

Pelari, Oltiana Muharremi

## Article

# New tax regime effects on local government units case study Vlorë Municipality

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## Kontakt/Contact

ZBW – Leibniz-Informationszentrum Wirtschaft/Leibniz Information Centre for Economics  
Düsternbrooker Weg 120  
24105 Kiel (Germany)  
E-Mail: [rights\[at\]zbw.eu](mailto:rights[at]zbw.eu)  
<https://www.zbw.eu/>

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## **New Tax Regime Effects on Local Government Units Case study Vlora Municipality**

**Oltiana Muharremi Pelari<sup>1</sup>**

**Abstract:** The primary purpose of the paper is to understand the impact of the territorial-administrative reform from 2015-2020 in Albania, especially in the Vlora Municipality. The debate over the benefits and consequences of decentralization has been ongoing for the past two decades. Decentralization has been used as an instrument of democratization in many developed and transitional countries. Only a few research papers are done to evaluate the impact of the reforms in Albania. The implementation of the reform started in 2015, and it is probably too early to discuss the outcomes. The analysis represents a single case study on the territorial-administrative reform in Albania. The reform has not generated the expected results in the Vlora Municipality and the overall Albanian economy. The most substantial portion of local government revenue still comes from the central government's unconditional transfers. This paper is one of the first that attempts to evaluate the impact of the reform in the Vlora Municipality. The study aims to serve as a tool for improving local government capacity and recommendations responding to citizens' requests for greater efficiency in public spending.

**Keywords:** Local fees; decentralization; fiscal policies

**JEL Classification:** H25; H41; H71; H72

### **1. Introduction**

Decentralization reform has progressed steadily during 1999 and 2000, based on the Constitution (1998), the European Charter of Local Self-Government (ratified in November 1999), and the National Decentralization Strategy, adopted in January 2000. From 1992 to 2000, some minor changes were made to the administrative-territorial division without structural changes. The years 2001, 2002, and 2008 can be considered as the most successful in the field of fiscal decentralization. Currently following the new administrative-territorial division (Law 115/2014), Albania is divided into two levels of local government units - 12 districts and 61 municipalities. The new law optimized the number of local government units sharply, reducing the number from 373 to 61. The communes and rural municipalities were eliminated after this division and now function as constituent administrative units of the new municipalities. Starting from 1998 and into 1999, the government of Albania developed a policy to promote the transfer of authorities and responsibilities to local governments. Decentralization laws have concentrated on the autonomy of local governments. Muharremi et al. (2014) show that the transition process in Albania has highlighted many problems, one of which is the quality and effectiveness of the fiscal policy, to create a stable relation between its objectives and the instruments used to achieve them. The main stages include the decentralization reform by signing the new Constitution of 1998, the ratification of the European charter of local-self and development strategy for decentralization, and local autonomy. The strategy included the option that local municipalities would collect small business tax fees. This option was adopted in the new law on the organization and functioning of local governments, the tax on small businesses defined as income generated locally.

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<sup>1</sup> Assistant Professor in Accounting, Meehan School of Business, Business Administration Department, Stonehill College, North Easton, MA, Corresponding author: olta.muharremi@gmail.com.

The new Law on Local Self-Government (139/2015), aimed to bring about further reform of the competences of local governments. Future objectives are (1) administrative and financial consolidation of the municipalities and (2) institutional and infrastructure support. It has managed to consolidate itself as an essential part of the executive power in the regional and local level to effectively and efficiently exercise its functions and public services. The units of local self-government are financed by tax revenues, fees, other local revenues, funds transferred from central government, and funds coming directly to them from the division of national taxes and borrowing, local borrowing, donations, and other sources provided by law. Taxes and fees constitute a significant financial source of local government budgets, and therefore the modernization of the sector will be more than justified. Public finances are a problem and an open debate between interest groups and the state. These debates aim at designing and implementing economic policies, social and fiscal policies more suited to the national conditions. In this context should be seen the general decentralization and fiscal policies which are aimed at creating the necessary financial resources for the realization of local government functions.

Passing the small business tax entirely under the administration of local government, reinsertion of agricultural land taxes, and giving local authorities the power to determine the base and tax rates, significantly increased fiscal and financial autonomy. However, Albania's transitional economy still appears weak and imperfect. A critical problem remains the collection and administration of local taxes. Better administration of local taxes is not essential to increase revenues and local funds, which will mean more investment and public services, but also crucial for the fact that through proper administration, it may be encouraging better policies and business partnerships. It will allow for investments in infrastructure and a reduction in unemployment, which leads directly to economic growth.

## **2. Literature Review**

In order to have adequate local governance, local autonomy is required. Decentralization of power and an increase in autonomy for local municipalities are parallel with fiscal devolution, which will increase revenues from taxes and fees. One of the toughest challenges that public finances have in transition countries is undoubtedly the collection and management of revenues from taxes and fees, a process that is becoming more important in Albania. Local government is responsible for providing a range of services, which may exhibit different characteristics. They can be public or private nature, but who possess little or no public features. Making these services a reality for its citizens, all local governments must first have a sufficient and reliable budget. The collection of taxes and fees provide a real opportunity for them to fulfill the mission for which they are elected.

How fiscal decentralization affects the "quality" of government activity can be seen from different points of view and operates through many mechanisms. On the other hand, the vast amount of theoretical and empirical literature that studies the relationship between decentralization and government efficiency can be divided into two broad areas: 1. the classical theory 2. the second-generation theory. Oates (1972) offers a theoretical framework in which fiscal decentralization can guarantee an efficient provision of public goods simply because local preferences are better satisfied than in the case of centralization. In this new or second-generation theory of fiscal federalism literature, the effect of fiscal decentralization has been modeled to embody the political process, and the possibility of asymmetric information across political agents (Oates, 2005). Differently from the classical approach, governments are assumed to maximize their objective function that does not imply

the maximization of social welfare. Decentralization's primary purpose is related to the efficiency concept. Stigler (1957) shows that fiscal decentralization brings government closer to the people, and a representative government works best when it is closer to the people. In many developed countries, local governments have benefited from an increase in the transfer of funds and power from the central government, with the rationale (and hope) that this will boost economic performance both locally and nationally.

The theoretical literature on fiscal decentralization points to the positive effects of fiscal decentralization. If countries have more significant financial autonomy or higher amounts of unconditional transfers to local levels of government, it will increase efficiency in both allocation and use of funds which ultimately, will bring about economic growth for the whole country. According to Kapidani (2015), the new reform in Albania provides proper planning for local economic development and the reduction of problems between administrative boundaries and the area of influence of the services provided by neighboring local government units. Guga (2018), found that the reform attempts to develop better relationships between the central and local governments and hence improve their service delivery, transparency, and accountability. Excellent performance of local government and the way it interacts with citizens impacts the behavior of local governments, the latter as well as in cohesion and trust within and between communities. Project "Support for Territorial and Administrative Reform - STAR II," was an initial attempt from international development partners to assess the local government performance at the Albanian national level. Through interviewing and consulting 12,000 citizens and 400 officials' municipalities, the project tries to give a picture of the local government, and how the local government work is perceived by a variety of stakeholders. They have created a mapping of local governance called "The evaluation of the local government situation," which is being implemented in the 61 municipalities.

### **3. Methodology and Data**

The research method used in this paper is an analysis of the secondary data from various national and international organizations regarding local taxes, and legislations about fiscal policies in Albania, such as the electronic bulletins of: OECD, World Bank, USAID, Albanian Statistics Institute (INSTAT), the Albanian Ministry of Finance and Economy, and data from Vlora Municipality.

#### **3.1. Revenues from local government**

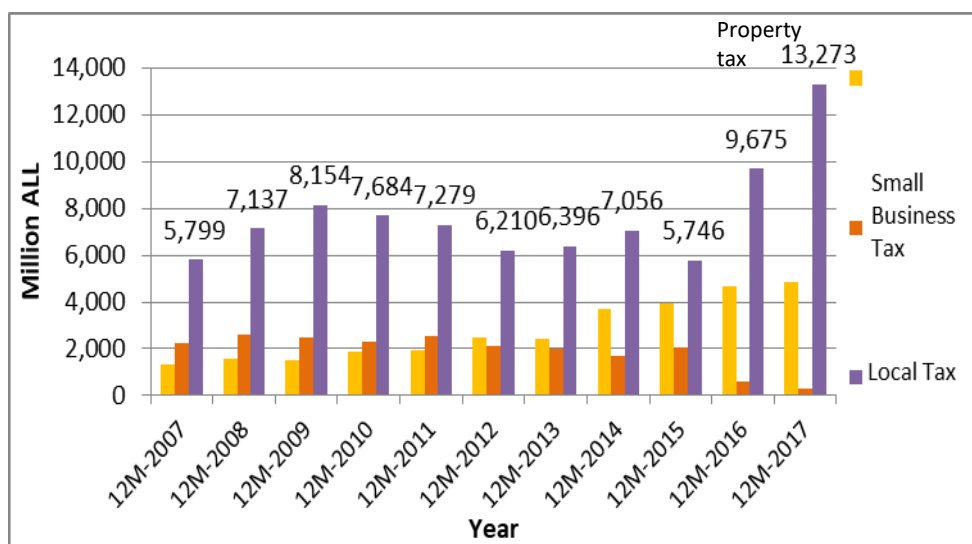
Albania is a country characterized by frequent changes in local tax and tariff laws over the last decade. The goal of frequent changes is to increase revenues for the budget of local government units. According to the Ministry of Finance and Economy, the decentralization process is a dynamic and continuous process aimed at increasing the autonomy of local communities in order to use public funds more effectively. The decentralization process also aims to increase fiscal autonomy and, therefore, local revenues. These changes in recent years aimed at increasing the discretion of the local self-government units to determine the tax base and level, as well as increasing the tax collection and administration capacity of the local self-government units.

Fiscal consolidation from local government that is portrayed on graph one refers to taxes that are collected and administered by local municipalities and communes. The three main groups are small business tax, property tax, and other local taxes. Over the years, delegated local taxes and fees have

undergone changes, which are reflected in the income provided by local governments. Graph 1 provides data from 2007-2017 of the income generated from the three significant taxes.

Local government revenues have undergone frequent changes during this period in terms of both the value and the source structure of these revenues, but in recent years these changes have had significant upward rates. The revenue decline in 2007 resulted primarily from the reduction of income taxes on small businesses as a result of measures taken in the 2005 fiscal package, in which local taxes on small businesses and simplified income tax turned into a single tax. The new tax rate was lower than the two existing taxes. This new tax harmed the transfer of tax collection and administration of local government units, which was associated primarily with management problems and local elections. The new tax measures come into fruition in 2008, where revenues grow by 20% compared to 2007, but again in 2010, local governments report lower revenues. Income from small business taxes declines in 2012 and 2013 because the number of new businesses decreases by 7% as a result of the deteriorating economic situation, the election year, and the decline in credit approvals from financial institutions. Based on the data studied, there is a decline of small business taxes in 2016 and 2017, due to the new tax regime implemented in 2016.

Local tax revenues account for 72% of the total revenue amount in 2017. Revenue growth comes as a result of the effects of the decentralization process and mainly local finance reforms in the 2017 budget, where local government units already collect more from local taxes and fees. While the contribution of property tax, is decreasing from year to year, reflecting the difficulties that local governments are facing in the administration and collection of this tax. The situation changes in the past three years, and tax collections show an increasing trend. Recent years have been associated with increased tax collection efficiency in local governments, which results in a higher level of decentralization for them. Also, collected revenues increase by 23% between 2016 and 2017. This significant increase in local government overall revenue mainly results from local taxes and then property taxes.



**Graph 1. Income by Source, for Local Government Units (100ALL = €0.81)**

*Source: Ministry of Finance and Economy (2018)*

### **3.2. The Reform Undertaken on Local Small Business Tax**

The local small business tax was first imposed in 2003, and it was a fixed tax according to categories of businesses and administrative classification of local units. By the end of 2006, this tax was administered by local governments (for the fixed fee) and central administration (a component of the simplified tax on profit as a percentage of turnovers of small businesses), while in 2007, this tax is entirely under the administration of local governments. The small business tax currently is the most important source of income for local municipalities. Generally, small businesses belong to that category of private enterprises that differ from a modest fiscal background. Often small businesses are unaware of the legal changes, and that puts them in a tough position of being fined by the local revenue administration, which pushes them towards evasive tendencies. Information from the National Business Registration Center (NRC) shows a significant increase in the number of registered small businesses (in some cities annual registration increases by 30%), while revenues collected from small business taxes do not increase proportionally (in some cases there is a decrease of income).

In 2016 the Albanian government implemented the new tax reform. The change brings about the abolition of the simplified income tax payment for small businesses with an annual turnover of up to 5 million ALL (€40,000). The changes in the new tax reform for small and medium enterprises are:

- The total abolishment of the simplified profit tax for businesses with a turnover of up to 2 million ALL (€18,000). These companies now pay a flat tax on profit of 25,000 ALL (€200);
- The total abolishment of the simplified profit tax for businesses with a turnover between 20 million and 50 million ALL (€163,000 - €407,000), which now pay a 7.5% tax on profit;
- The reduction of the simplified tax on profit (from 7.5% to 5%), for businesses with turnover between 5 million ALL and 8 million ALL (€40,000 - €65,000)

The number of businesses that will benefit from the fiscal changes and specifically, whose profit tax will be zero, is estimated at around 85,300. Reducing the fiscal burden on these businesses will improve their finances but is expected to bring economic growth to the country.

The main change in the draft law on local taxes consists of removing the small business tax and changing it into an income tax. The previous law on small business tax lacks a clear separation of powers between the Regional Tax Directorates and the local tax administration, which no longer exists. Currently, for these enterprises, a 10% income tax rate is applied, and the tax on small businesses paid to municipalities and communes is credited. According to a ministry of finance, in Albania currently, there are about 60,000 small business entities that are regular taxpayers. From a fiscal standpoint, the payment of this tax to municipalities and communes and the subsequent credit from the central tax administration, is leading to increased abuse and apparent underreporting, making personal income tax of small businesses a non-solid part of the monetary system. Over the years, the small business tax seems to lose its importance and is becoming an excessive burden for this business category.

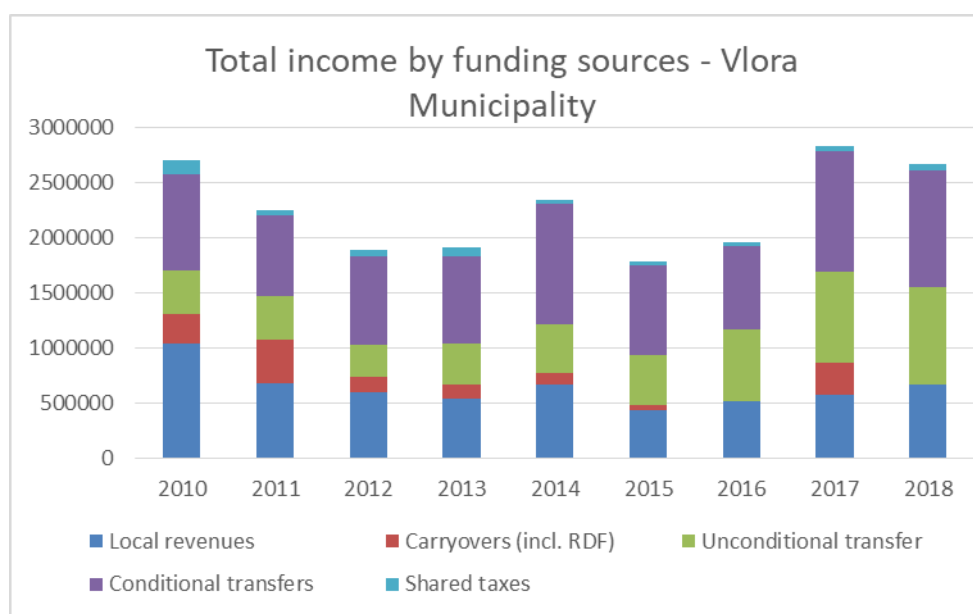
For this reason, the personal income tax of small businesses at the rate of 7.5% of taxable profit (the difference between fiscally recognized revenues and expenses) will consolidate this tax by excluding it from being a credit to the central tax administration and providing tax incentives. In the new fiscal package, the small business tax and personal income tax for small businesses are removed. These two taxes due to local government units and the central tax administration are replaced with a single tax, the simplified income tax for a small business. This local tax will be collected by the central tax

administration on behalf of the local municipalities, and there are substantial changes in the calculation method and payment.

Eliminating the small business tax will lower the total income for local governments between 1.82 and 1.95 billion ALL (€1.48 billion - €1.59 billion). Municipalities with populations over 20,000 will be affected the most. The negative effect on local government revenues is estimated to be around 2 billion ALL (€1.63 billion), which will be offset by the personal income tax on small businesses to the extent of 1.2 billion ALL (€976 million) administered by the central tax authority and 700 million ALL (€569 million) by increasing the central government unconditional transfer.

### 3.3. Case Study: Vlora Municipality

This study area is selected as it covers an important strategic area for the economic and social development of Albania. Vlora is one of the most important centers of the south with developed marine tourism, agriculture, livestock, and the olive processing industry. There is trading activity conducted through the Port of Vlora, which is the second-largest port in the country.



**Graph 2. Total income by funding sources over the years in the municipality of Vlora (Data in Mill ALL) (100ALL = €0.81)**

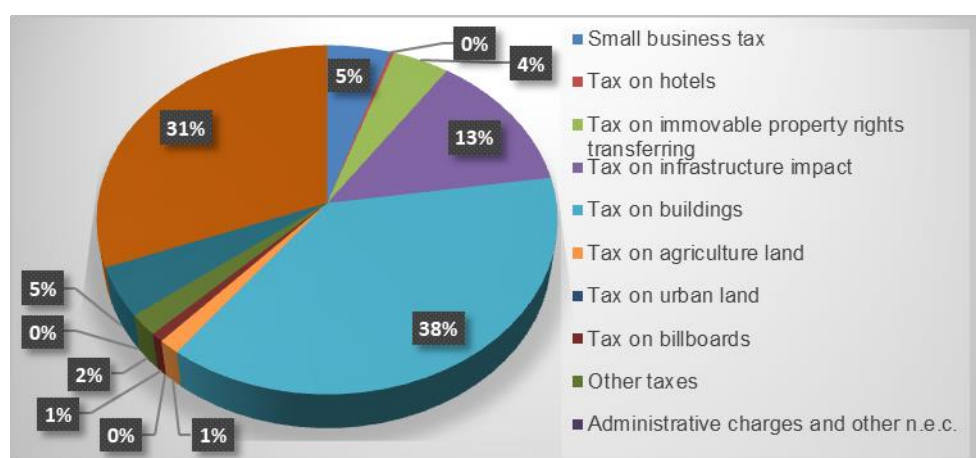
Source: <http://financatvendore.al/data/revenues>

Graph 2 shows the total income by different funding sources for the Vlora municipality during 2010-2018. The general unconditional transfer of the state budget shows an increase in value for the last three years. The unconditional transfer helps cover the difference between the cost of exercising the functions (spending needs) and the revenue that the municipality generates independently. Revenues for 2018 are 150% higher than in 2015, as the year before the implementation of the administrative-territorial reform. The graph shows that the largest share of local government's revenue sources is from the state budget at 48%, its own revenues at 38%, and 14% carryover from the previous year. Local revenues in recent years show signs of fluctuation because taxpayers avoid paying taxes. Having no significant legal restrictions for those who do not pay taxes makes it harder for administrators to collect them, this, in turn, brings less revenue. Between 2010 and 2013, local revenues decreased, almost more than half of the revenue collected in 2010. An increase in revenue is observed in 2014, but it is again followed by several years of declining rates.



Graph 3 shows different categories of revenue from local taxes. They come from the following categories: property tax, small business tax, tax on the transfer of ownership rights, used vehicle tax, billboard fees, fees on public space use, construction permit fees, and hotel accommodation tax. **For all these taxes, local governments determine the basic level, while the city council is permitted to lower or increase this level within an interval above the basic rate of tax, while for other temporary taxes, local units have total discretion to decide the type and level of the tax base.** Regarding the taxes and fees that are applied and collected by the city of Vlora, the most important one is the ‘tax on buildings’ or permit fees for new construction. The significant contribution of this fee reflects the large volume of construction in the city. The performance of this tax is unstable and depends entirely on the number of building permits.

The second most important tax in terms of contribution and stability is the fee for local public services (waste management, greenery), which is 31% of total tax revenue. The small business tax contributes only 4.87%. The decrease is primarily an effect of the new tax reform for small business enterprises. Although in recent years the income from the small business tax has been declining, especially in the last three years. Another tax that does not contribute to the budget is the property tax. It is difficult to collect this tax because there is no collection agency. Businesses are the only entities that regularly pay the property tax, while private owners tend not to pay this tax. Individual property owners will only commit to paying this tax by restricting the offer of administrative services. Families are forced to pay this fee only when seeking a residential certificate. Since 2016, to increase the tax collection fees for residential buildings, the Water Supply and Sewage Company includes the tax payment on the water bill equally divided for each month of the exercise year.



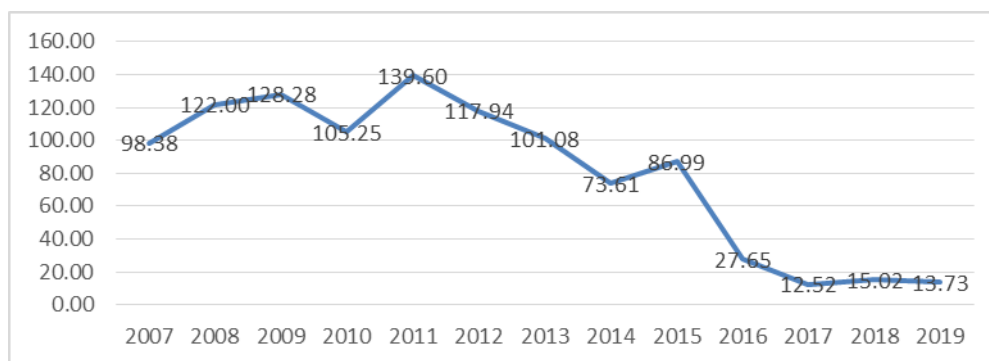
**Graph 3. Different Revenues from Local Taxation System for 2019**

*Source: Vlora Municipality*

Local fees make about 29.7% of the total revenues from their government resources. This municipality has a fiscal package that clearly distinguishes between the taxes and fees it applies, no duplicates in nature (their description, the basis on which they are applicable), and the general trend is downward. The street and garbage removal fees contribute 63% of the revenues from this tax. Income from local fees is following the same downward spiral as the other taxes. The non-existence of legal coercion and the inability to collect liabilities has increased the number of businesses and people who do not pay taxes and other local tariffs. Vlora Municipality lacks the financial capacities to set up an efficient collection system for local taxes and fees.



The performance of small business taxes has been very volatile in recent years. Currently, the number of small businesses in Vlora is 11,655, or 7.2% of the total small businesses in Albania. The number of new businesses registered in 2018 was 1,423, while the number of active businesses at the end of the year was 12,347. The region with the most significant number of small businesses is Tirana, which accounts for 33% of total businesses. Statistically, as shown in the graph below, this tax under local administration has its ups and downs and is very unstable. Over the first seven years from 2007-2013, the lowest level of collected revenue from this tax is 2007, a total amount of 98.38 million ALL (€80 million). In this particular year, this tax was entirely under the administration of local units, and the Municipality of Vlora, together with internal revenue administration, was unprepared and could not collect this tax. Even in the coming years, the growth rate of this tax is meager. In 2008, revenues from this tax increase by 24% compared with 2007. The decrease in 2010 is the result of changes in the local tax law of 2009 that alternates the fiscal burden for some local taxes. In 2011, income from small business taxes was at the highest level, 139.6 million ALL (€113.5million). There is a robust decline trend since 2011 for these taxes. The legal changes of 2014, in terms of the tax base and rate of small businesses, have contributed to lowering the small business collection rate, reaching the lowest level in 2017, with only 12.52 million ALL (€10.18million).

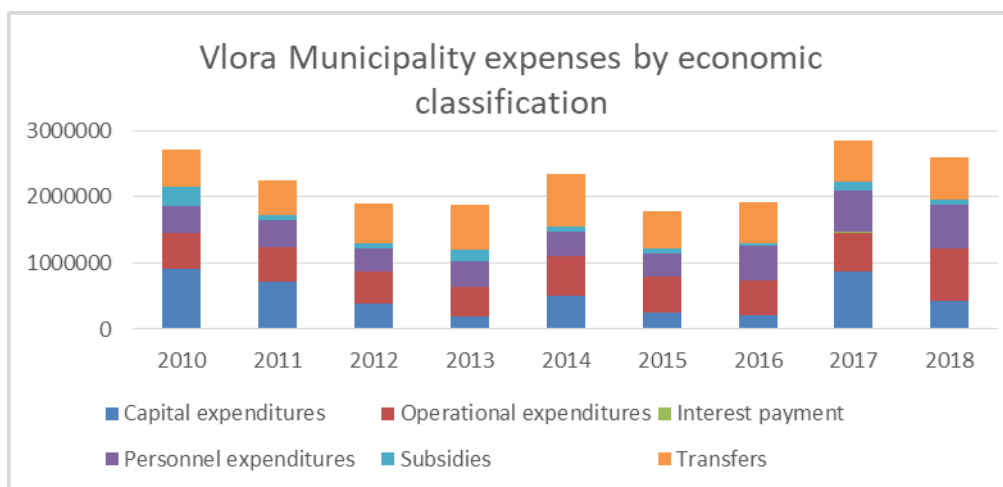


**Graph 4. The Performance of Small Business Tax from 2007-2019. (Data in Million ALL (100ALL = €0.80))**

Source: [http://financatvendore.al/data/revenues\\_comp](http://financatvendore.al/data/revenues_comp)

### 3.3.1. Local government expenses

With the implementation of the administrative-territorial reform, the ratio between capital expenditure and current expenditure is the same as the 2010-2011 report, with negligible changes. Overall, 62% of the local budget is for operating expenses and 38% for investments. 60% of total operating expenses go to maintenance, and the rest is to cover the cost of local administration personnel.



**Graph 5. Vlora Municipality expenses – Data in Million ALL (100ALL = €0.80)**

Sources: <http://financatvendore.al/data/expenses>

Municipal expenses are mainly incurred for:

1. Maintenance and repair of schools and public recreational buildings
2. Local public transport
3. Repair of local roads,
4. Construction of the sewage system,
5. Housing and communities' amenities
6. Salaries of officials and other municipal employees, including payment of social and health insurance.

In 2017 personnel costs increase by twice as much as in 2013, and operating costs show an upward trend as well. This is inconsistent with the objectives of the administrative and territorial reform in terms of better operational efficiency and a reduction in administrative costs. On average, local governments spend more than half of their budget on general public services, and about 30% on road infrastructure and transport services. Social assistance, presented as the single largest category of local government expenditure, accounts for about 30% plus of total local expenditure. Sports organization and management, institutions and administration of institutions (day centers, nursing homes, and orphanages) account for about 5% of local government expenditure. Local roads, public lighting, parks, and public squares are mainly financed through local government spending itself, and in some cases, through conditional grants received in the competitive grant scheme. This group of exclusive functions consumes about 30% of the local government budget. The economic composition of local spending has changed over the years, from focusing solely on salaries and contributions to an equal division between operating and maintenance costs and capital expenditures. Although operating and maintenance costs remain at the same level, labor costs (salaries and contributions) continue to rise. Investments will increase by 17.7% for 2019 and will be focused on the construction of rural water supply systems as well as the rehabilitation of several residential and re-paving blocks of rural roads.

#### **4. Conclusion**

Deepening fiscal decentralization, increasing financial autonomy, and consolidating local finances are among the government's main objectives in terms of effectively using local public funds and improving services. Local autonomy cannot be conceived without the financial autonomy of local government units. While administrative and political decentralization is more comfortable to be realized, fiscal decentralization is more complicated. The central government faces a lot more difficulties moving new taxes to local government units since there are deficiencies in the proper management of finances. The government needs a new and detailed legal framework to avoid the improper management of public finances, combined with a new administration able to implement this legislation. Albania ranks among the last countries in South-Eastern Europe in terms of municipal financing, although legally, the municipalities have similar functions with other regional municipalities.

The year-end 2015 legal changes to the monetary system, on the one hand, aimed to facilitate small business and the self-employed and on the other hand, attempted to normalize the situation in many sectors of the local economy. These changes, at the same time, increased revenues in some significant municipalities like the capital, Tirana, making it possible to provide more services of a higher quality. The easing fiscal policy in terms of the local tax burden was the "Simplified Income Tax" for the small business, which was abolished, thereby easing the small business and primarily the self-employed. The property tax for residential homes remained in most municipalities at the same level as before. For the first time in 2016, a new property tax was levied, which, although theoretically considered an added burden it has started to be applied at low values.

The challenge for both central and local governments is the continued decentralization of fiscal capacity. The main challenges in attacking the fiscal policy within the coming years for local governments will be:

1. Increasing transparency in decision making for the deployment and use of local taxes.
2. A necessary review in the legal framework and its application for property tax. In developed and developing countries, it is the primary tax revenue for local governments, while in Albania, it does not have the importance and proper weight in local revenues.
3. Investments in the modernization of local tax collection through various programs.
4. Formalizing the economy and lowering the level of tax evasion is still a problem that is not addressed as needed.
5. To not frequently change the legal framework for all local taxes, since it takes time to inform all interested parties for all legal changes, and it brings problems in meeting the required tax obligations by the citizens and businesses.

The following recommendations are provided in order to increase the local government budget by improving local tax administration and the development of new policies:

- To better inform taxpayers for their local obligations, the calculation method, and payment deadlines.
- Develop action plans for field inspections to reduce the informal sector, to expand the taxable base with more taxpayers, installment of cash registers as a legal instrument to measure daily sales.
- Provide an efficient information system for the local tax administration, transparency in the calculation of tax liabilities, producing tax bills, and mailing them to each taxpayer.

- Create effective management system environment, efficient and in line with the expectations of taxpayers, adopting policies necessary to ensure a successful tax collection
- Continuous improvement of information exchange with the central tax administration and other agencies, the National Business Registration Center, Agency for Legalization of Urban Construction Zones, Agency for Property Restitution and Compensation, National Civil Registry, and the new address system.

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