

FISCAL DECENTRALIZATION AND ECONOMIC GROWTH CASE OF ALBANIA

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Abstract

Recent years have seen worldwide interest in fiscal decentralization. Developed countries are reshaping their intergovernmental fiscal structure to be more in tune with the realities of the "post - welfare state". In many countries (mainly in those centralized) Central Governments regardless of the number of reforms and expenses, have failed in providing quality services and sustainable for the improvement of living standards for their citizens, because they are far from needs and problems faced by citizens every day. There are many empirical studies that analyze the relationship between fiscal decentralization and economic growth. According to the argument by Oates (1993) and Bird (1993), there are studies that show a positive effect of fiscal decentralization on economic growth. However, although most of theoretical literature discusses the potential positive effect of decentralization, there are empirical studies which don't report any significant relationship between these variables.

This paper is a literature review and has on focus to determine what effect has had the reform of fiscal decentralization on economic growth in case of Albania. It will serve as the contribution on fiscal decentralization topic, same as for academics, as well as for local governments units in our country.

Keywords: fiscal decentralization, economic growth, local government units, Albania

1. INTRODUCTION

Decentralization has become an international trend because has raised hopes for being seen as a radical reform with triple benefit (Kalin, 2002). Generally, fiscal decentralization is considered playing an important role to improve economic development. This is because there is devolution of fiscal power from higher level government to lower level government (Yulindra, 2012). Essentially decentralization is a democratic reform which seeks to transfer

political authority, administrative, financial and planning from central to local government. It seeks to develop civic participation, empowerment of local people in decision-making and to promote accountability and credibility, to achieve efficiency and effectiveness in the collection and resource management and service delivery¹.

There has been an ongoing debate between the theoretical and the empirical literature on the opinion that decentralization is an effective strategy to promote economic growth and development, and these especially in developing countries. Theoretically, decentralization can be viewed as a way to stimulate an increase in economic growth, with significant opportunities for better governance (Aisyah)

2. AN OVERVIEW OF FISCAL DECENTRALIZATION

Decentralization is a long-term process that includes, within an appropriate legal framework, different components, such as political decentralization, administrative decentralization and fiscal decentralization (Boschmann, 2009);

- Political decentralization refers to the transfer of functions or powers from the central government to local institutions that are governed by local political representation. This means of course, a decision-making power, but also accountability systems, which are being transferred from central to lower levels of government (Boschmann, 2009). Political decentralization aims to give citizens and their elected representatives more power in public decision making².
- Administrative decentralization refers to the termination of the line ministry staff from their respective ministries and their behavior under the control of local authorities, which includes procedures for creating a local charge. This means that local authorities can employ and dismiss their staff. Administrative decentralization presents the distribution of powers, responsibilities and financial resources necessary for the provision of services within the public sector (Lativack,J. & Seddon,J. 1998 – World Bank).
- Fiscal decentralization is the transfer of functions or powers from the central government to local institutions regarding to local decision making on the allocation of financial resources (ie financial powers) and the power to put local taxes.

Rondinely determines the policy of decentralization as a system that provides a channel for the central government in accommodating the public opinion through the local government. Thus, through this policy, local governments have a great opportunity at the regional level to manage their program and policy development (Aisyah).

According Feruglio (2007) the basic idea guiding fiscal decentralization is "the creation of an adequate and sustainable local income logical, but without creating additional costs for national finances and it is in compliance with fiscal and macroeconomic policies".

During the last two decades, many developed and developing countries have undertaken several reforms in their fiscal systems. Also these reforms were taken from the transition countries of Eastern Europe and ex Soviet Union. Many other countries in the region are in the process of implementation of deeper reforms in this area. But it should be noted that often

¹ Decentralization Secretariat, 1994: pg 33-34.

² <http://www.worldbank.org/publicsector/decentralization/political.htm>

the lack of macroeconomic stability constant or heritage of socialism and central planning has become difficult to build an effective system of decentralized.

Theoretical and empirical literature that examines the relationship between decentralization and government efficiency can be divided into two major areas (Porcelli, 2009):

- The classical theory
- Second-generation theory

The classical theory can be limited to three main contributions. Chronologically, we can mention Tiebout's model (1956), Oates (1972) with Decentralization Theorem, and, Brennan and Buchanan (1980). Oates (1972) and Tiebout (1956) provide a theoretical framework in which fiscal decentralization can guarantee an efficient provision of public goods simply because local preferences are more satisfied than in the case of centralization (Porcelli, 2009). The Second-generation theory - Here the main argument in favor of decentralization depends more on inefficient outcome of centralized decision-making process than the link between preferences and externalities, typical of the original version of the theorem of Oates (Porcelli 2009).

According Feruglio and Anderson (2007), the pillars of fiscal decentralization are four:

1. The assignment of their local own revenue sources: implies what would be the income collect by the communes and municipalities and what proportion will be the transfer from central government and which taxes will go entirely as government revenue.
2. Determination of expenditure responsibilities that means which are exclusive expense of the municipalities, which are functions delegated by the central government and which are the those costs which will be covered commonly from both sides.
3. Intergovernmental fiscal transfers are also associated with the point stated above, because it refers to funding provided to local units by the central government and given conditionally (conditional transfer) or for any need that the local government has (unconditional).
4. Local borrowing as a financing option: Local governments can also rely on this type of financing, although the burden for borrowing will fall back to the central government.

3. LITERATURE REVIEW ON FISCAL DECENTRALIZATION AND ECONOMIC GROWTH

In different theoretical literature on fiscal decentralization are highlighted potential positive effects of fiscal decentralization.

According to Tiebout (1956) and Oates (1972) a greater financial autonomy or more transfers of funds to local levels of government would bring more efficiency to the distribution and use of funds, both in manufacturing and, ultimately, economic growth . There are some premises for a positive relationship between fiscal decentralization and economic growth.

Tiebout and Oates started, firstly, the fact that fiscal decentralization, as a process, means a financial resource mobilization. Consequently, local governments, only because they have more autonomy, will be postponed to mobilize their financial resources instead of waiting for solutions to problems or provision of local public goods by the central government. In this way they utilize local resources that would otherwise remain unused.

According Grewal (2010) international organizations, such as the World Bank, African Development Bank, Asian Development Bank, the Organization for Economic Cooperation and Development, and Development Bank Inter-American, not only pay attention embracing fiscal decentralization ; they also support and encourage countries to achieve decentralization in their economies as an important part of a wider strategy for the protection of public sector efficiency. These organizations believe that fiscal decentralization strengthens the decision making process of local government levels, which leads to the acceleration of economic growth and development.

Another reason that would bring increased economic efficiency is the competition among local governments. Fears that enterprises and citizens can move to another location, increase the quality of policies, services and public goods provided by local governments.

Economic growth is considered the most important aspect in the implementation of decentralization because economic growth is a quantitative measurements in assessing the success of the development program. An increase of GDP is seen as an increase in the welfare of the population (Aisyah).

There has been an ongoing debate between the theoretical and the empirical literature on the opinion that decentralization is an effective strategy to promote economic growth and development, and this especially in developing countries. Theoretically, decentralization can be viewed as a way to stimulate an increase in economic growth, with significant opportunities for better governance (Aisyah)

The relationship between fiscal decentralization and economic growth goes from positive and statistically significant (Akai and Sakata, 2002; Purpose of, 2005; Filippetti and Sacchi, 2013) in a relationship in the form of a U-inverted (Thiessen, 2003), or in a neutral relationship, or slightly negative (Davoodi and Zou, 1998; Woller and Phillips, 1998; Rodriguez-Pose and Bwire, 2004; Thornton, 2007; Baskaran and Feld, 2009) to a strong negative relationship (Zhang and Zou , 1998 and 2001; Rodriguez-Pose and Ezcurra, 2011).

4. FISCAL DECENTRALIZATION IN ALBANIA

Decentralization of government in Albania began in the early '90s, when local governments first democratically elected. Despite we cannot talk yet for administrative and fiscal autonomy, '92 reforms laid the foundation for the creation of democratic local authorities, which are slowly being prepared to take more responsibility and functions.

The decentralization reform has progressed steadily during 1999 and 2000, according to the Constitution (1998), the European Charter for Local Self-Government (ratified in November 1999) and the National Decentralization Strategy, adopted in January 2000.

The most important step was the adoption and implementation of the Law no. 8652, 07/31. 2000 "On the Organization and Functioning of Local Government", which stipulates the rights and powers of local government units in accordance with the Constitution and the European Charter of Local Self-Government and it was followed by other laws that regulate the activity of local government (Oshafi, 2015). This package of reforms, which determined the main framework of decentralization of governance in Albania, was built on the assumption that local government units, which would not be able to provide separate

functions and responsibilities transferred, will use alternative offered of the Constitution of the Republic of Albania and the Law on the Organization and Functioning of Local Government to join with each other.

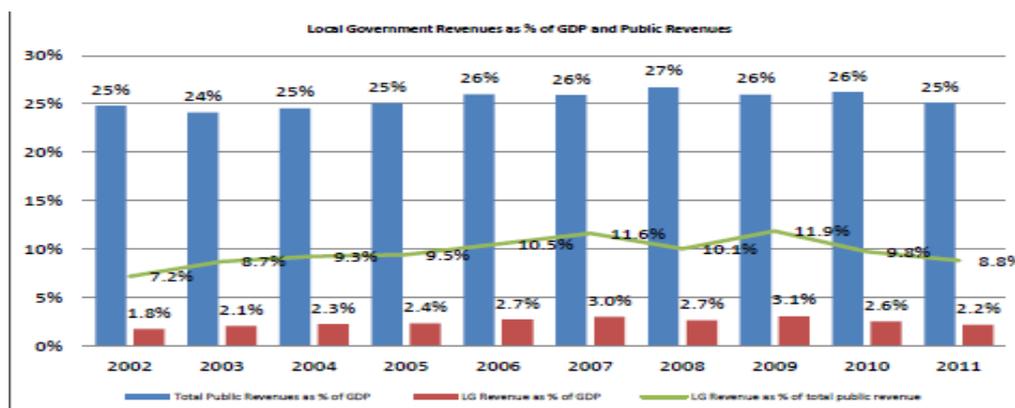
Throughout the period of decentralization local units have been proof of a process of restructuring and transformation in several important sectors. The objective of this process is to provide local governments adequate resources and capacities to perform the functions for which they are responsible. Three main pillars of decentralization are: institutional level; transfer of fiscal powers and appropriate legislation and strengthen their financial capacity. (USAID/LGDA, 2009).

Overall, the progress toward fiscal decentralization has not continued as was envisioned and some reversals have occurred in the fiscal and financial management capacities of the local government units (LGUs).

Before the enactment of the Law on “the new administrative-territorial”, Albania was divided into 308 municipalities and 65 communes at the first level and 12 districts in the second level. On 31 July 2014 the Albanian Parliament approved the Law on “administrative-territorial division”. Albania has a new territorial map, reducing 6 times the number of local units at the first level of government, from 373 local units in only 61 municipalities.

Figure 1.1 below shows local government revenues in Albania as percentage of both GDP and total public revenues between 2002 and 2011. As can be seen from the figure, local government revenues both as percentage of GDP and of total public revenues increased very substantially between 2002 and 2007, peaked in 2009, and then rapidly declined in 2010 and 2011.

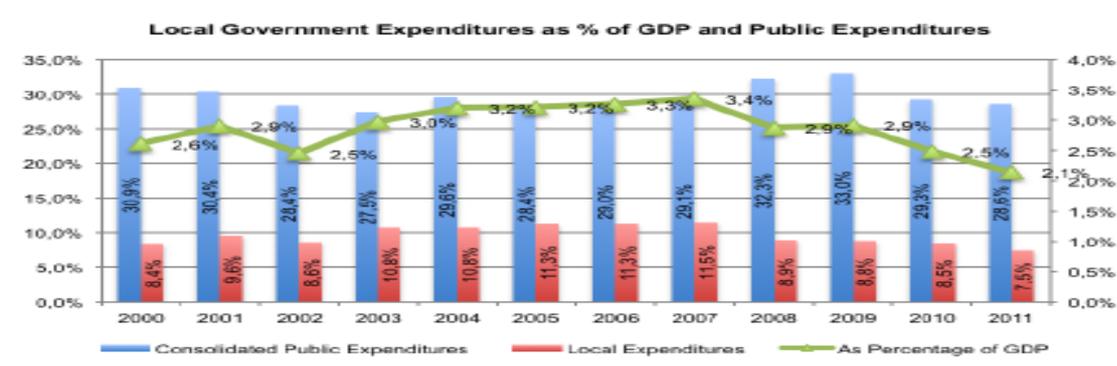
Figure 1: Local Government Revenues as % of GDP and Public Revenues



Source: (USAID/LGDA, 2012)

Figure 4.2 below shows local government expenditures in Albania as percentage of GDP and total consolidated public expenditures between 2000 and 2011. As can be noted from the table, local government expenditures increased substantially both as percentage of the GDP and of public expenditures between 2000 and 2007, when they peaked at 3,4% of the GDP, declined somehow during 2008 and 2009 to 2,9% of the GDP and then declined dramatically during 2010 and 2011 to the levels of 2,1%.

Figure 2: Local Government Discretionary Expenditures compared to GDP and Consolidated Public Expenditures Source: (USAID/LGDA, 2012)



RESEARCH FRAMEWORK

Reviewing literature on fiscal decentralization and economic growth indicates that there is a very extensive literature on this issue.

I am working for my PhD thesis and the focus of this study will be fiscal decentralization and economic growth in Albania.

In order to determine what effect has had the reform of fiscal decentralization on economic growth, and how is the effect measured in quantitative form, in the case of Albania, will be conducted econometric analysis of multiple linear regression on time series (OLS). In this study,

Panel data for the period 2000 to 2014 will be used to examine the impact of fiscal decentralization on economic growth in Albania. The decentralization reform has progressed steadily during 1999 and 2000, according to the Constitution (1998), the European Charter for Local Self-Government (ratified in November 1999) and the National Decentralization Strategy, adopted in January 2000.

Formally, the model of multiple linear regressions, given n observations, is:

$$\text{Model: } y = \alpha + \beta_1x + \beta_2z + \varepsilon$$

Where y is the GDP per capita growth rate, x is a set of control variables that are found to be significant in almost all economic growth studies. Such variables are the investment rate, the inflation rate, the rate of liberalization trade (both exports and imports more to GDP), human capital, and z is a vector of the variables of interest – in this case, the fiscal decentralization measures.

So, the research questions of my thesis will be: What is the effect of fiscal decentralization on economic growth in Albania?

Most of theoretical literature discusses the potential positive effect of decentralization, but there are empirical studies which don't report any significant relationship between these variables. This relationship I am going to test for Albania case.

CONCLUSIONS

Decentralization is a long-term process that includes, within an appropriate legal framework, different components, such as political decentralization, administrative decentralization and fiscal decentralization.

Fiscal decentralization is the transfer of functions or powers from the central government to local institutions regarding to local decision making on the allocation of financial resources (ie financial powers) and the power to put local taxes

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This research work represents only the start in the series of studies dedicated to fiscal decentralization in Albania.

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