



BUDGET COMPREHENSIVENESS

Brief document

This document is prepared by Decentralization and Local Development Programme (dldp), with financial support of Swiss Agency for Development and Cooperation (SDC)

This publication reflects the view of its authors and not necessarily of SDC.

Published by:
Decentralisation and Local Development Programme (dldp)
HELVETAS Swiss Intercooperation | Albania
Address: Str. "Ibrahim Rugova",
PLUS Building, 2nd Floor / No. 3. Tirana | Albania
www.dldp.al | www.km.dldp.al

Scope and time frame of local budget

The major instrument that regulates budgeting processes in the Republic of Albania is **Law no. 9936, dated 26.06.2008, 'on the Management of Budgetary System in the Republic of Albania'**. This law regulates the budgetary system in Albania, which is composed of the state budget, local budgets and special funds. This law introduced for the first time the statutory requirement for local governments, as well as other general government entities, to draft and adopt medium term budget programmes. The law regulates a series of issues pertinent to local governments as well, including structure, principles of budgets; elements of intergovernmental transfers; processes of budget preparation, execution and control/inspection; etc.

The budget cycle is annual and it coincides with the calendar year. Municipal government have to prepare medium term budget projections over a three year period in order to increase transparency and predictability of budgets as well as present the expected effects of budget programmes that extend over the course of several years. Given that budgets present estimates for the future years, they are also presented along with actual budget execution data to enable comparison, and track programmes or item that rise or decrease significantly. It is however clear that accuracy of medium term projections is not high; they are subject to many subjective assumptions and hence easily manipulated. As a matter of fact, budget compliance in Albania is weak even for the annual budget (PEFA assessment). Discrepancies with medium term budget data are understandably even higher.

A credible medium term budget with good projections would require predictable revenues as well as a basis for projections of several years of steady data in terms of priorities and main revenue sources.

Scope

Municipal budgets in Albania should be comprehensive and include all sources of revenue and all expenditures incurred in a given period by the municipality and its subordinate agencies. Nevertheless, the budget will not be comprehensive to the extent that every single expenditure will be presented in detail. Budget officials make a series of decisions and choices on the extent of inclusion of programs and subordinate agencies budgets. These include primarily choices on

the types of revenues to be included on the budget, and on the expenditure side the programs that will be included or excluded:

- Revenues:
 - General purpose grant income from the national budget
 - Earmarked grant income from national budget or other external sources (donors)
 - Tax and user charges income from own sources
 - Tax and user charge income from municipally controlled public companies (i.e. Water supply)
 - Non tax revenue, in particular
- Expenditures:
 - Typical expenditure programmes
 - Project expenditures extending over the course of several years (capital and operational expenditures)
 - Subordinate budget entities' budgets
- Local government debt:
 - Debt income
 - Debt repayment

Comprehensive budgets increase accountability and transparency and enable policymakers' and public scrutiny over the spending of public funds. However, too comprehensive budgets may become too difficult to interpret and information may be lost exactly because of the level of detail contained.

With regard to sources of revenues, municipal budgets in Albania should include all sources of revenues, regardless of the source and type. Budgets must be balanced (no deficit) hence no expenditure can be incurred beyond the level of approved revenue. However, in practice many municipalities prefer to operate with "independent budgets", implying the share of the budget that is under the discretionary authority of local government organs.

Budget departments and Mayors find that submitting budgets containing earmarked grants originating from the central government, over which they have no decision making

responsibility creates false expectations on the local council at budget adoption stage and complicates the budget process. In practice failure to include such revenues in the local budget does not change the outcome of the budget, as municipalities do not manage the funds on their own and any funds of these conditional grants that are left unspent by the end of the year cannot be carried over to the next financial year. Typical programs that are financed through conditional grants include social assistance and disability benefits; different subsidies to public companies and capital improvement programmes. However, local governments are in charge of procurement procedures or definition of eligibility for a large portion of these funds. Failure to submit them for adoption and scrutiny by the local council may reduce accountability of the budget execution process. Furthermore, sometimes local governments need to co-finance the functions or projects for which the conditional grants have been transferred from the national budget or a particular donor. In this case, it is even more important that the municipal budget endorses the external source revenue and authorizes spending of such revenue and additional own –source income on the given objective. In many cases this may provide evidence for unfunded mandates.

Consolidation of budgets is another issue that is related to budget comprehensiveness. Municipalities often control several separate budget entities, some of which are organized in the form of public companies. Water supply and sewerage companies are the typical case. In other cases, municipalities have established separate entities in charge of financing the education sector. In general, it is difficult to include the detailed budget of these controlled entities into the main municipal budget. This is particularly relevant for commercial companies, which operate according to different management rules as opposed to the municipal budget. Budget data for these cases should usually indicate net transactions between the municipal budget and the subordinate agency. The transaction can be negative – i.e the municipal budget provides a subsidy to the external budget entity; or positive, when the external budget entity transfer income from profit (surplus revenues). In case the municipality offers the water service internally though one of its departments, the budget must contained detailed data on collection of water fees and expenditures in the water programme. The principle is the same for other services, i.e. solid waste treatment may be provided internally and presented in detail in the budget; or outsourced to the private sector and only the concession amount needs to be presented in the budget.

Debt expenditure is reported as an off-budget item in the local budget. Local budgets must be balanced, hence can contain no deficit. Nevertheless, debt repayment schedules should be outlined in detail in the budget document, in order to enable analysis of debt burden and fiscal capacity. Generally, it would be recommended that debt repayment schedules are included in the budget. Furthermore, annual budgets may indicate annual interest payments as part of their capital expenditure program in case of borrowing for capital projects.

Personnel expenditures: Budget programme expenditure data are broken down by the main economic classification: personnel, other operational expenditures and capital expenditures. Budgets cannot be detailed enough to the level that it outlines personnel cost for each budget lines or department. However, it would be good if the budget contained an annex setting out the number of staff and respective remunerations based on positions.

Financial Information available

The availability of timely, accurate and complete financial and budget information on local government budget results and activities is important for at least four audiences. The local council members need the information so they can decide on local budget priorities and make reasoned choices among competing demands and needs. The local staff needs the information to manage and follow the local government financial situation, prepare analyses, and present the results to decision makers and council members. The central government needs it to prepare complete and consistent information on local government finances and to better understand the impact and significance of local finances. All these users also need the information to verify compliance with the law and to monitor if the local financial condition. Finally, providing accurate, timely and complete information to citizens is essential to ensuring that local officials are fully accountable to those who elect them to office.

The information presented should enable the user to understand not only what the local government paid for (i.e., how much was spent in salaries, for the electric bill), but also, what services were provided (what was the performance of the sanitation department, how many kilometers of local roads were built, repaired). Finally, the information is of limited use if it is not readily accessible to all interested parties inside and outside the local government.

In making such information public, it is important that the information be timely, accurate and complete. Even good information is less valuable if it becomes available late, long after the decisions have been made. The information is of little or no use if there is inconsistency in what information is reported or if there are errors in the numbers.

Budget Classification

According to the Law on Management of Budgetary System, the budgetary classification is in compliance with international standards and it includes minimally the following:¹

- a. an **administrative classification** which represents a classification of the general government units up to a spending unit level.
- b. an **economic classification** which represents the classification based on the nature of economic transaction.
- c. a **functional classification** which represents a detailed classification according to the functions or socio-economic objectives that the general government units aim to achieve.
- d. a **program based classification** which represents programs, subprograms and projects according to the objectives of the general government units.
- e. a classification by **source of financing**.

Budgetary classification, including codes and denominations are equal for all general government entities (central and local government entities as well as special funds). Functional classification splits budget data into ten functions/sectors, which are further disaggregated into subsectors. The functional classification is based on COFOG (Classification of Functions of Government, OECD) and GFS 2001 (Government Finance Statistics, IMF) standards. General Government Entities serve as the basis for budget (expenditure) planning and execution. The budget of each general government entity is divided into programme (policy) areas. The **budgetary programme** is a group of activities of the general government units that are

¹ Article 11, Law 9936

managed effectively and together contribute in producing identifiable and measurable outputs which contribute directly or indirectly in achieving objectives and goals of its budgetary policy. Each budget programme is subdivided into **activities** (set of activities undertaken at the program level for the delivery of an output), and **outputs** (goods and services delivered by activities of a budgetary program).²

Traditionally municipal budgets in Albania are **input based – line item budgets**. They focus mostly on input such as personnel, equipment and maintenance costs. Emphasis is allocated to the resources needed to accomplish their tasks; it is easier to compute and does not provide transparency over the outcomes that were achieved through this budget.

The budgetary system in Albania tends to orient budgets towards **programme (output) budgeting**. This has been achieved in terms of the medium term budget framework, but annual budget execution is still largely based on the line item model. Allocations to each department are broken down into the cost for each major purchase. Municipalities should move towards programme budgeting, focusing on the prioritization of programs and the extent to which they are cost effective as opposed to the results produced.

Local Budget and Fiscal Rules

The OECD conducted a survey of rules adopted in countries worldwide to constrain discretionary budget authority – what they refer to as “fiscal rules.” They reported the results of the survey and other related information as applied to local governments in a paper entitled *Fiscal Rules For Sub-Central Governments: Design and Impact*.³

The paper contains valuable comparative information on the limitations to local discretionary budget authority as practiced around the world. It shows clearly that there is no single preferred model. Practices vary from country to country. The paper also includes an interesting discussion of the impact of fiscal rules as viewed by economists. That discussion is useful to

² Article 2, Law 9936

³ Economics Department Working Paper No. 465 OECD December 9, 2005

The web site of the OECD Fiscal Federalism Network is
http://www.oecd.org/about/0,2337,en_2649_35929024_1_1_1_1_1,00.html

keep in mind as background when considering different approaches to the local budget process and intergovernmental fiscal relations.

There are several new terms that are important to understanding how economists view the impact of fiscal rules. They are

Allocative Efficiency – As applied to local governments this would be the situation when a local government is using its scarce resources to produce in the proper quantities the services that citizens value most.

Fiscal Sustainability (sustainability of deficits and debt) – This is the situation that exists when a country's fiscal trends are such that the ratio of total public debt and debt servicing to GDP is not increasing over time.

Procyclical Policies – The following table best describes this concept.⁴

Government	Good Times	Bad Times
Spending	Increases	Decreases
Borrowing	Increases	Decreases
Tax/Fee Rate	Decrease	Increase
Effect on Economy	Expansion	Contraction

Ratchet Effect – The seemingly irreversible growth of government that occurs because expenditure rises in good times and governments find it harder to cut spending than raise taxes during a downturn.

The paper arrives at two findings that are especially important and relevant:

[...] Fiscal rules would seem to be highly state [country] contingent, in the sense that their appropriateness depends on a range of institutional factors [specific to each country]

The adoption of a particular type of rule may entail a trade-off in terms of objectives served [...] [including] the size of the public sector, whether they distort public spending and lead to allocative inefficiency, and whether they support or undermine short-run stabilization policy and achieve longer-term sustainability.

⁴ National Bureau of Research Working Paper 10780 (<http://www.nber.org/papers/w10780>)

For example, *budget balance requirements and borrowing constraints may support fiscal sustainability at the cost of procyclicality and the loss in aggregate and allocative efficiency.*⁵

The following table extracted from the paper summarizes the tradeoffs.⁶

Effects on				
	Size of the public sector	Allocative efficiency	Deficits and debt sustainability	Pro-cyclicality
Budget balance requirements	“Ratchet effect” will lead to aggregate efficiency losses	Neutral if covering all spending Can lead to losses if partial	Stricter rules have a greater effect in preventing deficits arising and can ensure long-run debt sustainability	Induces pro-cyclical fiscal policy
Borrowing constraints	Can act as a budget balance requirement	If coverage partial, can distort spending and lead to inefficiencies	Can reduce the deficit bias and ensure debt is maintained at sustainable levels	Induces pro-cyclical fiscal policy
Tax limits	Can help restrain the size of government More successful the wider the coverage		Can lead to deficits if spending is not controlled	Pro-cyclical if revenue-based
Expenditure limits	Can help restrain the size of government More successful	Neutral if wide coverage Introduces inefficiencies if		Can help smooth spending, but if linked to income can lead to pro-

⁵ OECD (2005) pages 37 to 40

⁶ Table 13. Rule Impacts. OECD (2005), page 43

the wider the coverage	the partial coverage or no prioritisation		cyclicality
------------------------	---	--	-------------

It is not necessary to become expert in understanding the terms and the particular way in which economists view fiscal rules. It may be useful in going through the guidance document to consider quickly what might be the impact of a particular option you are considering. It is essential to keep the basic findings of the report in mind.

The particular institutional conditions in a country affect the choice of fiscal rules. Whatever fiscal rules you select will involve trade-offs between one objective and another. Some choices are better than others but there always will be a trade-off.

So, in brief, the key lesson is that “it depends.”

Rules for local budget and intergovernmental transfers

Measurable objective The policy should define the objective in terms that are measurable. In this way it is possible to quantify the existing conditions that the grants seek to remedy, especially in the case of equalization and to determine to what extent the grants succeed in addressing those conditions.

Existing conditions, not performance The transfers should seek to address problems that are outside the scope of management control of local governments. That is, they should compensate for differences in fiscal capacity not performance. Poorer communities, with a lower tax base, should qualify, not those that do a poor job collecting taxes. In the same way, the transfers should compensate for service needs not actual expenditures. The idea is to assist those whose needs are higher not necessarily those who are spending more. Otherwise, the transfers become incentives not to collect taxes and not to control costs.

Transparency Whatever the policy, the implementation of the policy should be through an objective mathematical formula to the extent possible. The formula should be used to calculate the grant amount, without subjective adjustments. If there is a need to rectify the State budget up or down in mid-year, the same formula should be applied to the larger or smaller pool of funds available to recalculate the grant amounts. Everyone should get the same share of the

pool of grant funds in any given fiscal year, whatever its total size. It should be clear in the law who will approve the formula and when. The formula should use only data that is readily available to everyone. Also, simple formulas are better than complicated ones. The objective is to make it possible for local governments to use the formula on their own to estimate in advance and subsequently to verify the size of the grant to which they are entitled.

Predictability Local governments cannot manage their finances successfully or effectively if they cannot predict what their revenues will be for future years. This includes the equalization grants. Local governments should be able to anticipate the amount of the equalization grant they will receive (if any) in the current and subsequent fiscal years within reasonable bounds. One way to achieve this is to adopt the formula used to allocate the grants one budget year in advance. For example, the formula that will be used in fiscal year 2000 would have been adopted in fiscal year 1999. This does not commit the national government to specific amounts in advance, as the size of the total pool of grant funds is not fixed, just to the formula. This way, using reasonable assumptions about the overall size of the grant pool (which might be provided by the Ministry of Finance), local governments can estimate future equalization grants they might receive. If there were a reason to modify the formula, the changes would not apply until one fiscal year later. In that way, the local governments have a full fiscal year to make any necessary adjustments. Ideally, after some initial period of experimentation and adjustment, the formula would remain fairly stable from year to year.