

Albania Fiscal Policy: Designing Tax Policy by Given Circumstances

Fatbardha Kadiu

Department of Public Administration
Aleksander Moisiu University of Durres
E-mail: fatbardhakadiu@uamd.edu.al

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Abstract I will consider through this paper the fiscal policy that Albania has applied in the recent years. First I will give an overview of macroeconomic situation in Albania. After that I will describe an overview of what tax system looks like in Albania, I will discuss the principle objective that Albania may attempt to achieve through the tax policy. I will conclude by considering the political economy environment within which tax policy and economic growth must be designed and implemented. The aim of the paper is to set out some of the basic problems facing tax policy in Albania and to outline some key element that should be considered in designing the best feasible tax structure for the particular circumstances at this particular time in Albania.

Key words: Tax system, fairness, efficiency, tax revenues, budget deficit

1. Introduction

The macroeconomic situation of Albania in these recent years looks very different of that of other transitional economies. The macroeconomic data shows that the economic growth of Albania (7.7 percent in 2008, 3.3 percent 2009, and 3.5 percent in 2010, forecasting 3.4 percent in 2011¹) did resist the shocks waves of global crises. On the other side the budget deficit from 5.7 percent of GDP in 2008 rose to 7 percent. This is due to huge expenditures from state budget for investment in infrastructure and also electoral campaign. The public debt is close to 60 percent of the GDP (59.5 percent of GDP). This data shows the risk of instability of macroeconomic situation of Albania in the incoming years. The inflation rate is at the level of 3 percent, which was also the target of the Bank of Albania². It should be mentioned that these parameters will exclude Albania from the countries which can profit in the future from the international loans with low interest rate.

In this circumstances one of the elements that should be analyzed is the way how to reduce this debt and deficits and how should government generate the revenues is the best way possible. The mechanism of generating the revenues for public sector is tax system. Coming to the tax system in Albania it is very hard to evaluate the system because of many different factors as the level of development, tax administration capacity and also its historical circumstances even though I will tend to make some outlines refereeing to the fiscal system.

First I will go through a short overview of what tax system looks like in Albania. Providing this background I will discuss the principal objective that Albania may attempt to achieve through tax policy. At the end I will show briefly at the political economy context within tax policy and development issues must be designed and implemented. I do not provide definitive answers to most of the question raised. My goal is just to set out some of the basic issues facing tax policy in Albania and to outline some key elements to be considered in designing the best tax structure for Albania at this present time.

Taxes are an important part of everyone life. In Albania everyone talks about them any times people try to trick when they can. Taxes matter. Not only individuals but also the businesses are influenced by tax

¹ Bank of Albania. (2008,2009) Annual Reports.

² Bank of Albania. (2010) Annual Report.

system on the way how they organize their activities and in where they are carried out. The reaction between individuals and businesses will then reflect to tax structure. At this point, knowing the mentality of both individuals and administration, rises the fundamental question of the paper: how Albania may best design her tax policy in order to achieve main objective of economic growth, given the complex economic and political environment we are facing.

Albania had undergone some reforms on tax system which had an impact on some important indicators related to tax system. One of these indicators is related to starting up business. Albania ranked 68th in 2009 and 46th in the 2010 out of 183 countries³.

I will be focusing more on practical issues rather than on theoretical issues. Practical tax policy can not be immune of the influence of either ideas or vested interests. Institutions also play an important role in shaping tax in Albania. Tax design is not immune to the influence of either ideas or vested interests in any country. But it is the idea of the whole society and not the individual interest that will better or worse of the economic situation⁴.

2. Actual Tax System

Albania uses flat rate tax for both consumption and income taxes. Even Albania is not pioneer of the flat rates it should be considered that is applied the lowest rates in the region (of 20 percent and 10 percent respectively). It did brought many benefits like the increase in foreign direct investment, reduction in tax evasion, narrowing the informal economy and increasing the economic activity⁵. But very rarely is emphasized the main argument for flat rates which is everyone should be equal in front of the law. This rates reduces the changes for tax fraud, it increases the incentives for economic activities without any distortion. All of this results in higher revenues, more savings and also more investment or more consumption.

Coming to the argument that this system punishes the poor people need to be analyzed in deep. The problem here arises from the point that is no definitive definition on categorization of who is poor as who is middle class. So before concluding to the "punishment for poor people" we need to make clear where the burden ranges for each categorization. After defining this concept we should consider the case how to help and not to grave the situation of poor people by different policies. One of these policies can be zero taxation for the minimum income living.

Another con for flat rate is: removing the progressivity from tax system vanish the taxation redistribution. However, empirical studies have shown that redistribution effect from tax system failed in many countries which also apply the progressive taxation⁶.

3. How Tax System Should be Designed

One of the main functions of a tax system is to generate revenues in order to finance the public sector activities. While evaluating decisions on tax system it should be considered some factors like the demand for public services, the level of development and also the capacity to levy taxes effectively. Also the decisions depends on the political environment, which means being less harmful from the political perspective.

Tax policy is not just calculating numbers. It reflects the political point of view about fairness and the desire of government to stay in power. Despite the desire of what individuals want the tax system to be like a

³ World Bank. (2010) Annual Report.

⁴ Keynes, J.M. (1936) "The General Theory of Employment, Interest, and Money". Maxmillan. London.

⁵ Mara, I.; Narazani, E.; Permeti, E. (2011) Did the flat tax reduce informal employment in Albania? CERGE-EI, Prague.

⁶ Chu, K., H. Davoodi, and S. Gupta .(2000) "Income Distribution and Tax and Government Spending Policies in Developing Countries," IMF Working Paper 00/62.

tax policy is limited on what that country can do. Fiscal policies should also consider the economic structure of the country, its administrative capacity and the political context.

All around the world the tax policy, on average is like 20 percent of GDP. In 168 countries the tax is around 18.8 percent of GDP⁷. The tax ratios vary from 10 percent in some countries, mostly in Balkans and East Europe to well over 40 percent in some other countries, mostly with high income. This does not exclude that some countries with high income do not apply low rates and some other countries with low income do not apply high rate of taxes. However, some low-income countries also had high ratios like Ukraine and some high income countries, such as the USA apply lower tax ratios.

Studies of Tanzi in 1987 divide the countries in three groups according to their GDP per capita. In the same study it was found that there exists a trend that tax rates increases as GDP per capita increases. In the low income group of countries, where Albania is part of, the tax ratio varies from 17 percent to 22 percent.

Before 2005 the tax ratio of Albania used to be 58 percent on average (all tax included) and in last years after 2007 it decreases to 35 percent. This ratio in western Balkans countries varies to 22 percent. One of the factors that can explain this relationship is the demand for public services which rises faster than the income in countries like Albania with low income. For example road infrastructure and the demand for public services tend to increase as income increases. On the other hand the capacity of countries to collect taxes increases as income level increases. This is meaningful only for poor countries. At some point the tax level decreases and the relationship between these two elements vanishes. In low income countries not only the income bases is important but also the institutional base has a great effect on the tax system. By institutional base I refer to tax payers' mentality including fiscal administration and also the trust that individuals have for the government⁸.

The consumption tax, VAT, in Albania is 20 percent where in the countries around it varies from 15 to 25 percent, it used be in this rates from nearly two decades. Where as the income tax is 10 percent for both personal revenues and corporate taxes. These two categories are relatively low with the countries on the region but the gap is created from the tax of social contributions, which is 23 percent. Most of the taxes come from taxes on imports. In small countries like Albania the trade tax are very important which account for a high percentage of tax revenues. Albania raises more revenues at the border, where relatively few collection points need to be controlled. For the same reason, we are more likely to rely more heavily on excise taxes. Direct taxes like VAT require both a more effective tax administration and more sophisticated taxpayers.

4. How Should the Revenues be Generated

The importance of fiscal policy has changed during last years, especially for Balkans countries as they are making kind of fiscal competition between each other. The tendency is to lower them as much as possible, in order to attract foreign direct investment. This trend on one side brings positive results to individuals and corporation but it causes a considerable gap in budget by increasing the deficit and the foreign debt. Even Albania is in the limits of the foreign debt range it seems than in the coming years it will suffer of a higher foreign debt.

It remains two options that can be used by government which is the increase of tax rates, politically very difficult to be applied, and secondly it will decrease the public investment or government expenditure. The government expenditure in Albania, referring to a country with small government is 32 percent of GDP. In general, countries referred to as "small countries", have and expenditure nearly 35 percent of GDP. So the alternative to decrease the government expenditure for our country is already exhausted.

⁷ Fox, W. and T. Gurley. (2005) "An Exploration of Tax Patterns around the World," (with Tami Gurley), Tax Notes International.

⁸ Bird, R.M., J. Martinez-Vazquez and B. Torgler. (2006) "Societal Institutions and Tax Effort in Developing Countries".

A tax system should generate revenues to fund projects government expenditure. As a general rule, revenues increase should be nearly equal to the overall economic growth. The income elasticity of a tax system measures how fast revenues grow relative to the economy. Elasticity is defined as the percentage change in tax revenues divided by the percentage change in GDP. Elasticity equal to one, for example, means that tax revenues will remain a constant share of GDP. Elasticity greater than one indicates that tax revenues grow more rapidly than income. In principle, revenues should grow at the same rate as desired expenditures. In other words, the income-elasticity for revenues and expenditures should be the same. Albania has failed to achieve this target that is why it went through frequent tax "reforms". In our country the most elastic tax is the tax on consumption, even in general the personal income tax is the most elastic one. A balanced set of tax instrument rather than a single revenue source will lower tax revenue volatility, just as an individual can reduce the volatility of her investment portfolio by adopting a diversified investment strategy.

5. How Fair can be the System

Conceptions of fairness likely differ among members of a society. Traditionally, tax scholars have defined fairness in terms of horizontal and vertical equity. Horizontal equity requires those in similar circumstances to pay the same amount of taxes. Horizontal equity often embraces some notion of ability or capacity to pay. Vertical equity requires "appropriate" differences among taxpayers in different economic circumstances. In practice, however, neither concept is particularly helpful in determining appropriate tax policy.

Simply saying we should accord equal treatment to equals is useless. A detailed ethical framework is needed to make comparisons, whether comparing equals or making "appropriate" comparisons among unequal's. Without such a fundamental framework one cannot evaluate the relative fairness of different proposals or different tax regimes. In the end, all we can say about fairness is that every one is equal in front of the law. This concept publicly accepted thought our society gives a simple and direct notion on progressivity and proportional system of tax.

For example, some countries may wish to favor cities, others rural areas. Some may choose to favor rich savers in the name of growth, others the poor in the name of redistribution. Like most policy instruments, tax policy can play many tunes. What is critical from an equity perspective is, first, to be aware of the equity implications of tax reforms for different groups and, second, to ensure that the actual outcome of such reforms is consistent with the intended outcome. Attempts to redistribute income through taxation have generally not been effective in most developing countries⁹.

It is often unclear who actually bears the economic costs of taxation. As economic conditions vary among different countries, taxes that have the same legal incidence may have different economic incidence in different countries¹⁰.

6. Redistribution Effects

Low income countries are generally less capable of using the tax system to redistribute income¹¹. Income and wealth taxes play a relatively small role in the tax structure of such countries as compared to developed countries. The personal income tax is often merely a wage withholding tax. This tax in Albania is one percent of the GDP. Nonetheless, income taxes have an important role in these countries. Even our sole objective is

⁹ Chu, K., H. Davoodi, and S. Gupta .(2000) "Income Distribution and Tax and Government Spending Policies in Developing Countries," IMF Working Paper 00/62.

¹⁰ Shah, A. and J. Whalley.(1990) "Tax Incidence Analysis of Developing Countries: An Alternative View," World Bank Economic Review.

¹¹ Bird, R.M. and E. M. Zolt .(2005) "Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries," UCLA Law Review.

economic growth, a clear case exists for taxing corporate income, if only to collect a fair share of the revenue that multinational and large domestic businesses derive from economic activities in that country. This is the case where the multinational companies have a rate of 10 percent of corporate tax as the ones which are domestic companies, but in our case the individual can not go and open its own business in the other countries, this means that this actual policy hurts the Albanian businessmen and favors the foreigners. Since corporations are the engine of development in all modern societies, a tax on corporations is in effect a tax on the modern, growing sector of the economy. Albania needs to tax these corporations in order to ensure that the ones who benefit more from the system to pay their fair share. On the other hand it should ensure corporate taxes are not so high as to discourage growth. In general, even the best approach for countries is thus to impose a moderate, stable tax on all corporations, probably at the same rate as a flat income tax (as Albania already applies) it should be considered the option to impose on other forms of capital income received by persons.

The most effective way to reduce inequality is not through taxation but rather through spending programs targeted at the poor. Expenditures aimed at improving primary education or primary health services are likely to prove more effective at reducing inequality than trying to change the tax system to tax the rich. The role of the tax system in emerging countries is essentially to raise the revenue for such expenditure programs rather than to play a substantial redistributive role in its own.

As I mentioned before an option that should be considered in Albania is the increase in the burden of minimum living income that should not be taxed. Also in a longer period the option of poor families to be taxed by consumption tax with a lower rate is an alternative of helping the category of people that lives with minimum income.

7. Tax Administration

The best tax policy in the world is worth little if it cannot be implemented effectively¹². Tax design in Albania is strongly influenced by economic structure. Albania has a large traditional agricultural sector that is not easily taxed. Also it has a significant informal economy that is largely outside the formal tax structure (even the trend of shadow economy in Albania is decreasing). This means that the size of the untaxed economy is in part a function of tax policy.

Three elements should be considered essential to effective tax administration in Albania: the political will to administer the tax system effectively, a clear strategy for achieving this goal and adequate resources for the task. It helps if the tax system is well designed and relatively simple, but even the best designed tax system will not be properly implemented unless these three conditions are fulfilled. Except of the last one having a simple tax system the other two seems missing in Albania. Most attention should be paid to the resource problem like the need to have sufficient trained officials and adequate information technology. Also strategy implementations should be part of the tax administration. All of this can not be achieved by a sufficient political support; even the best strategy cannot be effectively implemented.

If the political would exist, the blueprint for effective tax administration is relatively straightforward. The tax administration must be given an appropriate institutional form, which may mean a separate revenue authority¹³. It must be adequately staffed with trained officials. It should be properly organized, which generally means an organizational structure based on a function rather than on a tax by tax basis. Computerization and appropriate use of modern information technology is important, but technology alone is not sufficient and improvements must be carefully integrated into the tax administration.

¹² Bird, R.M. 2004. "Administrative Dimensions of Tax Reform," Asia-Pacific Tax Bulletin.

¹³ Taliercio, R. 2004. "Designing Performance". World Bank Policy Research Working Paper No. 3423.

The modern approach to tax administration rests on treating the taxpayer as a client to be served and not a thief to be caught. Unfortunately, the latter attitude seems to prevail in Albania. Of course, some taxpayers are not honest, so a second important task of our tax administration is to reduce tax evasion. In addition to undertaking the difficult tasks involved in extending the reach of the tax system into the informal economy to the extent feasible, close attention must also be paid to such simple but often neglected tasks as ensuring that those who are in the system file on time and pay the amounts due. In Albania the fiscal amnesty in the last years has negatively influenced the mentality of tax payers. And it should be unacceptable as soon as possible this kind of thinking.

Also adequate interest charges must be imposed on late payments to ensure that non-payment of taxes does not become a cheap source of finance. Similarly, an adequate penalty structure is needed to ensure that those who should register do so, that those who should file do so, and that those who under-report their tax bases are sufficiently penalized to increase the costs of evading tax.

A third major task is keeping the tax administration honest. No government can expect taxpayers to comply willingly if taxpayers believe the tax structure is unfair or the revenue collected is not effectively used. But even a sound tax structure can be vitiated by a corrupt tax administration. Other developed countries took centuries to develop and implement sound tax administration practices aimed at preventing dishonest tax officials' result succumbing to obvious temptations¹⁴. Corruption undermines confidence in the tax system, negatively affects willingness to pay taxes, and reduces our capacity to finance government expenditures.

8. Effects of Tax System on Growth

There is no magic tax strategy to encourage economic growth. Some countries with high tax burdens have high growth rates and some countries with low tax burdens have low growth rates. Looking at the relationship between growth rates and tax rates in the United States over the last 50 years reveals that the U.S. had its greatest periods of economic growth during those years where the tax rates were the highest¹⁵. Of course, this does not mean that high tax rates are the key to economic growth. The point is simply that the relationship between taxes and growth is complex. The case of Albania in recent years is just the opposite case of that of USA. By applying low rates of taxes, Albania become one of few countries in the Europe which did had considerable economic growth given the world economic circumstances.

Albania has sought to improve its economy by introducing a variety of tax incentives (the lowers rate in the region for both personal income and corporate taxes) for investment, for savings and for employment. Even theoretically the incentives may be effective in inducing investors to behave differently than they would have done in response to market signals, the result is often distorting and inefficient, diverting scarce resources into less than optimal uses¹⁶, Albania case become a paradigm of this theory. But tax incentives can not compensate for the absence of such critical factors as a sound macroeconomic policy, good infrastructure and a stable governance system.

9. The Political Economy of Taxation

Albania relied heavily on taxes on international trade, but this tax base is becoming increasingly hard to tax in the face of pressures for trade liberalization. Economic growth is often encouraged by, and results in, closer involvement with the international economy, but globalization may also lead to fiscal problems. Policy

¹⁴ Webber, C. and A. Wildavsky. (1986) *A History of Taxation and Expenditure in the Western World*. New York.

¹⁵ Slemrod, J. and J. Bakija, (1996) *Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform*. Cambridge, Massachusetts.

¹⁶ McLure, C. (1999) "Tax Holidays and Investment Incentives: A Comparative Analysis," *Bulletin for International Fiscal Documentation*.

makers of tax policy are facing difficulties on taxation. The problems are usually exacerbated by the political economy context within which taxation must be designed and implemented. Tax policy decisions are not made in a vacuum. Nor are they made by a disinterested benevolent government.

Policy reflects a set of complex social and political interactions between different groups in society in a context established by history and state administrative capacity. Taxation is not simply a means of financing government but one of the most visible parts of the social contract underlying the state.

The success of any tax reform thus largely depends upon the way in which different political groups perceive the reform and how they react to their perception. To an important extent, then, tax reform is "an exercise in political legitimacy"¹⁷. The bureaucracy, those who will have to implement the reform, must also support it, or at least not actively oppose it.

Some see the inevitable political processes underlying reform as "statist" in the sense that the state can be viewed as an institution in its own right that seeks to maintain and increase its capacity, including its capacity to collect taxes. Others see acceptance of increased tax burdens as inextricably entwined with the expansion of a more democratic polity and a more inclusive society. Whether one views tax policy from the traditional public economics and administrative perspectives set out earlier or the more explicitly political perspectives just mentioned, one conclusion is inescapable. Getting taxes right in low income countries is a complex and difficult question. But given its impact on the wellbeing of people, it is important that we should try to get it as right as they can.

10. Conclusions

As outcome of the paper I would like to say that Albania tax policy like many other transition economies still needs intervention in order to get a better economic situation where both the economy can be encouraged and the poor category of people be protected.

The flat rate taxes for multinational companies should be reconsidered as the Albanian businessmen still do not have the right to set their business to other countries.

The rate of zero taxation should be applied to a higher limit of income in order to help the poor people.

The value added tax should be considered for the same category of poor people and families by applying a different consumption tax. This different consumption tax can not be varied from good to good but from family to family. Even it looks a good option we should keep in mind that still the tax administration is not in the capacity of collecting the tax at the efficient level by this policy but it can applied in the later years to come.

As a final conclusion I would like to say that Albania tax administration needs a long term strategy, which of course, needs the political will of the parliament.

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¹⁷ Lledo, V., A. Schneider, and M. Moore .(2003) "A Critical Survey and Policy Recommendations," Institute of Development Studies, University of Sussex.

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