



Local Government Debt and Fiscal Autonomy

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Abstract: *The purpose of the study is to analyse and discuss the local government debt and fiscal autonomy. It is very important to understand the composition of the municipal budget, its own income and government transfers. The study will analyse the revenues and expenses of municipalities (operational and capital) as well as the ways of financing investments. Literature and statistical data show the financial inability of the local government to cover expenses and to invest in public works. Some municipalities have received loans from Second Level Banks for capital investments. Furthermore, the study will analyse the use of debt, its effects and its efficiency. In Albania, the fiscal autonomy of the local government is still a problem, since the municipalities find it impossible to generate income and meet the needs for investments and expenses, bringing a strong dependence on the central government. Also, the study will discuss the ways how municipalities can increase their level of income, their good management and the increase of financial autonomy.*

1. INTRODUCTION

Borrowings and debts of municipalities are two of the most critical points of public management. Local government debts should be taken into consideration by policy makers since the economic development or destruction of a country starts from the local administrative units. During these 34 years of transition in Albania, decision-making policies have been oriented mainly from the center to the grassroots. Strategic plans have been drawn up as the only ones at the national level, where unfortunately most of them have remained simply on paper. Albania's economic development would be more stable if the priority in the management of development funds was directed towards local units, bringing financial decentralization and real local policy-making.

The consideration of the economic development of the regions, accompanied by the evidence of social-cultural differences, would be a solid basis for real local decision-making and national development policies, in accordance with the identified regional priorities. Statistical data show that local revenues of municipalities are not sufficient to meet all expenditure needs. Also, the lack of income penalizes the municipalities even in the process of borrowing from second level banks, since they do not meet the criteria for repayment of loans, while for any local borrowing the financial guarantor must be the Ministry of Finance.

Hence, there is a strong need for the government to focus on the process of decentralization and powering the local governments, as a pole for sustainable development economy.

2. LOCAL GOVERNMENT REVIEW

Albania is one of the countries of the Western Balkans which aspires to join the EU. During these 33 years of transition, Albania has continuously drafted and implemented reforms within the framework of the approximation of its legislation with the EU. What has been done so far has

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focused on the policies and good governance of the central government, but in parallel with it also solid efforts for the decentralization and good functioning of the local government, as part of the integration package of our country in the EU.

The drafting of the Territorial-Administrative Reform in Albania took place in 2015 and focused on the improvement of local governance. Today, after 8 years of its implementation, we are able to analyze and see the first effects. During this period, we can mention as a legislative achievement the approval of the Intersectoral Strategy for Decentralization and Local Governance, a document followed by: (i) the implementation of the Administrative and Territorial Reform (RAT), (ii) the approval of Law No. 139/2015 “On local self-government”; (iii) approval of Law no. 68/2017 “On the finances of local self-government”.

The Intersectoral Strategy for Decentralization and Local Governance 2015-2020 was designed to strengthen local governance, to adopt the decentralization process according to the EU model and to consolidate the principles of fiscal and political administration of Local Units. At its core, decentralization has the principle of subsidiarity and the responsibility of the local government to be as close as possible to the citizens (Haxhimali, 2024).

With the beginning of the implementation of the Territorial Administrative Reform in 2015, priority has been given to fiscal decentralization, but even today we do not have visible results of it. Decentralization should bring citizens’ problems closer as well as their faster solution. On the other hand, the process of decentralization would empower more the citizens, since investment projects and expenses would be more controlled by the citizens themselves. However, the process has not been implemented in all the purposes of its drafting, as well as the full distribution of administrative and financial powers of the new municipalities. The reality in the country’s municipal units is different. There is a lack of investment transparency and often public hearings are not taken into consideration (Haxhimali, 2024).

The process of decentralization includes the transfer of power from the central level to the local level and increases democracy and local decision-making authority. Decentralization increases the confrontation of elected local authorities with citizens, as well as the responsibility of the local governments to manage revenues and expenses. In this aspect, fiscal decentralization will force local elected officials to pay more attention to the community, their needs and medium and long-term economic development. But, for this process to succeed, the financial and decision-making power of the local authority must be guaranteed at a new level. Until now, local units do not have independence from the central government as they lack the necessary financial resources.

Also, the majority of municipalities do not have the ability to borrow money from the banking system (loans). The financial system is not yet ready to finance municipalities, as the risk in lending without a guarantee from the central government is still considered very high. Municipalities are outside the capital market. This would require an improvement of the regulation for local borrowing, where the municipalities increase their competencies, as well as the ability to generate income through the sale of local bonds. But, on the other hand, in the conditions when the state debt at the end of 2023 was calculated at 71.5% of GDP, this figure has exceeded the norms established by the Maastricht Treaty (60% of GDP), which means that the government finds it more difficult to support as a guarantor of the municipalities’ debt because it would have to further consolidate the debt and the deficit (Ministry of Finance, 2024; NALAS Report, 2024).

Therefore, the application and full implementation of the decentralization process, monitored by the government, is required as soon as possible to avoid the financial problems that small municipalities and municipalities that cannot collect their local revenues. If fiscal decentralization does not happen, then the municipalities will be faced with the impossibility of managing the new administrative competencies. Many delegations of new responsibilities, such as those in education, health, agriculture, transport, etc., which have been added to the competences of new municipalities, will not be implemented if the responsible ministries do not transfer the requested grants. Therefore, a combination of revenues would be more consistent and efficient for both the central government and the local government. On the other hand, the central government does not delegate fiscal powers due to the lack of human resources that the local government has. Then, under these conditions, control and monitoring of the funds allocated by the relevant ministries against the local government would be recommended. Auditing and controlling the use of funds will increase the efficiency and accountability of local authorities. Parallel to the above, it would be required to set up a computerized system, which will facilitate the identification of all families and private entities that must pay local obligations (Stafa, 2021; NALAS Report, 2024).

The allocation of additional funds and the development of investments will increase production and consumer capacities. However, this remains the will of the central government to develop the regions at the same level. Decentralization will increase the responsibility of mayors in the use of funds and their collection.

Moreover, the full implementation of the decentralization process will promote cooperation between the local government, the private sector and civil society. Sectoral and regional development strategies would be more important if the RAT was designed for economic and non-political-electoral interests. Economic development would be the priority of every region. Also, in addition to the efforts to make the local government financially independent, it would be more important to develop the techniques and institutional relations to make the decentralization process more easily accessible to the citizens.

2.1. Dependence of Municipalities on the Governmental Block Funds

The lack of full revenues and the high level of expenses for salaries, operational expenses, payments for services and investments, force the municipalities to be dependent on the state budget. Unconditional transfer, conditional transfer and Regional Development Fund (RDF) are three important elements in the fiscal functioning of municipalities. As long as the local revenues do not cover the costs of services provided by the municipality, then the deficit occurs. The study shows that around 60-80% of local income goes to salary and operational expenses; only 12-20% goes to capital expenditure. All other expenses and investments are covered by the government (NALAS Report, 2024).

Municipalities are still not able to generate enough income to govern themselves. Even the new competences that were added, have not been completed with full conditional transfers for the performance of these functions. The relevant ministries still do not allocate funds through the Municipalities, at the same level that they spent for the same functions when they were under their responsibility. The good functioning of the local government requires sufficient funds to guarantee the quality of services and investments for all administrative units. Until now, administrative units do not have the same investments and service provisions, and there are many areas that do not even receive basic services, regardless of paying municipal taxes and fees.

The non-collection of revenues is due to the high informality of the municipalities (families and businesses that do not pay or have not signed contracts with the municipality for the services they benefit from) or unregistered businesses/families. Therefore, the fiscal burden falls on businesses and regular families who always pay. Social responsibility and conscience is at low levels. This would urgently require a complete registration of all families and businesses, where each municipality would have a more complete view of the financial opportunities it can accumulate. If informality is fought, then we will see that the municipalities will collect more income (Haxhimali, 2024).

2.2. Financial Independence of Municipalities

As far as the study analyzed above, the municipalities are not financially independent. Their good functioning depends on the funds allocated by the state for each municipality. Also, the lack of a capital market has reduced the possibility for municipalities to generate funds from other sources. It would be necessary for the Albanian Stock Exchange (ALSE), in cooperation with the Ministry of Finance and the Municipalities of Albania, to draw up a regulation for the sale and purchase of municipal bonds. This would be a form of independence for income generation, even though the Ministry of Finance would again be the guarantor. Another possibility would be syndicated loans (loans taken from several banks, but with citizens' deposits). This form is not applied in Albania, but it would give power to the citizen in the decision-making of municipal investments. The citizen's contribution would be an amount requested by the municipality, where the citizens through the banks would offer their deposits against a well-formulated contract with the repayment terms. This would make the municipal executives accountable and increase citizen activism. However, this could not happen in most of the municipalities of Albania, due to the lack of funds or financial culture, but some municipalities could be an application model. Also, this would increase the need for the adoption of a new Law on Local Referendums, where important investments for municipalities would pass through citizen decision-making. This requires political and civic will (Haxhimali, 2024; Brugmann, 2023).

The consideration of the economic development of the regions, accompanied by the evidence of social-cultural differences, would be a solid basis for real local decision-making and national development policies, in accordance with the identified regional priorities. Statistical data show that local revenues of municipalities are not sufficient to meet all expenditure needs. Also, the lack of income penalizes the municipalities even in the process of borrowing from second level banks, since they do not meet the criteria for repayment of loans, while for any local borrowing the financial guarantor must be the Ministry of Finance. The June-July period is the time when the project budgets of the municipalities for the following year begin to be drawn up. This process requires the coordination of statistical data, monetary funds, government grants, projects from the central and local government, but also a complete analysis of the credit-taking and credit-paying power of the municipalities, in relation to the projected investment zeros, in order to realized with funds received from the banking system (NALAS Report, 2024).

After the approval of Law no. 9868 dt. 4.2.2008 "On Local Borrowing", it is found that only very few municipalities have received loans from second level banks. Controversial is the fact of matching or not the priorities for investment judged by the public, in relation to the decision-making of the municipalities to invest the loan received in local development projects.

At the same time, this process must be preceded by real listening to the public and voters, taking into consideration their concerns in investments by municipalities, giving decision-making more democracy and inclusion towards a reliable model of "participatory budgeting".

Unfortunately, it is found that hearings and discussions with the public are missing and there is no transparency for the expenses incurred by the municipalities, regardless of the origin of the invested funds. Informing the public about the loan received from the bank, the conditions and the destination of the investment, for the funds received as a loan through the banking system, is minimal or non-existent.

Also, it is found that considering the risk of political rotation, the municipalities tend to maximize and often exceed their credit-paying ability, using the loan received for investments within the election mandate, while the loan repayment terms go beyond one electoral mandate. This results in investment restrictions in the short and medium term for the leaders of the new municipalities, penalization in new borrowings, stronger financial discipline in the collection of revenues from municipalities and penalization of local taxpayers with an additional tax (Haxhimali, 2024).

The issue lies in the late reaction of the Ministry of Finance, as this is the institution that “legitimizes” the borrowing and creation of municipal debts. In addition to the fact that the municipalities have financial difficulties, due to the non-complete implementation of fiscal decentralization, the Ministry of Finance is the main responsible for the financial impasse that the municipalities are going through.

Municipalities are dependent on the central government through unconditional transfer, conditional transfer and Regional Development Funds. The Ministry of Finance should consider the means for paying off the accumulated debts of the municipalities, as these debts weigh heavily on the pockets of citizens and contracting businesses from the municipalities. The more this debt deepens, the more local taxes and fees will increase, which are reflected in the Fiscal Packages. It is the right time for the Ministry of Finance and the local government to reconcile expenses and income so that the debt does not deepen for the new fiscal year 2025, where a significant increase in expenses and the end of investments are also expected as a consideration of an electoral year.

3. LOCAL GOVERNMENT REVENUES AND EXPENSES

Below it is given the structure of the public debt for several years.

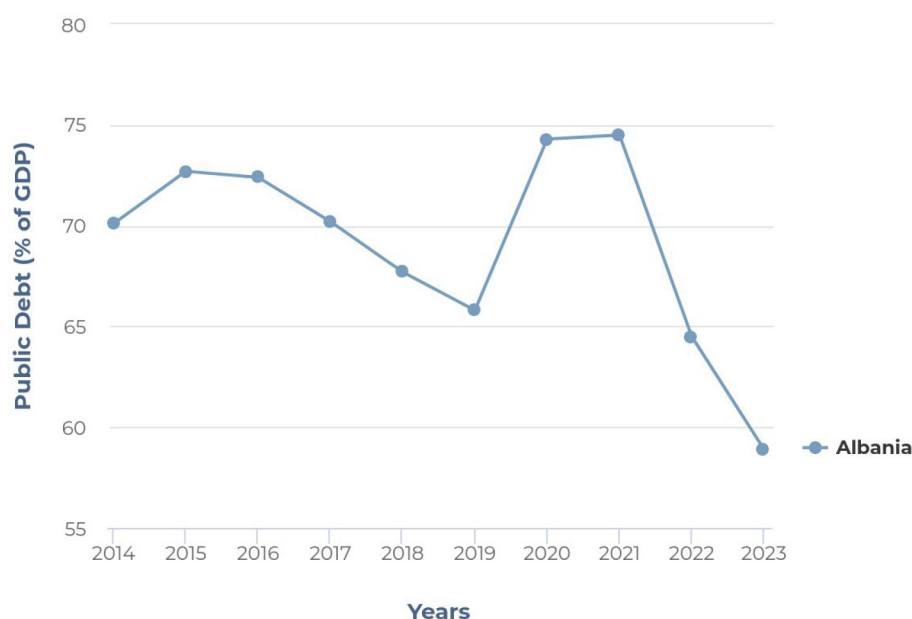


Figure 1. Structure of public debt 2014-2023

Source: Focuseconomics (2024)

According to the graph above, we see the fluctuations of the public debt, which has experienced a strong increase during the years 2019-2021, but has begun to decrease, reaching the level of 59% at the end of 2023. Albania has a high level of debt public, due to the mismanagement of public money and investments. Governments are still working and testing mechanisms for public debt control. Bad debt management also leads to wrong decision-making, regarding the distribution of income. Poor management of budget revenue sources also leads to a decrease in investment funds and government transfers to local governments.

The figure below shows the income of the local government.

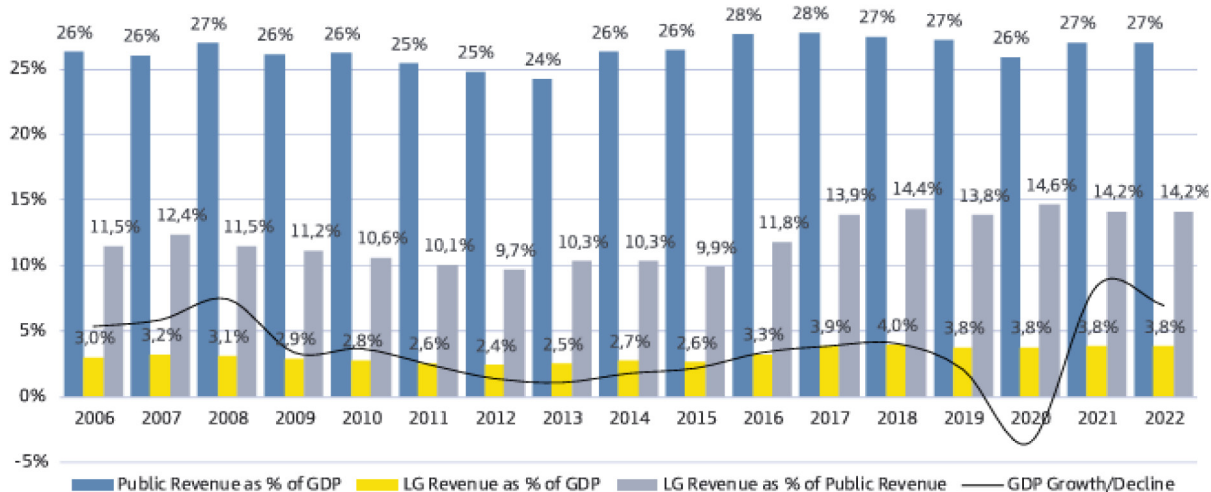


Figure 2. Local Government Revenue as % of GDP and Total Revenue

Source: NALAS Report (2024)

From the above comparative data, we see in detail the income of the state budget and the income of the local government as a % of GDP as well as the fluctuation of economic growth. The study clearly states that local revenues remain almost constant, where they experienced a slight increase after 2016-2017 (it that time Albania adopted the new Territorial Reform and local governments got more competencies and funds for the new services), but again it seems that municipalities are still very dependent on government transfers.

Table 1. Municipality Revenues

	2022	2023	Difference %
Own income	31,725,743,040	35,048,913,604	10.47%
Unconditional and specific transfer	28,863,571,194	34,891,876,612	20.89
Local taxes	3,030,878,854	3,370,161,765	11.19%
Total	63,620,193,088	73,310,951,981	15.23%

Source: Ministry of Finance (2024)

From the above data, the study shows that local income and government transfers are very close, this means that the local governments do not generate enough income to cover their expenses, and they are dependent on the central government. Although local revenues have increased from 2022 to 2023, again the dependence on the Government is great.

Figure 3 gives us the sources of income as a % of total income, so from those data, it is seen the equality of local income with government transfers.

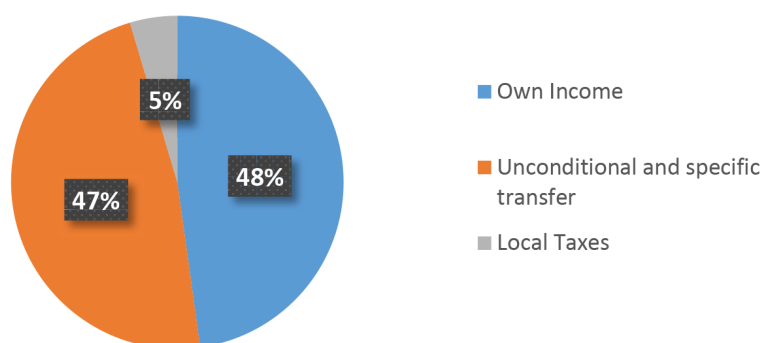


Figure 3. Sources of Income

Source: Ministry of Finance (2024)

Furthermore, the study strongly shows that fiscal decentralization would force municipalities to be more efficient in collecting revenues and managing expenses. From the analysis of the official figures, it can be seen that the performance of the municipalities, especially in the collection of revenues, leaves much to be desired. The realization of income at the national level does not exceed 30% of the total income. In the conditions where the municipalities depend on: Block transfers from the government (~70) then we can say that the decentralization process has not happened completely. Local government with a low level of local income is highly dependent on unconditional transfer and conditional transfer (NALAS Report, 2024).

Based on the NALAS Report (2024), the municipalities of the Western Balkan Countries (WB) have less developed the process of decentralization compared to the municipalities of the European Union countries, also the distribution of grants or transfers from the central governments. In general, WB municipalities have less income, less funds for investment, and less decision-making than their co-sisters in the EU. Data on expenses are given below.

Table 2. Municipality Expenses

	2023
Expenses from its income	68,336,317,873
Wages and insurances	29,449,805,197
Operational expenses	22,735,602,814
Capital investments	16,150,909,862
Total	107,222,909,862

Source: Ministry of Finance (2024)

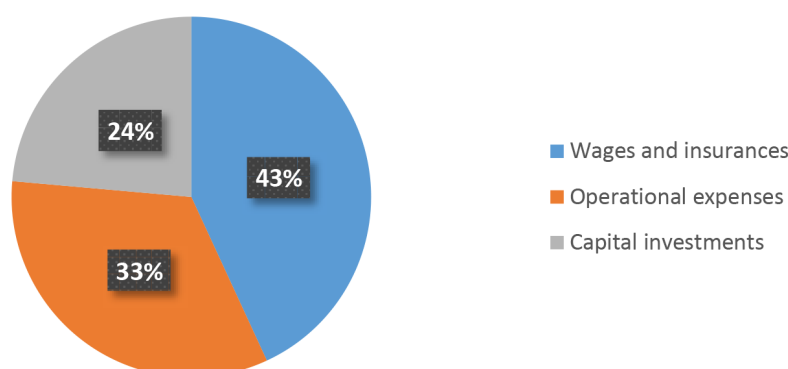


Figure 4. Municipality Expenses from Its Income

Source: Ministry of Finance (2024)

From the above data, the study clearly states that the local government's income are mostly spent on salaries and insurance as well as operational expenses. This means that the local governments have very little funds to invest in infrastructure and services. This is a very critical issue for the local government, as it shows how little of its income it generates, meeting only short-term expenses. This shows again the high dependence of the local government on the government for block grant funds.

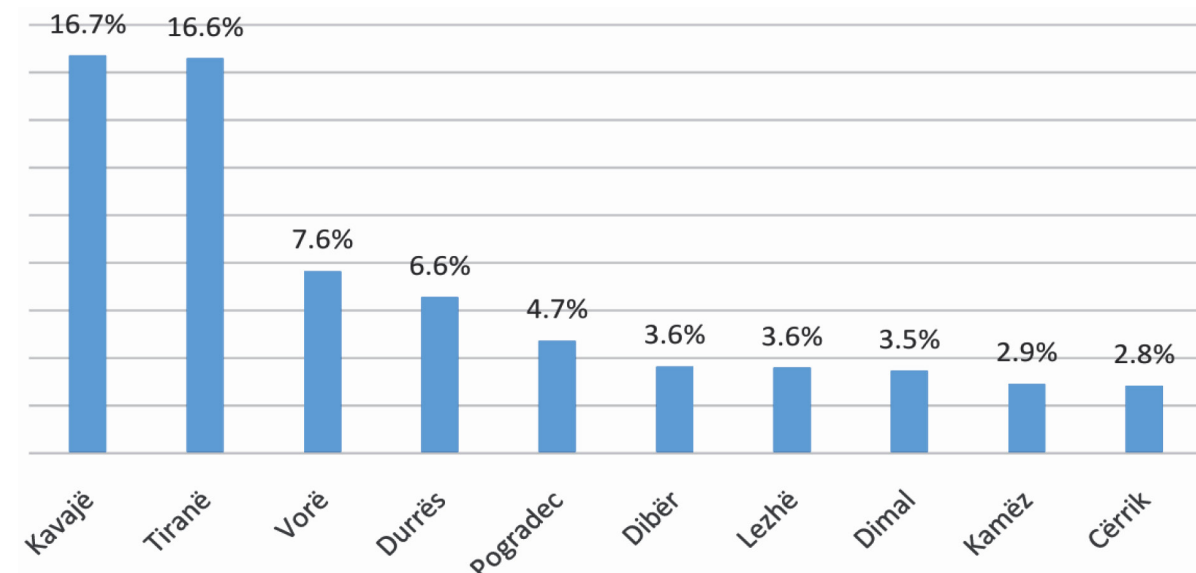


Figure 5. Local Debt/Total Income

Source: Ministry of Finance (2024)

The above data confirm the high borrowing costs as well as the inability of the municipalities to repay them since their income cannot cover the costs. The increase in the level of borrowing costs has also caused an increase in local taxes and fees (in most municipalities +30% is allowed by law). In addition, the lack of funds has increased the debt of municipalities to third parties (expenses for capital investments, services, court decisions, etc.). These debts amount to USD 280 million, created mainly during the last two years. Municipal debt is on average 2% of GDP and is added to the public debt. This means that if the debts of the municipalities are not controlled, very soon the state budget will have an additional heavy local burden (Ministry of Finance, 2024).

Also, Albania, like other WB countries, still finds it difficult to borrow locally, and it can even be said that it is still a new instrument to finance local government. The biggest difficulties in applying this instrument are: the financial inability of the municipalities to pay the debts; the high level of public debt as well as regulatory frameworks which are very centralized, strict and bureaucratic. In addition, the local government also lacks trained and experienced human resources for collection and strong control of that debt. Therefore, taking into consideration the low level of income from their resources, the local government (small and medium-sized municipalities) has made it impossible for local government. Moreover, the municipalities of the country have never applied the instrument of local government bonds (NALAS Report, 2024).

4. FUTURE RESEARCH DIRECTIONS

The development and decentralization of local government remains one of the challenges and priorities of sustainable development for Albania. Albania still needs great support from the EU, in terms of monitoring, training and financing for the independence of local government. A

decentralized and developed local government would bring about an improvement in the economic and social situation of the country. If we had a developed local government, then we would also have local economic growth, which all together would bring sustainable GDP growth.

In the future, this topic will be developed by making concrete comparisons of Albania with the countries of the Region as well as SEE, to see the adopted policies and mechanisms, in order to benefit the best from the experiences of other countries.

5. CONCLUSION

The study analyzed the difficult situation where the Municipalities of Albania stand, because of lack of funds, low level of local revenues, high deficit ratio and high level of expenses. The study showed the importance of the full completion of the decentralization process, the full distribution of government funds for the additional powers that the municipalities receive, as well as the increase of human capacities for the management of funds, projects and services.

Municipalities are very dependent on the Government because to get a loan, the government is needed as a guarantor. But, very few municipalities have this opportunity, since most of them do not have borrowing capacities. Municipalities still have debts to third parties, and cannot borrow from banks.

The study showed that the income level of the municipalities is low and this leads to the inability to pay the debts or loans received. This has also led to an increase in local taxes for citizens. It is also very necessary to apply financial and debt management policies and to monitor the level of debt and deficit.

Municipalities should allocate funds for more capital investments that generate production, employment, and income for businesses and citizens. Also, the Municipalities together with the Ministry of Finance should start discussions on drafting the Regulation for Local Government Bonds in the Albanian Stock Exchange (ALSE). In addition, inter-municipal cooperation should be increased, as well as stimulating Lending for local government by citizens (union loan).

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