard to find a political issue in which the Democrats and the Socialists were not engaged in something resembling the political equivalent of total war.

Nonetheless, the unraveling of the decentralization reforms was more than simply the collateral damage of a larger struggle. On the contrary, the nature of the reforms both helped set the stage for the war and stoked its flames in critical ways. Chart 1 below presents the composition of local government revenues between 2000 and 2008. The conversion of earmarked grants into general grants in 2002 marks the real beginning of the reform. The incredibly rapid growth of own-revenues that begins in 2003 is the result of the 2002 passage of the Law on Local Government Tax Systems.

Chart 1: The Composition of Local Government Revenue, 2000–2008 (in billions of lek)



Source: Chart prepared by author, based on data provided by the Ministry of Finance.

In 2003, however, the government changed its transfer policy by slashing the general grant by one-third. Moreover, it kept the general grant low in 2004 and increased it only slightly in 2005, but still held it well below its level in 2002. Clearly, after an initial year of largesse, the Socialist government decided that local governments could and should pay for themselves. Indeed, the policy looked to be stunningly successful precisely, because between 2002 and 2005 local governments' own-revenues almost tripled and their total budgets rose a healthy 15 percent.

What cannot be seen from the chart, however, are either the distributional consequences of the Socialists' policies or the way local governments went about exercising their new tax powers. Taken together, these factors go a long way toward explaining—if not necessarily justifying—the policies of the Democrats after 2005. They also shed light on why the Socialists' pursuit of a decentralization strategy built around maximizing local government own-revenues proved to be self-defeating.

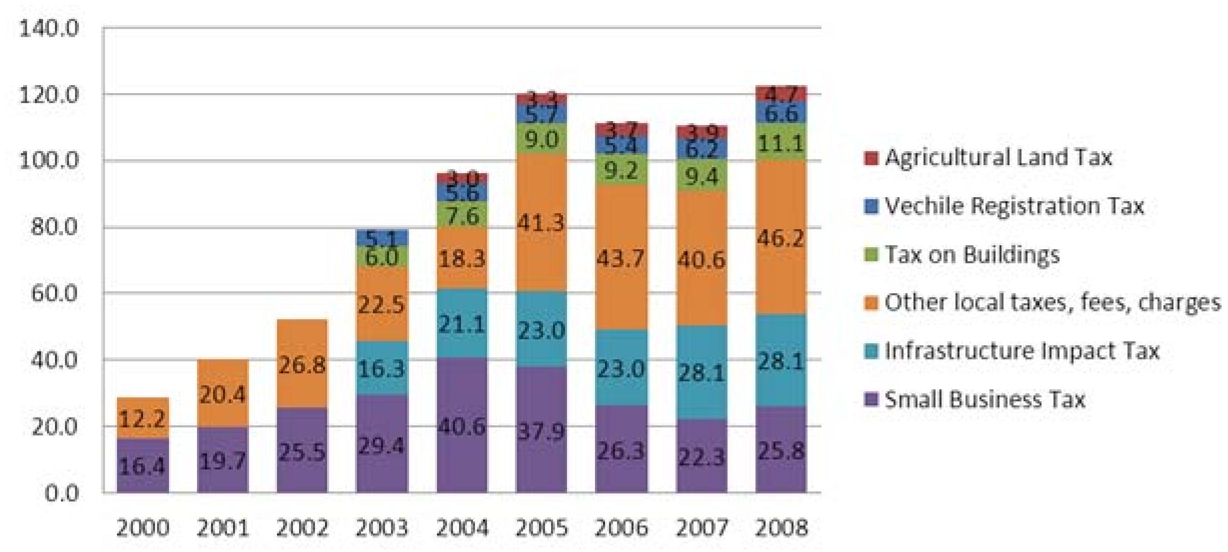
Consider first the distributional consequences of Socialist policies. Unfortunately, we do not have the distributional data that would allow us to say how much of the growth in own-revenues accrued to large urban jurisdictions and how much went to smaller rural ones. But data from other countries with similar demographics and similarly skewed tax bases suggest the magnitude of the problem: In Serbia, 20 percent of the population lives in Belgrade, but the capital city is responsible for almost half of all local government own-revenues. Similarly 25 percent of Macedonians live in Skopje, but the capital city generates 57 percent of the country's own-revenues (Levitas 2010b, Levitas 2009).

Given that 20 percent of the population of Albania resides in Tirana, it is reasonable to assume that at least half of all own-revenues were collected in the capital city. Moreover, we can be sure that the lion's share of the rest accrued to other larger jurisdictions (e.g., Durrës, Elbasan, Korçë, Fier, and Vlorë), meaning that the passage of the Law on Local Government Tax Systems did little to improve the financial situation of the vast majority of Albanian local governments.

Even the Socialists' reform of the grant system may have ultimately worked again them. In 2002, total grants increased substantially, and we can assume that this growth combined with the equalization components of the new formula produced revenue gains in poorer jurisdictions. But the ensuing cutbacks in grants make the situation between 2003 and 2005 much less clear, especially since the total grant level ended up being lower in 2005 than it had been in 2001. This suggests that even with equalization, many smaller jurisdictions were getting less in grants than before the reform began and that most could not make up for the losses with own-revenues because their tax bases were inadequate. As a result, the real beneficiary of the increase in local government own-revenue powers was the country's larger (Socialist-led) jurisdictions, particularly Tirana. Moreover, after the Socialist's reduction of the general grant in 2002, all local governments were under serious pressure to make aggressive use of their new tax powers just to stay in the same place.

Now let us consider how local government used these powers: Chart 2 below presents the composition of local government own-revenues from 2000 through 2008. It shows that local government own-revenues increased dramatically in 2003, once the Law on Local Government Tax Systems went into effect in 2002. Most of the initial growth comes from the four new taxes introduced by the law: the infrastructure impact tax, the tax on buildings, the vehicle registration tax, and the agricultural land tax. In 2005, however, the category of "Other Local Taxes, Fees, and Charges" exploded.

Chart 2: Local Government Own-Revenues (in billions of lek)



Unfortunately, we lack the data that would explain what exactly was going on. Nor do we have data that would allow us to distinguish between own-revenues from businesses and own-revenues from individuals. Case studies of the situation, however, make possible judgment calls on both fronts. First, the explosion of the category "Other Own-revenues" was driven by new user charges. Most of these charges were not imposed not for services like water supply and sewage—where the consumption of firms and individuals can be reasonably measured—but rather were for general urban services like public lighting, street cleaning, and park maintenance. In other words, local governments started imposing user charges to pay for services that should by financed by taxes because the consumption of these services cannot be reasonably attributed to particular users. Moreover, the rates they imposed on firms were much higher than those they impose on households (Levitas 2010a).

Thus, in the jurisdictions we examined—public lighting, street cleaning, and park maintenance fees—all tended to be somewhere between 30 and 70 times higher for businesses than for people. Indeed, 50 to 80 percent of the total yields of these fees came from firms, not households. Similar if less dramatic tendencies were observed with respect to both the property tax and the infrastructure impact tax. With the property tax, local governments tended to impose the maximum statutory rates allowed by law on both business and individuals. But because these rates are higher for businesses and because business rates collection was much more successfully enforced, payments by individuals typically constituted less than 50 percent of the total tax yield. Similarly, local governments imposed much lower infrastructure impact taxes on residential construction than on commercial construction, and were much more aggressive about collecting it from companies (Levitas 2010a).

To summarize, not only did Albanian local governments use their new tax powers to invent fees and charges, but they clearly placed the lion's share of the local government tax burden on firms and not individuals. Thus, the Socialist policy preference for making local governments pay for themselves did not produce the sort of taxation that in the fiscal federalism literature is supposed to encourage the greater accountability of local officials to their electorates. On the contrary, it seems to have encouraged predatory taxation.

The Democrats' policy response to this unpleasant reality after 2005 was in turn painfully logical. Politically, their base of support lay in precisely those jurisdictions that were hurt most by the Socialists' rollback of the general grant and the ones least able to make up for the losses by exercising increasing their own-revenues. Moreover, the volume of complaints from small businesses everywhere provided them with both the economic rationale and the political opportunity to take strong counter measures.

What Did They Do?

The Democrats created a new category of "competitive" earmarked grants and used them to direct funds to their political base in the provinces, while making a play for the support of small businesses everywhere by constraining the ability of local governments to tax them. These constraints enraged the larger jurisdictions and fueled the wider conflict with the Socialists, and also further confused the already fuzzy distinction between taxes and user fees. In short, the Democrats whittled away at the financial independence of local governments in ways that put the future of Albania's decentralization efforts at risk.

4. Fiscal Federalism and Its Discontents: General Lessons from the Albanian Case?

Important lessons can be learned from Albania's once promising but now apparently stalemated decentralization effort. The first is that in developing or transitional countries, it may be unreasonable to think that decentralization agendas can be successfully pursued through projects whose primary focus is on making local governments pay for themselves. Put another way, the virtuous circle of accountability, efficiency, and democratic legitimacy that the fiscal federalism literature links to local taxation—and places at the center of its normative justification for decentralization—is unrealistic in most developing countries for at least three reasons.

First, only a handful of good local taxes can be assigned to local governments, and the two most robust ones—the *ad valorem* property tax and local PIT surcharges—are at best long-term projects in most developing countries. Second, the tax bases of developing countries are typically skewed dramatically toward larger jurisdictions in general and capital cities in particular. This makes it virtually impossible for poor rural jurisdictions to derive significant revenues from local sources. Finally, giving local governments wide revenue-raising powers in countries where there is little history of direct taxation of individuals is likely to result in the predatory taxation of local businesses.

The second major lesson is that decentralization projects in developing countries should be grounded in creating and maintaining stable, adequate, and equitable grant systems. This means that at the beginning of most decentralization projects, emphasis should be placed more on increasing the expenditure autonomy of local governments than on increasing their revenue raising powers. It also means that the normative goal of strengthening the accountability, efficiency, and legitimacy of local governments should be built first around ensuring that they have the money and spending authority to actually improve the lives of their citizens, and only secondarily on their ability to tax them.

In practice, of course, it has proved notoriously difficult to get national governments to put in place and maintain stable, adequate, and equitable transfer systems. The most important reason for this is simply that national governments in general and those of developing countries in particular are naturally reluctant to constrain their future budgetary choices by transforming state revenues into fixed commitments for transfers. Technically, correcting this problem is straightforward; all that has to be done is to define the size of the local government transfer pool as being equal to some percentage of the state budget or of the yields of particular national taxes. In fact, if the Socialists had done this in 2002 not only would the size of the general grant have remained constant but it is also unlikely that the reforms would have provoked the self-destructive political backlash that they did.

The fundamental problem here, however, is not a technical one. Rather, it is about political will and about overcoming the basic attitude of most ministries of finance—and the International Monetary Fund (IMF)—that stabilizing transfer pools in the name of decentralization is a less important policy goal than preserving the expenditure flexibility of hard-pressed, cash-poor national governments.

Our argument is not that national governments have no need to worry about preserving their budgetary flexibility. Nor is it about whether decentralization can present threats to a country’s macroeconomic stability, because it surely can. Rather, our argument is about whether some of our ideas about what constitutes good decentralization actually get in the way of making the hard, pragmatic choices critical to creating sustainable local governments in developing and transitional countries.

So far, we have argued against the normative ideal that in the best of all possible worlds local governments would pay for themselves. This ideal gets in the way of good policy; at a minimum, it directs attention away from the importance of transfer systems, and at a maximum, it belittles them. But two other cornerstones of the fiscal federalism literature are equally problematic. The first concerns the way the fiscal federalism literature frames the question of how determine what “adequate” local government revenues might look like. The second concerns how it approaches the problem of making transfer systems “equitable.”

Defining an "Adequate" Transfer System

The central methodological principle for designing intergovernmental finance systems in the federalism literature is that "finance should follow function." What this means is that in thinking about the "adequacy" of local government revenues in general and transfers to local governments in particular, reformers should first figure out which functions should be decentralized to local governments, then estimate the costs of those functions, and only as a last step determine how much money local governments should get from some combination of transfers and own-revenues.

This principle sounds reasonable and in many ways is a useful heuristic device, but for two reasons it is problematic when thinking about decentralizing functions to newly created local governments in developing and transitional countries. The first is that the nature of the initial functions that are typically devolved to local governments in developing countries are broad and diffuse. On one hand, local governments should maintain and improve many different kinds of local public infrastructure such as roads, bridges, canals, irrigation systems, schools, lights, parks, recreational facilities, and cultural sites. On the other hand, they also provide a hodgepodge of basic public services that range from urban planning and permitting, to civil registration, to solid waste collection, water supply, and sewage treatment. In other words, local government functions are difficult to clearly define, standardize, and cost-out.

The second and more profound problem is that it is precisely these "functions" that most centralized states undersupply, underfund, and manage in chaotic ways. Indeed, in many cases this is precisely why decentralization is appealing and is on the political agenda at all. In practice, the list of functions that we typically want to assign to local governments is long, but the amount of historical spending on them by the national government is not only short but also scattered across line ministries and their territorial representatives at the local level. As a result, identifying what these functions cost on the basis of past practice—on what the national government has historically spent on them—is virtually impossible because, almost by definition, too little money has been spent and the spending records cannot be reconstructed.

In other words, the "finance should follow function" principle breaks down in practice when decentralizing basal metabolic functions to newly created local governments in formerly centralized developing and transitional countries. Instead, what we typically have in these countries are some baseline expenditures that the national government has made on the wages of people working at the lowest level of the state administration, and a long list of partially and unevenly funded "functions" whose historical "costs" are essentially beside the point. The mantra that "finance should follow function" actually instructs us beat our heads against the impossible. Moreover, ministries of finance and the IMF often use this belief to justify either delays in giving newly created local governments more money until these calculations can be made, or the practice of giving them funding equal only to those "costs" that can be identified as historical national government expenditures.

In short, the use of the "finance should follow function" principle in developing and transitional countries typically yields delayed and conservative definitions of what "adequate" local government revenues should look like. This is not to say that is impossible to err in the other direction. Nor is it to say that in some situations, national governments simply cannot afford to finance the "legitimate needs" of local governments. Rather, in the last instance, the "finance should follow function" principle not only fails to gives us a good handle on what "adequacy" might mean, but in a fundamental way obfuscates the real issue: Decentralization projects in developing and transitional countries are undertaken in large measure precisely because centralized states typically mismanage and underfund local services. As such, the promise of decentralization cannot be built solely around the idea that democratically elected and accountable local officials will manage these services more efficiently. On the contrary, it must be buttressed by the idea that more money will actually be spent on them.

How much more of course, remains an open question. But answering this question has less to do with costing-out functions that have been chaotically underfunded in the past and more to do with making difficult political decisions about how much money policymakers think the national budget can afford and newly created local governments can rationally spend. The issue boils down to what percentage of the state budget can be earmarked for local governments without disturbing a country's macroeconomic balances and without swamping local governments in cash they cannot spend.

The Search for "Equity"

The fundamental methodological instruction contained in the literature on determining equitable grant systems is that local governments should receive equalization grants calculated as the difference between their *standardized* revenues and their *standardized* expenditure needs. It is beyond the scope of this essay to fully unpack the methodological nuances behind this instruction or to go through the various techniques that can be used to standardize revenues and expenditures. In general, though, local governments should receive transfer payments equal to the difference between their per capita revenues at an average level of fiscal effort and some calculation of their per capita expenditure needs.

In practice however, fulfilling these instructions is a huge technical and political challenge in most countries. In developed countries, calculating a jurisdiction's ability to generate revenues at an average tax burden is reasonably straightforward if most local government revenues come from the property tax or a local PIT surcharge and there is accurate information about the base of these taxes in all jurisdictions. In developing countries, however, the process is much more difficult because these taxes either do not exist or (in the case of property tax) the methodologies that local governments use to value their bases are not commensurable across the whole country.

The real problem, though, is on the expenditure side. Here, making calculations of the expenditure needs of local governments is extremely difficulty even in developed countries. Such calculations require not only pricing the average costs of the major services that local governments provide, but also developing various measures to adjust these averages in accordance with the amount of a particular service that an individual local government is likely to perform and for the differential costs of providing that same service under different socioeconomic or geographical conditions. As a result, these calculations require extensive, regular, and reliable data on the unit costs of a wide variety of public services. They are also incredibly politically contentious because the assumptions behind every calculation—indeed, every data point—can have palpable financial consequences for different local governments.

Indeed, the intensity of the data requirements and the inevitable politicization of the calculations make it relatively rare that the literature's methodological instructions for improving the equity of grants systems are actually applied --even in developed countries. Meanwhile, in developing ones, we not only don't have reliable, regular information data on the unit costs of most services, but –as we have discussed before—there is literally no data about the costs of many "functions": Historically these functions have been provided so rarely and chaotically that they simply don't exist except as something that local governments *should do*.

In sum, the methodological principles proposed by the fiscal federalism literature about how equalization grants should be understood are of extremely limited practical value in developing countries. Nonetheless, ministries of finance and the IMF often use these principles to explain why efforts to improve the horizontal equity of a system should be minimized or postponed until better data comes along. Here too, in other words, the way we have come to understand the meaning of the "stability, adequacy, and equity" of local government finances actually impede our ability to formulate pragmatic solutions to the challenges of decentralization in developing and transitional countries.

Now let us look at what a more pragmatic set of methodological instructions might yield in terms of policy recommendations for Albania today.

5. Toward a Pragmatic Reform of Albanian Intergovernmental Finance

Albania is a poor country that has problems with tax collection at all levels of government. Indeed, public spending in Albania represents a small percentage of the country's GDP (c. 25 percent) compared with European norms (c. 45 percent). Until tax collection improves, public funds for all purposes will be hard to come by and local governments in particular will find it difficult to increase their share of the fiscal pie. In short, serious disputes over how much the national government can afford to give local governments in transfers are unavoidable for the foreseeable future.

Table 1 below presents the evolution of local government revenues as a percentage of both gross domestic product (GDP) and the state budget between 2000 and 2008. To make the table more intelligible, the years have been broken down into three periods. The years 2000–2001 represent the pre-reform period. The years 2002–2005 correspond to the period when the Socialists introduced major reforms. And the years 2005–2008 mark a period during which the national government was controlled by the Democratic Coalition.

Table 1: The Evolution of Local Government Finances, 2000–2008									
	Period I		Period 2				Period 3		
	2000	2001	2002	2003	2004	2005	2006	2007	2008
LG Rev as % of GDP	2.2%	2.3%	2.7%	2.2%	2.4%	2.5%	2.7%	2.7%	2.9%
LG Rev as % of State Budget	8.7%	9.3%	10.7%	9.2%	9.6%	10.0%	10.8%	10.7%	10.9%
Transfers as a % of State Budget	6.4%	6.5%	7.3%	4.7%	4.8%	4.6%	6.3%	6.7%	7.1%
Uncond. Transfers as % of LG rev.	32%	36%	57%	41%	36%	36%	34%	33%	33%
Cond. Transfers % of LG rev.	42%	34%	11%	10%	15%	10%	24%	30%	32%
Own-Revenues % of LG revenues	26%	30%	32%	48%	50%	54%	42%	37%	35%
Source: Ministry of Finance; State budget does not include the budget of funds; transfers to local governments not netted out of local government revenues.									

As the table shows, local government revenues were 2.3 percent of GDP and 6.5 percent of the state budget prior to the reforms of 2002. This level is low, even compared with other countries in the region where local governments have not been assigned major social sector responsibilities like primary and secondary education. For example, local government revenues in Serbia and Croatia are around 6 percent of GDP, in Bosnia and Herzegovina around 5 percent of GDP, and in Macedonia (prior to the decentralization of teachers' wages to local governments) about 3 percent of GDP.

In light of these comparisons, the Socialist government's decision to increase local government revenues from 2.3 percent of the GDP to 2.7 percent by expanding the transfer system in 2002 seems justified and commendable. However, three postscripts should be noted. First, the decision was not based on any sort of "finance should follow function" calculation of "adequacy." (Nor do we think it could it have been.) Second, even though the increase represented a significant growth in local government revenues, it still left local government revenues in Albania low as a share of GDP compared with those of its neighbors, to say nothing of the rest of Europe. Over time, this share percentage will have to grow. Third, and most important, the government reversed the decision in 2005, apparently convinced that the growth in own-revenues made the boost in the transfer system no longer necessary.

The reversal led transfers to local governments to plummet from 7.3 percent of the state budget to 4.8 percent, less than they were before the reforms began. This suggests that the government saw the increase in transfers not as stable commitment to local governments but as a temporary measure designed to kick off the reform, which they expected to roll back once local governments began "paying for themselves." Then, in 2005, following the electoral victory of the Democrats, the percentage of transfers going to local governments rose, mostly because of the expansion of earmarked (competitive) grants. Indeed, by 2008 the total amount of grants in the system had risen to 7.1 percent of the state budget, just under their 2002 levels.

From a purely pragmatic point of view, this suggests that the national government can afford to provide local governments with transfers equal to *at least* 7 percent of the state budget and that the next round of reforms should peg the transfer system to something like this level for the immediate future and so long as major new functions are not being devolved to local governments. This may not seem like a revolutionary conclusion, but a lot of damage could have been avoided if it had been reached and abided by in 2002.

With respect to own-revenues, let us begin by looking briefly at the problem of user fees and charges. As we have seen, by 2004 local governments, under pressure from the contraction of the transfer system, began to invent user fees and charges and to impose and collect them primarily on businesses. In 2008, the Democratic Coalition responded to their explosive growth by introducing an amendment into the Law on Local Government Tax Systems that tried to cap them, at least for small business. This amendment further blurred the already confused distinction between user fees and taxes.

Taken together, this double movement suggests two sorts of reforms. The first would introduce an enumerative list of legitimate user fees into the Law on Local Government Tax Systems. This list would reduce the space that local governments had to invent fees that are really unregulated taxes. The second reform would be to express the maximum level of user fees that local governments could impose on firms as a multiple of what they are willing to charge individuals or households, say 2.5 to 3 times.

What this multiple should be—indeed, whether it should be allowed at all—is of course debatable, but it is certainly preferable to allowing local governments to charge businesses 50 times what they charge households for solid waste collection or water. It would create a significant but bounded incentive for local governments to increase the direct taxation of households. In other words, such statutorily defined multiples are a pragmatic comprise between several policy objectives: maintaining or increasing local government own-revenues, preventing the predatory taxation of businesses, and encouraging local governments to engage in the unpleasant task of charging voters for the public services they consume.

Now consider the small business tax (SBT). This tax was assigned to local governments with the 2002 reform and ran against the general principle that it is unwise to give local governments the power to tax businesses. At the time, however, the decision made some sense because local governments desperately needed revenue and because the national government had yet to develop the capacity to tax the explosion of small businesses that emerged with communism's collapse. Since then, however, the capacity of the Albanian state to tax small businesses has steadily improved. First, the government has progressively extended the VAT system to include ever smaller enterprises by lowering the threshold for being in the system from 8 million lek in turnover to 5 million lek, and more recently to 2 million. Second, it has begun to require all small business to pay the same 10 percent profit tax that it imposes on larger firms and on personal incomes. As such, while tax collection remains a problem it is clear that the national government now has the instruments to tax small businesses that it lacked at the beginning of the reform period, and which at least partially justified assigning the tax to local governments.

Moreover, and equally important, these new instruments are complicating the administration of taxes for small business and colliding with the local government SBT. The lowering of the VAT threshold from 8 million lek to 2 million lek has left Albania with two different tax definitions of what as small businesses is: For the SBT, a small business is still defined as any enterprise with less than 8 million lek in turnover, whereas for VAT purposes it is any firm with less than 2 million in turnover. This movement has encouraged small business to try to artificially lower their turnover to avoid paying VAT. It has also created confusions between national and local tax administrations about who is responsible for verifying the turnover of small business.

The extension of the profit tax to small businesses has created similar problems. Like individuals and large firms, small businesses are now required to pay a 10 percent profit or income tax to the national government. To avoid double taxation, however, they are allowed to deduct what they pay in the SBT to local governments from their liability to the national government. Again, this has not only been confusing for tax payers, but has led to conflicts between national and local tax authorities over who is responsible for enforcing compliance. In short, the extension of the VAT system and the introduction of the profit tax suggest that the SBT should be eliminated because it is now extremely confusing and costly to administer, because it was never a great local tax to begin with, and because its historical utility seems to have run its course (Levitas 2010).

The elimination of the SBT, however, would immediately present the question of how the national government should replace the revenues that local governments will lose. One answer is simply to expand the grant system. Another one is to give local governments a share of the PIT generated in their jurisdictions. This seems to us the better answer for a variety of pragmatic reasons.

To date, the Albanian intergovernmental finance system has rested on two pillars, grants and own-revenues. This is unusual because most of transitional Europe and the rest of the world make extensive use of a third pillar, shared taxes, particularly shared PIT. Indeed, Albanian legislation contains provisions that foresee giving local governments PIT shares, but these provisions have never been used. Moreover, the Ministry of Finance is still registering PIT on the basis of employers' headquarters and not the residences of employees, something that would have to be changed in order to begin PIT sharing.

Nonetheless, there are a number of compelling immediate and strategic reasons for simultaneously introducing PIT and eliminating the SBT. First, the origin-based sharing of PIT provides local governments with a direct incentive to promote economic growth and job creation while constraining their natural temptation—which exists with the SBT—to tax it away. Second, the yields of shared PIT will flow by and large to the same jurisdictions that have been deriving the most revenue from the SBT. This makes the shift from one revenue source to the other relatively simple from a technical point of view and much easier politically. Third, PIT sharing provides a strong incentive for local governments to help the national government improve tax collection, something Albania sorely needs. Fourth, it will place the Albanian intergovernmental finance system on the same three financial pillars—grants, own-revenues, and shared taxes—as most of the rest of (at least transitional) Europe.

Finally, and both paradoxically and perhaps most important, the introduction of PIT sharing would make it easier to construct a more equitable grant system and to strengthen the equalization provisions governing the general transfer. The equalization component of the current transfer system is being driven by a crude measure in which area is taken as a proxy for "rurality" and "rurality" as a proxy for relative wealth. This measure is better than nothing, but it is not very effective and is extremely inefficient. After all, it does little for small jurisdictions that have weak tax bases while unnecessarily directing funds to big jurisdictions with strong ones. Most important, the measure is not directly linked to the actual revenues that local governments are capable of generating.

At the same time, bear in mind fiscal federalism's proposition that equalization systems should be based on filling the gap between a jurisdiction's standardized revenue-raising capacity and its standardized expenditure need: On one hand, we have argued that building such systems in developing countries is unrealistic because the data do not exist to make a rational set of calculations on either side of the equation. On the other hand, we have argued that this methodological norm is often used as a justification for delaying serious efforts to improve equalization systems in developing countries.

Origin-based PIT sharing creates a mechanism for doing this, if in fact PIT returns can be placed on a residency basis. Indeed, this mechanism has been extremely successful in many transition countries, such as Poland and Serbia. But the basic idea is simple: Per capita revenues from PIT become the basic measure of the relative wealth of local governments for equalization purposes. And equalization grants are calculated by giving poorer jurisdictions some percentage of the difference between their per capita PIT revenues and the national average for all local governments.[3] As such, the origin sharing of PIT sharing provides the national government with both an objective measure of the relative wealth of local governments and a transparent metric than can be used for equalization.

Of course, this measure is not ideal because it does not standardize the expenditure needs of local governments. Nor does the measure tell us how large the PIT share should be or to what level of the national average local governments should be equalized. In Albania, the parameters of the former question would probably be determined by the size of the PIT share necessary to replace the total revenues that local governments lost with the elimination of the SBT, though here it is of course possible to also consider using the PIT share to increase total local government revenues. Meanwhile, the parameters of the latter question—to what percentage of the national per capita PIT average should local governments be equalized—would have to be established by

[3] The Polish system, for example, guarantees all jurisdictions whose per capita revenues from the PIT share are less than 90 percent of the national average, 90 percent of the difference between their actual per capita PIT revenues, and 90 percent of the national average multiplied by the population of the jurisdiction. Thus, if the national per capita average of the local government PIT share was 100 units of PIT revenue and a jurisdiction of 5,000 people had PIT revenues equal to 70 units, that jurisdiction would be entitled to an equalization grant equal to 90,000 units of revenue (90 = 90 percent of the national average; 90 minus 70 = 20; * 90% = 18; *5000 =90,000).

considering what percentage of the general grant would be consumed by the equalization rule that was chosen.

None of the answers to these deeply political questions is obvious. Nonetheless, we believe that the question themselves mark an improvement over thinking that in an ideal world, local governments would support themselves by own-revenues; that in the next best world, the adequacy of the transfer system can only be calculated when all local government functions are properly costed out; and that making the transfer system more equitable is better left until the gap between a jurisdiction's standardized revenue-generating capacity and its standardized expenditures need can be calculated.

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