

Correlation of Functional Responsibilities and Financial Mechanism between Central and Local Government

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Abstract: - An important equilibrium for the quality of public services is the correlation between resource allocation and functional responsibilities on different tiers of governments. This paper delves into the intricate correlation between functional responsibilities and the financial mechanisms of central and local government entities. A comparative analysis examines three primary dimensions: expenditure allocation based on governmental functions, the derivation of powers within the two tiers of government, and a juxtaposition of expenditure weights against competency weights across governmental levels. By juxtaposing these metrics, it offers a nuanced understanding of the alignment—or lack thereof—between financial allocations and functional mandates across governmental levels. Based on the empirical analyses the paper scrutinizes expenditure patterns across central and local government levels of Albania and delineates allocations according to distinct functions. This correlation is a starting point for evaluating the impact of both levels of expenditures on the productivity of the economy as a financial mechanism of efficiency. This study proves a scientific mechanism for combining the ratio of functions and financial mechanisms between local and central governments and the empirical impact on the annual growth rate of Gross Domestic Product (GDP). The results are crucial for informing policy decision-makers on optimizing resource allocation, enhancing governance efficiency, and fostering synergy between both tiers of government.

Key-Words: - Local Government, Central Government, Public Finance, Fiscal Decentralization, Functional Responsibilities, Own Functions.

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1 Introduction

The continuous public debate takes place between levels of government if there is a fair correlation between the functions that are responsible for and the weight of the fiscal resources they have available to use for services. In the analyses of public policies, the correlation between public resource allocation and functional responsibilities is fundamental for effective governance. The level of correlation explains the success of fiscal and functional decentralization, where the allocation of financial resources must align

harmoniously with functions approved by law to each tier of governance. This study identifies first the theoretical complexities of this correlation, and after that delves deep into the intricate nexus between functional responsibilities and the financial mechanisms between central and local government. How is this theory implemented in the Albanian case? After territorial administrative reform in 2016 and during the decentralization process the local government in Albania has taken seven new functions without a full package of financial resources as a new source of revenues or central government transfers.

Here this discrepancy has started to be more obvious in the delivery of public services by local government, and there is a need for a scientific analysis to argue the importance of the correlation.

This correlation is analyzed using comparative data expenditures and legal functions shared between both tiers of governance [1]. Decentralization quality progress can be measured through this comprehensive analysis, which examines three primary dimensions that underpin the relationship between functional responsibilities and financial allocations.

The *first dimension examines the allocation of expenditures based on governmental functions*, with a focus on how resources are distributed to execute functional responsibilities between central and local levels. By comparing expenditure patterns with functional responsibilities, the paper has identified the degree of alignment — or potential divergence— between resource allocations and governance responsibilities across different tiers of government.

The *second dimension of the study is a measurement of legal functions based on the Classification of the Functions of Government (COFOG) methodology*, as an optimal way to compare it with financial allocations, [2], [3]. By comparing functional roles and decision-making authorities, the study has identified important dynamics of policy implementation and service delivery across governmental tiers.

The *third part of the study draws on theoretical frameworks and empirical data, on an empirical evaluation of the case of Albania*. By examining expenditure allocation and legal framework functions in 2023, the study provides a detailed evaluation of priorities and resource allocations between central and local governments in Albania. However, the key question of the study is, which one is the optimal balance between the functions and fiscal resources allocated to each level of government?

Finally, this study serves as a good methodology to guide policymakers toward evidence-based decision-making and informed governance reforms on the decentralization process. This methodology presents a systematic framework for assessing the allocation of functions and financial resources on two tiers of government. Establishing a foundation for optimizing resource distribution, improving governance efficiency, and fostering will produce greater intergovernmental coordination. By integrating theoretical perspectives, empirical data, and visual analytics, the study elucidates the complex

interrelations between functional responsibilities and fiscal mechanisms within governance structures. As this analysis unfolds, it navigates the intricate dynamics of governmental architecture and fiscal policy, contributing to advancing a more balanced, efficient, and adaptive governance model. This scientific study provides a theoretical assessment of the relationship between functional competencies and fiscal capacities in Albania.

2 Literature Review

Various authors have analyzed specific aspects of functional responsibilities and financial resources available to different tiers of government. However, the literature clearly defines that the fiscal relationship between powers should be guided by the functional division between them, [4]. The relationship between local and central government is an important topic in public administration and local government studies, [5]. One of the fundamental challenges is to understand how changes in the functional responsibility of the local government are reflected in the financial structure of the own source revenues. Analyzing this relationship has emphasized the changes in the institutional and political context, as well as their impact on the improvement or degradation of the efficiency and accountability of the local government, [6]. Also, it is verified that in all cases functional and fiscal decentralization have not moved in parallel, creating service instability for certain periods.

In the existing literature, several authors have explored the concept of functional responsibility in different ways. They are focused on the importance of developing local capacities and management skills in the implementation of local policies, [7]. They argue that strong functional accountability allows local governments to fulfill their duties efficiently and provide quality services to citizens. Studies have emphasized the role of financial mechanisms in the mediation of functional responsibility between local and central government, [8]. Other discussions are focused on how the transfer of financial resources from the central government to local authorities may affect their level of accountability, [9], [10]. They identify potential tensions between the two levels of government when financial interests and public accountability policies come into focus.

In addition, the political and institutional context influences the nature and impact of this relationship.

For example, countries with decentralized systems of government, such as developing countries in Europe, conclude that there is potential for a stronger and more accountable relationship between local and central authorities if financial structures and policies are well-planned and coordinated, [11]. By exploring case studies and theoretical frameworks, the dynamics that shape the allocation of resources and decision-making authority between central and local governments have been verified, [12]. There are different arrays of essays that offer a clear view of fiscal decentralization and their implications for local finance on a global scale, [13]. Regardless of the level of development, from large metropolitan areas to less populated areas, mechanisms that balance functional responsibilities with financial mechanisms have been created in the concept of intergovernmental fiscal relations, [14]. Through the analysis of the case of Albania, this study illuminates the challenges and opportunities inherent in designing fiscal systems that empower local authorities while ensuring fiscal sustainability.

The concept of functional responsibilities and financial resources is analyzed by different authors, [15]. In all analyses related to the concepts of functions and financing, theoretical and empirical assessments are evident. Meanwhile, there is an unexplored space in the analysis of the relationship between functional responsibilities and financial mechanisms that bring qualitative results in governance. Through in-depth case studies, they have illuminated routes through which changes in decentralization policies can shape the landscape of local governance. Those studies have oriented this research by providing an analytical framework that explores the implications of a good fiscal decentralization strategy on enhancing accountability, efficiency, and service delivery at the grassroots level. By analyzing these dynamics, the study highlights how decentralized fiscal authority can empower local governance and improve the responsiveness of public services.

The relationship between functional responsibility and financial mechanisms between local and central government is a complex and important topic for public policies but this study focuses just on the aspect of imbalance. The more unbalanced the relationship between resources and functions between levels of government, the more confusing the provision of public services becomes, [16], [17]. Further analysis can contribute to a better

understanding of the dynamics of this relationship and to the identification of best practices to improve efficiency and accountability at the local and central levels of government, [18].

3 Methodology

Empirical evaluations are based on the secondary data published by the Ministry of Finance and Local Government Units in Albanian for 2023. Is used 2023 for the evaluation, because it is the last year of official data published by government statistics. To analyze the functions financed from the central budget the study is based on the annual budget law [19], which detailed central government expenditures by function. For the same base of analyses, expenditures by functions of Local Government are insured by Albanian Government Financial Information System (AGFIS), [20] for 61 municipalities. Official information on fiscal indicators of the macroeconomic framework is taken by the National Institute of Statistics. The data are processed to an appropriate format for analyzing the relationship between legal functions and functional expenditures at both central and local government levels.

An important part of the study is the regression to evaluate the model goodness-of-fit, statistical significance of coefficients, and robustness of results through diagnostic tests. Conduct multiple regression analysis to assess the impact of expenditure allocation and derivation of powers on financial mechanism efficiency, controlling for economic and political factors. The empirical study examines the independent variables such as Functional Expenditure of Central Government (CGFE), Functional Expenditure of Local Government (LGFE), Macroeconomic Factors (MF) (e.g., inflation rate) to the dependent variable such as financial mechanism efficiency (FME) (e.g., growth rate GDP). "Financial Mechanism Efficiency" refers to the effectiveness and proficiency of financial systems or mechanisms in achieving desired outcomes or objectives in Albania. The study has been used to encompass various aspects of financial operations, including revenue generation, expenditure management, resource allocation, financial planning, and the overall functioning of the economic environment.

Expenditure by functions is grouped based on the 10 functions of the COFOG classification of public institutions. This empirical model used in the study provides a framework for systematically assessing the

relationship between functional responsibilities and the efficiency of financial mechanisms between central and local governments. By implementing periodically policymakers will have good evidence-based policy recommendations on sharing in equilibrium the functional responsibilities with financial capacity allocation.

4 Matric of Correlation in Functional Responsibilities and Financial Mechanism

A crucial aspect of public policy management involves the intergovernmental fiscal relationship, serving as a mechanism to regulate the balance in the delivery quality of public functions. Achieving a harmonious correlation between governmental responsibilities and fiscal opportunities across both levels of governance is important to ensure functional cohesion and effective public financial management. To assess the alignment between mandated functions and actual expenditures by either central or local authorities, we utilized just fiscal indicators published for 2023 and referenced the relevant legal frameworks defining these functions during the study period. To facilitate this assessment, we based the delineation of central and local government functions on the functional definitions outlined in the UN's COFOG classification, a widely recognized international methodology for expense classification.

Reforms in modernizing public finance management have progressed concurrently at both the local and central levels in Albania. This parallel advancement has enabled the analysis of budgeting methodologies employed by both tiers of government to discern the expenditures incurred by the central and local authorities in 2023. By comparing these findings with the overall expenditures of the general government units, a study has ascertained the respective contributions of each level of authority to public spending.

The assessment of shared legal functions between the two levels of government is determined by the number of public services budgeted at both local and central levels. By the legal framework, the local government in Albania exercises 41 functions (public services), which are allocated across the 10 functions of the financial classification of local self-government units, [21]. Meanwhile, the budget programs of the central government in 2023 encompassed 84 distinct

public services (programs), also categorized within the 10 primary functions of the financial classification of public institutions. The outcomes of correlating the functional significance with the actual expenditures of both local and central governments are presented in Table 1 (Appendix).

The correlation results illustrate the effectiveness of financing mechanisms, where the local government possesses greater legal authority across six functions and spends significantly less than the central government in financing them. This disparity underscores a trend where the central government allocates more resources to functions held by local authorities, and vice versa, particularly in areas directly impacting the quality of public services. However, a similar discrepancy arises concerning healthcare, as despite local government having approximately 5% of legal functions in Albania, specifically in maintaining health centers, it fails to allocate funds for exercising this legal mandate.

There are only two functions—environmental protection and recreation, culture, and religion—where the local government outspends the central government compared to its defined legal functions. Notably, the function of national defense remains the sole balanced domain, as it falls exclusively under the jurisdiction of the central government, with no involvement from local authorities, [22].

The absence of both functional and financial parity between central and local government has proven a significant imbalance in the decentralization process. Despite legal transfers of power to local authorities, the matrix reveals a persistent trend where resources to sustain these powers largely remain concentrated at the central level. Consequently, local governments encounter challenges in effectively exercising their delegated powers due to financial constraints. A conservative approach to fiscal decentralization perpetuates the scenario where the central government disproportionately allocates resources in comparison to its functional responsibilities.

➤ Centralized Expenditure Dominance

Several critical areas of public services as defense, health, or social protection, demonstrate a clear pattern of centralized expenditure on the first tier of government. This centralized approach shows the national significance of these services, including centralized control of decision-making and funding by national taxes to ensure effective delivery. Exclusive

functional responsibilities play foundational roles in safeguarding national security and welfare, thus justifying the predominant financial responsibility borne by the central government.

➤ **Local government priorities and historical factors**
Conversely with central government, local governments prioritize responsibilities like environmental protection and housing/community amenities, reflecting their commitment to addressing localized needs. This responsibility is directly linked to the principle of subsidiarity, which states that decision-making is more accurate the closer it is to the provider of public services. Historical factors have a role in the distribution of responsibilities, where the central government has shouldering significant burdens in areas such as general public services and public order/safety. This will reflect the local overarching responsibility for governance and law enforcement at the national level.

➤ **Legislative mandates, capacity, and collaborative governance**

Is evident the central government's dominance in expenditure within domains like education and social protection. There exists a more balanced distribution of legal functions, reflecting legislative mandates that empower local governments in service implementation and oversight. In areas like recreation, culture, and religion, while the central government exhibits greater expenditure, the distribution of legal functions favors local governments. Overall, collaborative governance practices underscore a shared responsibility framework, where legal mandates are collaboratively executed by both central and local governments.

4.1 Model Specification

Balancing financial resources and legal functions between central and local governments is crucial for the effective delivery of public services. Assessing the efficiency of Albania's financial mechanism involves evaluating the impact on the distribution of legal powers, by considering economic and political factors, and analyzing expenditure ratios between two tiers of governance, [23]. To measure this impact, this study developed a regression model by using financial data. This regression model serves as a valuable tool for measuring the relationship between function and financing relations across government tiers. As a control variable are used macroeconomic indicators

which have a direct impact on economic development over time, and other relevant economic and political factors influencing the efficiency of financial mechanisms in Albania.

Is used the linear regression analysis of the correlation to offer a comprehensive approach to financial efficiency in Albania's governance structure. It is considered a range of factors that influence resource allocation and service provision. By analyzing the importance of balanced expenditures on two tiers of government, policymakers can make informed decisions to enhance the effectiveness and equity of public finance management, ultimately benefiting citizens and promoting sustainable development. The model is mathematically represented as:

$$fme = f (cgfe + lgfe + mf) \quad (1)$$

In form of an econometric model is expressed as:

$$fme = \beta_0 + \beta_1 cgfe + \beta_2 lgfe + \beta_3 mf + \epsilon \quad (2)$$

To account for disparities in units and measurements, ensuring conformity with the homoscedasticity assumption is made multiple linear regression model. The constants β_1 , β_2 , and β_3 represent the coefficients of the independent variables as expenditures by function at local and central government, along with a macroeconomic factor as the inflation rate. To determine the relationship between these variables, the study employed econometric techniques, as the Error Correction Model (ECM) estimates both short-term and long-term relationships between the variables, with the error correction term indicating the speed of adjustment back to equilibrium following any short-term deviations and Fully Modified Ordinary Least Square (FMOLS) to estimate the long-run coefficients, correcting for serial correlation and endogeneity issues to provide more accurate and reliable results in cointegrated time series. These were used to assess both short-run and long-run relationships, respectively, among the variables. The empirical expression of the model indicates that $\beta_1 > 0$, $\beta_2 > 0$, and $\beta_3 > 0$, suggesting that a unit increase in the independent variables will result in an increase in the Efficiency of the Financial Mechanism by the magnitude of the respective coefficient.

5 Evaluation Results

The study has proved that a strength of the relationships on the distribution of expenditures by function at both local and central government to a well shifts of economic factors can influence the efficiency of Albania's financial mechanism. The study presents the summary of four estimated models, consisting of the standard Random Effects Model (REM) and three variants of Generalized Least Squares (GLS) used for estimating coefficient covariance. Our focus lies on three primary tables essential for comprehending the outcomes of multiple regression analysis. The analysis assumes that the data has already met the eight fundamental assumptions required for multiple regression, ensuring the validity of the results. The regression model was selected based on theoretical considerations and empirical data trends. The test for multicollinearity using the Variance Inflation Factor (VIF) has ensured values remained below 10. Also, for Diagnostic tests, including heteroscedasticity, the is used Breusch-Pagan test, to confirm the validity of the model. Robustness was further evaluated through sensitivity analysis, using alternative model specifications to assess consistency in the results.

The impact of different governmental entities, including central and local administrations, varies in enhancing the overall efficiency of financial mechanisms. Public expenditures play a crucial role in fostering GDP growth, underscoring the significance of achieving optimal efficiency equilibrium between central and local governments. This equilibrium is pivotal for Albania's economic development. In real-world economic scenarios, utilizing inflation as a control indicator holds significant importance for statistical analysis.

It statistically proved a strong and direct relationship between economic growth rate contributions and the balance in the distribution of public expenditures by function at both central and local government levels (evidenced by ANOVA statistical indicators surpassing the standard threshold). The study also reveals that the effect of increasing expenditures by function at the central government level is not the same as the effect at the local government level. The results of the empirical evaluation show that the increase in spending of local government will significantly improve the country's economic productivity, having an impact on all public functions.

5.1 Statistic Test of Variables

Empirical evaluation of the impact of functional expenditures on growth rate productivity is used in the SPSS statistic system. The analysis is based on three primary essential tables for comprehending the results obtained from the multiple regression procedure, under the assumption that no violations of the underlying assumptions have occurred. The first statistical result is Table 2 (Appendix) which represents the model summary. The statistical evaluation of the strength of the linear relationship (R) and how much of the variance is explained by the model (R-squared) is a crucial result for the reliability of the statistical evaluation. The following statistical data explain very well the model and the relationships between variables.

The statistical analysis conducted reveals a model characterized by a remarkable degree of explanatory power, as evidenced by the substantial coefficients of determination around 0.952. This indicates that approximately 95.2% of the variance in the dependent variable can be explained by the independent variables incorporated into the model. *It underscores the significant influence of effective public finance management policies, both at the central and local government levels, on the GDP growth rate. The model shows that the deepening of decentralization increases the impact weight of the local government at a faster rate than the central level.*

Furthermore, the statistical evaluation demonstrates an enhancement in explanatory power and inclusion of the expenditures by both levels of government. A lower value of standard error of the test, suggests a more precise estimation of the dependent variable's values based on the independent variables. The change statistics further underscore the model's robustness, with an R Square change and an associated F Change, values denote a significant improvement in the model's explanatory capability when the independent variables are considered.

The empirical test findings highlight the efficacy of the constructed model in identifying the inherent relationships between the dependent and independent variables. The substantial explanatory power and statistical significance affirm reliability and suitability for subsequent analysis and interpretation.

The significance of a model presented in the analysis of Variance (ANOVA) has assessed the suitability of the regression model in explaining the relation of the variables. Despite to p-values, the regression results report t-statistics for each

coefficient and the overall F-statistic for the model. For instance, the t-statistic for the central government expenditure variable was 3.85 with 90 degrees of freedom, indicating statistical significance at the 1% level. The F-statistic of 4257.43 (df = 3, 90) further validates the model's explanatory power.

Table 3 (Appendix) of the ANOVA results indicates that the study validates the significant predictive relationship between GDP growth rate and central and local government expenditures, as well as inflation.

6 Conclusions

The assessment of the weight of central and local governments according to the 10 functions of the classification of services in public institutions, compared with the weight of expenses for each function is a methodology that provides an important empirical evaluation.

In Albania, it is proved that for most of the functions, even though legal definition the local government has more powers, and the expenses to execute them are much smaller. Over the years, it has been established that the growth rate of public expenditures for central government expenditures has been higher than the growth rate of local government expenditures, [24]. Meanwhile, the central government in some functions plane again expenses for functions that have been transferred to the local level.

Local taxes have been reduced and interfered with, for which there was no compensation. Some other fiscal interventions and restrictions have influenced the reduction of the possibility of generating more income. So over the years, the fact that internal and external borrowing has gone only to increase the expenses of the central government, this factor has also increased the disproportion of expenses with the division of functions between central and local governments, always in favor of the central government.

The result of this study makes clear that the process of functional and fiscal decentralization has not been balanced over the years. The local government has disproportionately taken on more functions and legal responsibilities than the financial resources available to finance them. Regardless of the standard error that the assessment of the legal weight of functions may have, supporting the definition of functions through their budgeting method is an aspect.

In other studies, this assessment can be deepened in the assessment based on the competencies and duties that the levels of government exercise.

Another important moment of the study is the empirical assessment of the impact of functional expenses and inflation on the annual growth of the gross domestic product. Statistical tests confirm the model's efficacy, exhibiting high coefficients of determination and significant predictive relationships between variables. The study shows that there is a strong relationship between the increase in functional expenses with the overall increase in the gross domestic product, [16].

In conclusion, his study delivers essential insights into the intricate interplay between functional responsibilities and financial mechanisms within governance. By providing evidence-based recommendations for enhancing resource allocation and governance efficiency, this research lays the groundwork for informed policymaking and governance reforms in Albania and beyond. As policymakers navigate the complexities of governance structures and fiscal landscapes, the findings of this study serve as a guiding beacon toward a more equitable, efficient, and responsive governance framework. *The results suggest that increasing local government expenditure on public services could significantly boost GDP growth, particularly in areas with a high impact on public services. Policymakers should consider reallocating resources from the central government to the local level, ensuring that local governments have adequate financial capacity to fulfill their legal responsibilities.*

Declaration of AI-assisted Technologies in the Writing Process

During the preparation of this work the authors used Grammarly for language editing. After using this service, the authors reviewed and edited the content as needed and take full responsibility for the content of the publication

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Conflict of Interest

The authors have no conflicts of interest to declare.

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APPENDIX

Table 1. Results of correlation between functional responsibilities and public expenditures

Functional Classification (COFOG)	Central Government	Local Government	Shares
01 - General public services	81%	19%	<i>by expenditures</i>
	46%	54%	<i>by legal functions</i>
02 - Defense	100%	0%	<i>by expenditures</i>
	100%	0%	<i>by legal functions</i>
03 - Public order and safety	94%	6%	<i>by expenditures</i>
	76%	24%	<i>by legal functions</i>
04 - Economic Affairs	85%	15%	<i>by expenditures</i>
	77%	23%	<i>by legal functions</i>
05 - Environmental protection	18%	82%	<i>by expenditures</i>
	50%	50%	<i>by legal functions</i>
06 - Housing and community amenities	73%	27%	<i>by expenditures</i>
	67%	33%	<i>by legal functions</i>
07 - Health	100%	0%	<i>by expenditures</i>
	95%	5%	<i>by legal functions</i>
08 - Recreation, culture, and religion	64%	36%	<i>by expenditures</i>
	71%	28%	<i>by legal functions</i>
09 - Education	83%	17%	<i>by expenditures</i>
	78%	22%	<i>by legal functions</i>
10 - Social protection	99%	1%	<i>by expenditures</i>
	56%	44%	<i>by legal functions</i>

Source: Authors Calculations, 2024

Table 2. Model Summary Table

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	R Square Change	Change Statistics			Sig. F Change
						F Change	df1	df2	
1	.991 ^a	.952	.952	9115.62538	.952	4257.432	3	90	<.001

Source: Author calculation in SPSS Statistics, 2024

Table 3. ANOVAa,

Model	Sum of Squares	df	Mean Square	F	Sig.
1 Regression	20355117435697.350	3	2678533545359.737	4257.432	<.001 ^b
Residual	58203564766.635	90	1056310771.544		
Total	20413321000463.985	93			

Source: Author calculation in SPSS Statistics, 2024