

# 1. THE STRATEGIC SETTING

*To sustain its impressive record of growth and poverty reduction, Albania will need to increase private investment and find new sources of productivity growth. However, the private sector still faces growing constraints including a labor force with a low skill endowment, a poor quality of infrastructure and inadequate utility supplies, relatively high labor taxes that add to costs and increase informality, and a weak governance environment that imposes high transaction costs on firms.*

*Public expenditure policy is at the heart of these development challenges. In particular, the size and resourcing of the state are critical in shaping the broad macroeconomic framework for investment and job creation, while the effectiveness of public spending affects the pace of human capital accumulation and the productivity of private investments, and the institutional framework of the public sector shapes the environment for doing business.*

*This report finds that the size of Albania's government at 29 percent of GDP is broadly appropriate, but that resource mobilization is distortionary—high payroll taxes have discouraged the creation of formal sector employment. More important government spending in Albania is inefficient—the country could achieve its current outcomes with fewer resources. Finally, the weak institutions and fiduciary practices in the public sector continue to jeopardize the overall governance environment and fundamentally undermine the efficiency and productivity of capital spending, a complement to improved private investment.*

## A. INTRODUCTION

**1.1 Public policy instruments available to the Government affect development objectives both directly through public sector interventions and through their impact on the private sector.<sup>1</sup>** First, tax policy raises the necessary resources for the public programs, but the design features of these policies have direct growth and redistributive impacts. Second, expenditure policy, through its impact on the level and composition of expenditure can be used to influence policy outcomes. Finally, the regulatory and institutional policy framework establishes the rules of the game within the economy and defines the incentives along which both public and private agents would base their decisions.

**1.2 This report focuses on the last two policy instruments, expenditures and institutions.** It assesses the extent to which they have contributed to the achievements of Albania's development objectives under the National Strategy for Socio-Economic Development (NSSD) and suggests expenditure and institutional reform options that should underpin the ongoing preparation of Albania's National Strategy for Development and Integration (NSDI) and its objectives to stimulate growth and further reduce poverty.

**1.3 A good understanding of the broader growth, poverty and institutional context would be necessary to inform future expenditure policy options. This chapter lays down these elements.** First, it discusses Albania's growth and poverty reduction trends and determinants and identifies the binding constraints to growth and unemployment. For that purpose it builds on recent economic and sector work,<sup>2</sup>

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<sup>1</sup> See Parmestro, Rajram and Tiongson, 2005, for details about analytical frameworks for analyzing public spending.

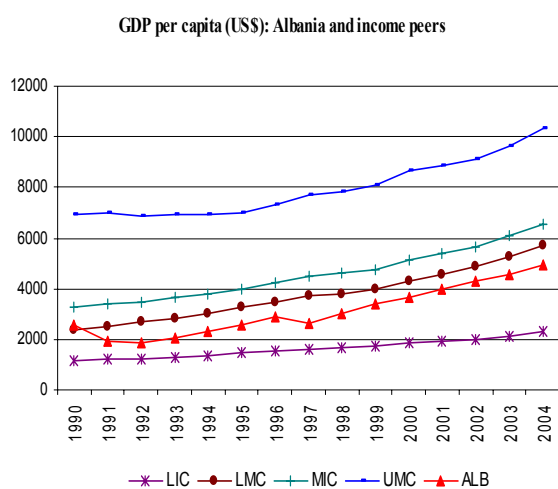
<sup>2</sup> "Albania: Sustaining Growth Beyond the Transition" (World Bank Country Economic Memorandum, December 2004). "Albania: Labor Market Assessment" (World Bank, December 2005); Albania Living Standards Note, June 2006.

as a background for assessing the role of public spending in addressing these constraints, through public expenditure allocation and reforms in the medium term. Second, it discusses the role of the public sector in improving long-term growth prospects including through its size, resourcing, and the quality of its institutions. Finally, the chapter discusses the overall key vulnerabilities that affect macroeconomic sustainability.

## B. GROWTH AND POVERTY REDUCTION

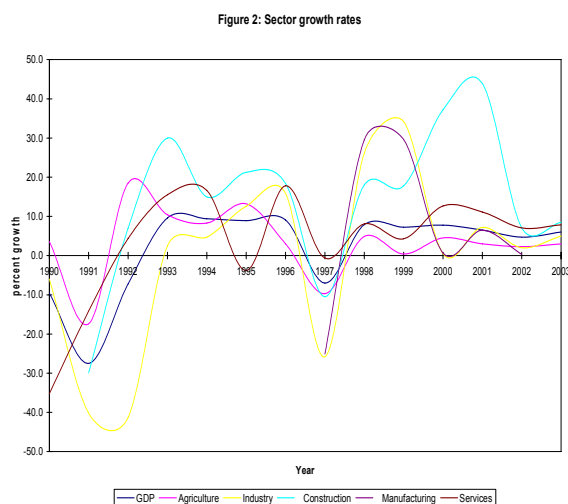
1.4 **Rebounding from the financial collapse of 1997, Albania performed very well in sustaining high rates of economic growth.** Economic activity recovered and real gross domestic product (GDP) growth rates accelerated to an average annual rate of 7 percent over the period 1999-2005, allowing Albania's per capita GDP to approach middle income country levels (see Figures 1.1 and 1.2). This growth record has been the highest among transition economies. Since transition, Albania's growth has been driven primarily by the improvements in the allocation of resources from low productivity sectors, firms, and activities to higher productivity ones.

**Figure 1.1: Regional Comparisons: Real GDP Per Capita (1990-2004, 1990=100)**



Source: WDI 2006.

**Figure 1.2: Evolution of Sectoral Growth Rates (1990-2005) in Albania**



Source: INSTAT.

1.5 **Much of this economic performance has been underpinned by sustained fiscal consolidation and macroeconomic stability.** The Government succeeded in reducing the overall deficit from 13 percent of GDP in 1997 to 3.4 percent in 2005, while the primary deficit declined from 7.3 to 0.3 percent of GDP during the same period. Lower public sector borrowing requirements resulting from fiscal consolidation sustained the downward trend in interest rates, and kept year on year inflation within the Bank of Albania's target range of 2-4 percent. However, signs of mounting inflationary pressures have emerged recently, largely driven by a higher than expected spurt in credit growth (Table 1.1). A surge in imports in parallel with a deceleration in exports, and combined with the deterioration in the electricity sector performance during the last quarter of 2005, along with a slow down in the construction sector, are damaging growth prospects for 2006: the latter is projected to 5 percent in 2006.

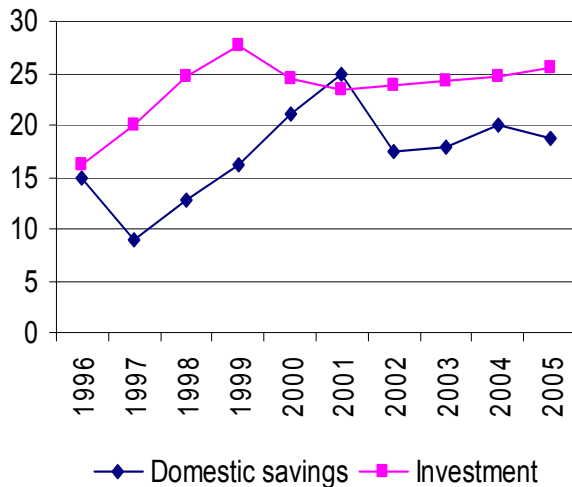
1.6 **During the transition, growth has been driven primarily by improvements in the allocation of resources as reflected in high rates of total factor productivity growth.** Resources have been reallocated from low productivity sectors, firms, and activities (for example, subsistence agriculture) to

high productivity ones (for example, export manufacturing). As a result, total factor productivity (TFP) growth explains almost all growth in the 1993-2003 period 6.1 percent of the annual average of GDP growth of 6.3 percent.

**1.7 External migration has given an additional impetus to growth by boosting domestic consumption.** This reflects the large-scale migration to Greece, Italy, and other countries in Europe; since 1990, about one-fifth of the total population has left and is living abroad. Migration has been an important strategy for coping with the lack of jobs and decent earnings opportunities at home. Official estimates indicate that remittances are the largest source of foreign exchange, equivalent to almost 14 percent of GDP. This flow has stimulated domestic demand, especially in non-tradable activities such as construction and services, and has complemented the earnings of almost all resident Albanians.

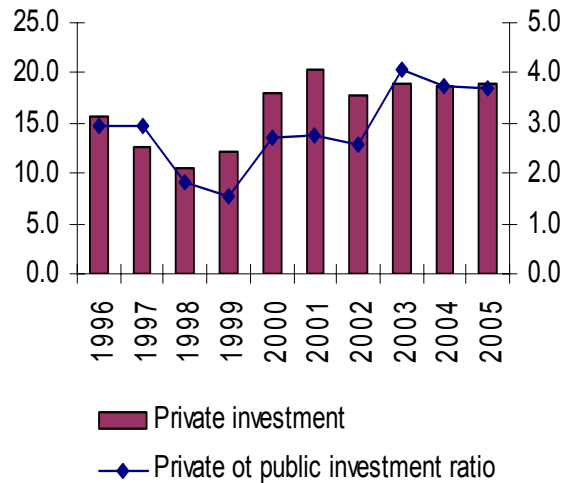
**1.8 Meanwhile, the contribution of factor mobilization and the accumulation of both labor and capital have picked up only modestly and face constraints.** Investment rates rose after the financial crisis of 1997, but after 1999 they have declined and stagnated. This reflects, in part, sluggish foreign direct investment, which at 3 percent of GDP is at a low level compared to other transition and high growth economies. With consumption persistently high, domestic savings have declined after 2001 (Figure 1.3 and 1.4). Both the migration of young workers and the low savings rate will continue to limit the growth of the factors of production and confirm the need to find sources of TFP growth.

**Figure 1.3: Savings-Investment Gap 1996-2005 (% of GDP)**



Source: MoF and IMF.

**Figure 1.4: Private and Public Investment 1996-2005 (% of GDP)**



Source: MoF and IMF.

**Table 1.1: Albania: Selected Economic Indicators, 1996-2005**

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
(Percent change unless indicated otherwise)										
Nominal GDP (billions of leks)	314.9	322.2	412.3	474.3	530.9	587.7	624.7	682.7	766.4	836.8
Real GDP growth	9.1	-10.2	12.7	10.1	7.3	7.0	2.9	5.7	5.9	5.5
CPI inflation (annual average)	12.7	32.1	20.9	0.4	0.0	3.1	5.2	2.4	2.9	2.4
Lending int rate, nominal, e.o.p. a/	28.8	43.0	25.0	25.8	23.7	11.9	16.0	10.5	13.7	12.2
Deposit interest rate nominal, e.o.p. b/	19.1	27.8	16.5	9.1	7.7	7.8	9.3	7.6	6.0	5.6
Unemployment rate, annual average	12.4	14.9	17.8	18.4	16.8	16.4	15.8	15.0	14.4	14.2
(Percent of GDP)										
Foreign savings c/	11.5	8.0	3.3	3.7	3.6	2.8	7.2	5.5	3.8	5.0
Gross dom savings	4.0	8.8	12.9	16.2	21.1	24.8	17.4	17.9	20.0	18.6
Public d/	-8.6	-8.8	-4.6	-1.6	-1.6	-0.6	0.0	-0.1	0.1	0.8
Private	12.6	17.6	17.4	17.8	22.6	25.4	17.4	18.0	19.9	17.8
Gross investment	15.5	16.8	16.2	19.9	24.6	27.6	24.5	23.4	23.8	23.6
Public	4.5	4.3	5.8	7.8	6.6	7.3	6.7	4.6	5.0	4.6
Private	11.0	12.5	10.4	12.1	18.0	20.2	17.8	18.8	18.8	19.0
(Percent of GDP)										
Total rev & grants	18.3	18.3	24.2	25.5	23.8	23.7	24.7	24.5	24.1	24.0
Total exp & net lending	30.4	31.4	34.5	34.9	31.9	31.6	31.4	29.0	29.2	27.4
Interest payment	3.1	5.8	8.8	7.5	5.8	4.3	4.0	4.4	3.7	3.1
Primary balance	-9.0	-7.3	-1.6	-1.9	-2.4	-3.6	-2.7	-0.2	-1.4	-0.3
Overall fiscal bal Public & publicly- guaranteed debt	-12.1	-13.1	-10.3	-9.4	-8.2	-7.9	-6.6	-4.5	-5.1	-3.4
Domestic		84.6	75.9	72.7	72.8	67.6	65.0	61.8	56.5	54.5
External		46.5	43.5	43.4	42.6	41.0	41.7	41.1	38.5	37.9
		38.1	32.4	29.3	30.2	26.6	23.3	20.7	18.0	16.6
(Percent of GDP unless otherwise indicated)										
Export GNFS	11.6	11.1	10.3	17.3	19.0	20.4	20.5	20.8	21.5	21.7
Imports GNFS	36.0	37.3	35.8	41.9	40.6	42.9	46.3	45.9	43.2	44.3
Current account bal	-9.1	-11.1	-6.3	-7.6	-6.6	-5.8	-10.0	-8.1	-5.5	-7.8
FDI, net	3.4	2.1	1.5	1.1	3.9	5.0	3.0	3.2	4.6	2.9
Worker remittances	14.1	11.6	16.1	9.5	12.1	13.2	13.0	14.0	13.8	14.2
Official reserves, mths imports, G&S	3.1	4.5	3.7	3.8	4.1	4.6	4.4	3.9	4.1	4.2
(Percent of GDP unless otherwise indicated)										
Broad money	49.1	61.6	58.1	61.7	61.8	67.1	65.3	65.0	65.7	68.5
Domestic credit	3.5	4.0	3.6	3.6	4.2	4.7	6.4	7.7	9.3	14.5
In local currency			2.3	1.7	1.4	0.8	1.5	1.6	2.0	3.6
In foreign currency			1.3	1.8	2.8	3.8	4.9	6.1	7.3	10.9
Private domestic credit growth	30.5	19.0	14.7	13.3	31.8	23.4	41.0	31.0	37.0	74.9
Exchange rate Lek/US\$, e.o.p.	105.0	150.7	150.3	138.2	143.9	143.5	140.4	120.9	102.5	100.2
Exchange rate Lek/Euro, e.o.p.				147.5	133.5	130.6	138.5	142.6	132.5	124.0

<sup>a/</sup> Refers to interest rate on 6-12 month loans in lek.

<sup>b/</sup> Refers to interest rate on 12 month deposits in lek.

<sup>c/</sup> Negative of current account including official transfers.

<sup>d/</sup> Revenue including grants less current expenditure and net lending.

Sources: NSI, MoF, BOA, INSTAT, World Bank and IMF databases.

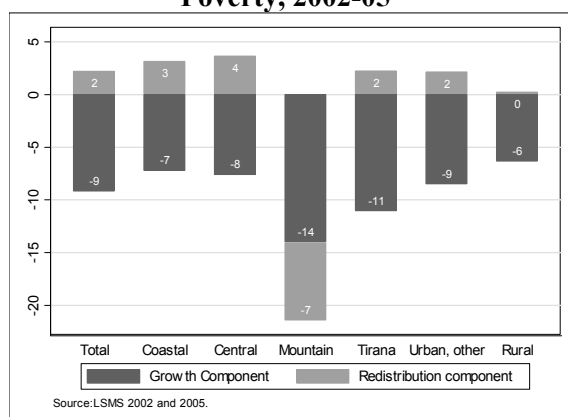
1.9 **Poverty has declined significantly, a result of the sustained recent growth.** The absolute poverty headcount rate declined from 25 percent in 2002 to 19 percent in 2005, or 6.8 percentage points, lifting 221,000 people out of poverty (Table 1.2). This decline is higher than witnessed recently in most ECA countries and other middle income countries.<sup>3</sup> The decomposition of changes in poverty reduction into growth and redistribution components reveals that the poverty reducing effect was growth-driven, with the increase in mean consumption being responsible for a drop of 9 percentage points in the poverty headcount (Figure 1.5). A marginal increase in inequality contributed to increasing poverty by 2 percentage points. The elasticity of poverty reduction to GDP growth is -3.6, higher than the average -2.5 for Southeastern Europe, suggesting that Albania's poverty is much more responsive to GDP growth than is the case in the neighboring countries.

**Table 1.2: Poverty in Albania (percent of individuals)**

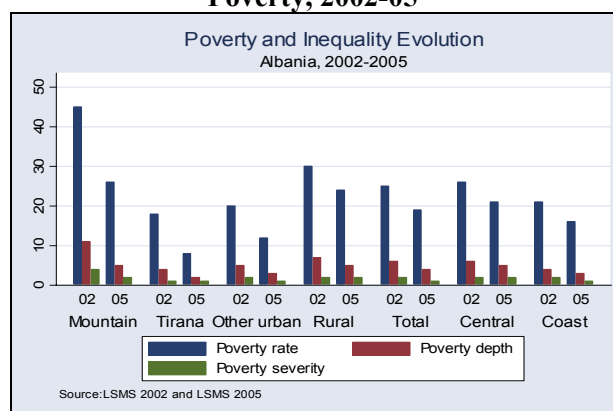
	Tirana		Other Urban		Rural		Total	
	Poor	Extreme poor	Poor	Extreme poor	Poor	Extreme poor	Poor	Extreme poor
Headcount 2002	17.8	2.3	20.1	4.8	29.6	5.2	25.4	4.7
Headcount 2005	8.1	1.0	12.4	2.7	24.2	4.5	18.5	3.5

Source: LSMS 2002 and 2005.

**Figure 1.5: Decomposition of Change in Poverty, 2002-05**



**Figure 1.6: Evolution and Distribution of Poverty, 2002-05**



1.10 **Much of the growth has taken place in and around urban areas, drawing internal migration from the countryside.** Tirana, for instance managed to slash its poverty rate by more than half. Indeed, urban poverty has declined much more rapidly, than poverty in rural areas. Still, compared to 2002, the number of poor people in rural areas has decreased by 18 percent (though extreme poverty rates were hardly affected) (Figure 1.6). The mountain region even gained significantly from both growth and improvement in income distribution, primarily due to migration and a shift in relative prices in favor of agricultural products.

1.11 **Sustaining these accomplishments will not be easy, as the past pattern of growth is not sustainable over the medium term.** The evidence from a growth accounting exercise<sup>4</sup> indicates that gains from improved resource allocation is diminishing and that total factor productivity growth has

<sup>3</sup> See World Bank (2005), *Growth, Poverty and Inequality*, Chapter 2.

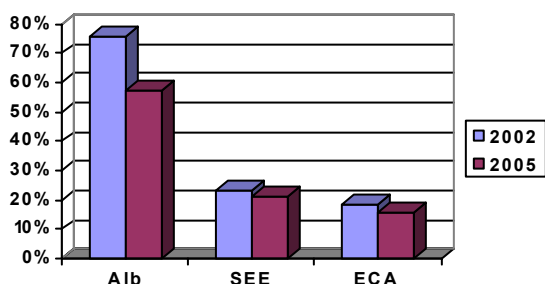
<sup>4</sup> "Albania: Sustaining Growth Beyond the Transition", Country Economic Memorandum" (CEM), World Bank, 2004.

slowed significantly in recent years. Constraints to new sources of TFP growth include low levels of education and lack of appropriate skills in the labor force;<sup>5</sup> barriers to entry and exit for firms (new firms usually bring with them better technology); and government institutions that create high transaction costs for firms, reduce learning opportunities, and encourage sub-optimal resource allocation. Consumption growth continues to be kindled by large remittance flows and the growth in private credit.

1.12 **Many of the structural issues that plague Albania’s economy and hamper private sector activity depend heavily on the performance of the public sector.** Poor quality and outdated infrastructure, and relatively low-skilled labor, represent major impediments to doing business (Figure 1.7, Figure 1.8, and Figure 1.9).<sup>6</sup>

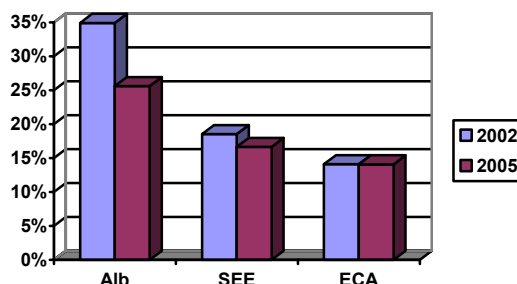
**Figure 1.7: Electricity as a Problem for Doing Business, Albania and Comparator Countries, 2002-2005**

*Percent of firms stating that the provision of electricity is a problem doing business*



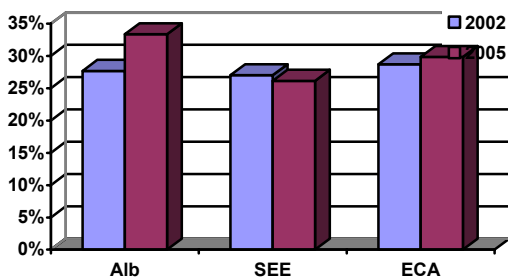
**Figure 1.8: Transport as a Problem for Doing Business, Albania and Comparator Countries, 2002-2005**

*Percent of firms stating that transportation is a problem doing business*



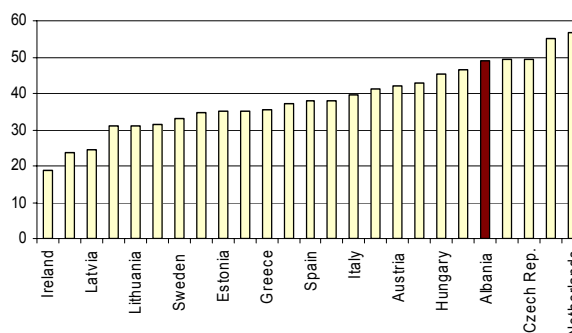
**Figure 1.9: Workers’ Education as a Problem Doing Business, Albania and Comparator Countries, 2002-2005**

*Percent of firms indicating skills and education of workers is a problem doing business*



Source: BEEPS and World Bank staff estimates.

**Figure 1.10: Social Security Contributions Rates Albania and Comparator Countries, 2002-2005**



Note: Contribution rates for Albania before July 2006.

1.13 **In addition, high payroll taxes have discouraged formal employment and dampened labor demand.** Three-quarters of the labor force is now employed in the informal sector. In addition, while

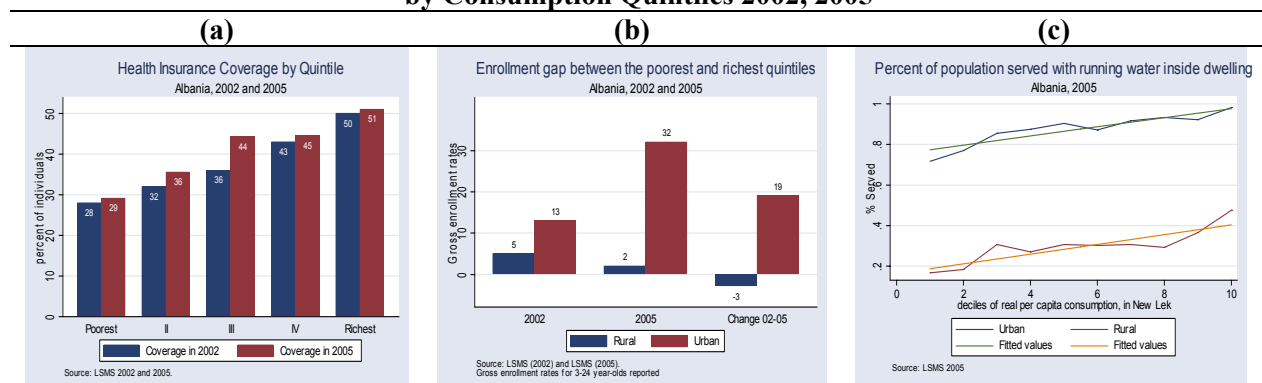
<sup>5</sup> More skilled workers would imply an augmented labor supply, and so would increase the part of growth attributable to labor, but would also boost TFP to the extent that more skilled workers provide learning externalities to the rest of the labor force. The CEM (2004) provides evidence of significantly greater private returns to higher education.

<sup>6</sup> Business Environment and Enterprise Performance Survey (BEEPS).

formal sector wages are lower than the Southeastern Europe average, they have been rising in relative terms and are higher than those in competitors such as Bulgaria and Romania (Figure 1.10).<sup>7</sup> A combination of all these factors, in addition to unfair competition, tax harassment, weak governance and corruption means that firms have a weak foundation for being competitive and explains why the export base is so narrow.

1.14 **Meanwhile, the fight against poverty is far from over.** While the rapid growth in incomes was the key contributor to poverty reduction, it was partially offset by increasing inequality, especially in the coastal and central areas. Rural poverty remains high, with the headcount still at 24 percent in 2005, compared to 11 percent for urban areas. Furthermore, the poor are primarily less skilled, with only primary education, and have less access to education in urban areas. They also tend to be employed in the informal sector without the protection of formal sector regulations. Wide variations in health and educational status as well as in access to services among regions are mirrored by variations in spending at the local level (Figure 1.11).

**Figure 1.11: Health Insurance Coverage, School Enrolment and Access to Water by Consumption Quintiles 2002, 2005**



### C. GOVERNMENT AND LONG - TERM GROWTH

1.15 **Public expenditure policy is at the heart of these challenges to spur new productivity growth and reduce poverty and inequality in access to services.** Public expenditure policy has a fundamental role in terms of: (i) establishing the broad macroeconomic framework for investment and job creation; (ii) providing the public services that contribute to human capital accumulation or to private sector productivity growth; and (iii) creating conducive institutional and regulatory frameworks for private investment. In particular, the size and resourcing of the state are critical elements in the macroeconomic framework for investment and job creation. In turn, the allocation and efficiency of public spending will affect the delivery of public services that support human capital accumulation, and will influence public investments that augment the productivity of private investment.

1.16 **However, achieving a better allocation of the expenditures needed to support growth and job creation will not happen “by fiat.”** This will require continued improvements in the institutional framework for translating expenditure policies into budget plans and ensuring effective budget execution.

1.17 As will now be discussed, **performances over the past 5 years leave a lot to be desired in all three dimensions.** The issue is not so much that the Government would not have sufficient resources for

<sup>7</sup> Albania Labor Market Assessment, 2006.

the task at hand (its size is comparable to what would be expected at that level of income), but is more that (i) the Government finances itself in a way that discourages employment, (ii) that it uses the said resources in an inefficient manner, and (iii) that despite the best laid plans, the governance framework it provides remains weak.

## Size of Government

1.18 **The Government's current fiscal strategy of keeping government small at around 30 percent should be maintained and consolidated.** The Government's fiscal strategy aims at keeping government at around 30 percent of GDP. In doing so, it plans to review spending priorities while keeping the focus on social and infrastructure sectors, to improve the quality of expenditure and receive value for money, and to increase tax yields through administrative reforms.

1.19 **Cross-country analysis undertaken in this report for a group of high growth countries of varying levels of income suggests that the size of Albania's government is moderate by international standards.** General government spending as a share of GDP at an average 30.5 percent during 2000-04 places Albania within a group of European countries with relatively small governments, such as Lithuania, Latvia and Estonia. In a broader perspective, however, the current level of spending is actually larger than in some model high growth countries, such as, Korea, Chile, Ireland, Malaysia and Thailand. As a matter of fact, some of the most rapidly growing countries that have extended periods of growth like Albania have been able to achieve that with expenditure to GDP ratios at or below 30 percent of GDP. Table 1.3 present budget data for a number of countries—mostly the cohesion countries and new EU candidates in Europe, but also some countries that have a record of two or more successive decades of rapid GDP growth.

1.20 **A key question often asked is whether such large public sectors in the New Member States hurt growth.** Alternatively, it has also been asked whether the small public sectors in several of the emerging markets are detrimental to development if basic services and safety nets are not provided. There exists a wide body of research encompassing many countries across the world indicating that economies with large public sectors tend to grow more slowly and suffer higher rates of long-term unemployment.<sup>8</sup> Tanzi and Schuknecht (2000) have found that state spending need be no more than one-third of GDP in order to achieve most of their key social and political objectives.<sup>9</sup> Albania's growth has been particularly buoyant in recent years. Growth is also very strong in countries with even smaller governments.

1.21 **The question of what is an adequate size of government is not an easy one.** It depends heavily on citizen preferences for public goods and state protection against economic hardship. A range of studies<sup>10</sup> has included econometric tests aimed at explaining the ratio of public expenditure to GDP by economic and social factors that are felt to shape and reflect citizens' preferences (the determinants of the level of public spending). A similar exercise has been conducted for this report.

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<sup>8</sup> For example, see S. Foelster and M. Henrekson, "Growth Effects of Government Expenditure and Taxation in Rich Countries," *European Economic Review*, vol. 45, August 2001, and for developing countries, J. S. Guseh, "Government Size and Economic Growth in Developing Countries: A Political Economy Approach," *Journal of Macroeconomics*, Vol. 19, January 1997.

<sup>9</sup> See V. Tanzi and L. Schuknecht, *Public Spending in the 20<sup>th</sup> Century*. Cambridge University Press, 2000.

<sup>10</sup> These explanatory variables include the level of per capita income, external openness, population size, and degree of urbanization, among others. Examples of these studies include D. Rodrik, "Why Do More Open Economies Have Bigger Governments," NBER Working Paper 5537, April 1996; S. Commander H. R. Davoodi, and U. J. Lee, "The Causes and Consequences of Government for Growth and Well-being," Background paper prepared for the World Bank *World Development Report 1997*; and A. Alesina, R. Wacziarg, "Openness, Country Size and Government," *Journal of Public Economics* (69), 1998.

**Table 1.3: General Government Revenues and Spending for Selected Countries**

Country	GNI per capita (US\$ PPP, 2004)	Spending (% of 2004 GDP)	Revenues	Real GDP growth per capita (1993-2003)
<b>Albania</b>	<b>5,070</b>	<b>28.7</b>	<b>23.7</b>	<b>5.8</b>
<b>Fast Growth Small Government (FSGB)</b>				
<b>Average</b>		<b>28.1</b>	<b>27.8</b>	<b>4.4</b>
Ireland	33,170	34.3	34.5	7.4
Korea, Rep.	20,400	20.8	31.1	4.0
Lithuania	12,610	33.6	31.4	4.1
Estonia	13,190	37.9	39.6	6.0
Chile	10,500	21.1	23.3	3.0
Latvia	11,850	35.9	34.8	5.6
Malaysia	9,630	28.8	23.5	2.6
Romania	8,190	30.7	29.6	2.1
Thailand	8,020	16.8	17.1	2.5
Armenia	4,270	20.9	19.2	6.7
Georgia	2,930	28.2	22.1	4.0
<b>Fast Growth Big Government (FGBG)</b>				
<b>Average</b>		<b>43.7</b>	<b>41.3</b>	<b>3.9</b>
Spain	25,070	39.6	40.0	2.5
Greece	22,000	48.3	43.6	2.9
Slovenia	20,730	43.1	41.7	3.4
Czech Republic	18,400	41.9	38.6	2.6
Hungary	15,620	49.3	43.0	3.5
Slovak Republic	14,370	38.9	35.0	3.8
Poland	12,640	44.2	41.4	4.0
Croatia	11,670	51.6	47.2	4.7
Bulgaria	7,870	40.0	41.7	2.0
Bosnia and Herzegovina <sup>1/</sup>	7,430	40.5	40.3	9.1

<sup>1/</sup> Relative to GDP adjusted for the size of the gray economy.

Sources: World Bank, national authorities.

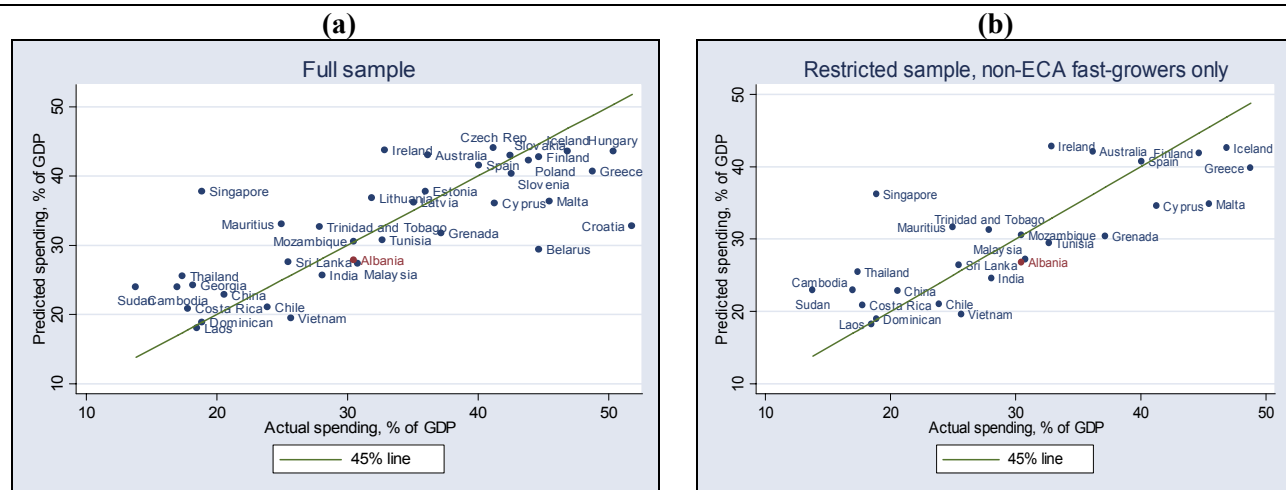
1.22 The results suggest that **(i) overall levels of spending in Albania have been relatively in line with what would be expected given the economic and social circumstances of the country; and (ii) a drive to increase public spending is likely to be unnecessary and wasteful**, as a more efficient use of existing public resources may yield more effective government services. The question here is whether one can find countries with consistently high rates of growth that, other things being equal have public sectors that are smaller, larger or similar in size to Albania. Figure 1.12 (a) presents the result of a regression based on the data of the 38 countries with the fastest per capita growth rates in the period 1994 to 2003.<sup>11</sup> The graph plots the level of public spending predicted by the estimated regression against the actual level of public spending. The diagonal line through the origin gives the set of points for which the two levels are the same. Points to the right of the line represent the set of countries that have actual expenditures that are higher than predicted by their GDP per capita and regional location. At 30.5 percent of GDP, on

<sup>11</sup> A comprehensive data set was created for nearly 140 countries. The average per capita growth rate for the entire set is 2.0 percent over this period, and the standard deviation is 2.1. The 38 countries were selected by finding the dataset that contained only growth rates of at least 2.5 percent (or one-quarter standard deviation above the average), which is a very fast growth rate by historical standards. Average expenditure ratios in 2000 to 2004 were regressed on real per capita GDP in 2000 (in logs) and on regional dummy variables.

average in 2000 to 2004, Albania's level of spending is 2.7 percentage points of GDP more than predicted by the model.

1.23 **Repeating the regression without including countries from Europe and Central Asia indicates that the current level of public spending would be about 3.7 percentage points of GDP higher than predicted by the model.** Figure 1.12 (b) presents the results for a subset of the original sample (28 out of 38) that excludes countries in the ECA region. This is to control for the effect on growth rates and expenditure associated with massive economic restructuring and other processes, including growing integration with the EU, and thus to remove a possible European bias towards larger government. The predicted value of spending for the country is derived by applying the coefficient estimates for the 28 country sample to Albania's indicators. The results are very close to the ones in the larger sample of fast-growing countries, further reinforcing the conclusion that current levels of spending relative to GDP are more than adequate to have an effective public sector and to sustain existing high levels of growth.

**Figure 1.12: Actual and Predicted Levels of Public Expenditure, Albania and Selected Countries**



Source: WDI.

1.24 **The overall level of tax revenues at 22 percent of GDP is also in line with Albania's level of development, but the structure of revenues has been distortionary.** Although in general tax rates are comparable with other high growth and transition economies—except for extremely high labor taxes<sup>12</sup> weak administration and low compliance result in a very narrow tax base that bears the brunt of resource mobilization and is further disadvantaged by corruption in tax collection. High social insurance levies on employees and employers of about 42 percent of gross wages when combined with personal income tax, resulted in a tax wedge of 33 percent of labor costs. This wedge is high when compared with low income countries (although somewhat typical in the ECA region), creates a disincentive for formal sector job creation and has contributed to the growing in formalization of the Albanian economy.

1.25 **As a result, job creation remains weak despite sustained GDP growth.** Job creation in the private sector has been weak, especially in the formal sector. According to new estimates<sup>13</sup> only 60 percent of the working age population was employed in 2004, which is below other countries in the

<sup>12</sup> The decision of the government to reduce social insurance contributions by 9 percentage point as of July 2006 is a positive step demonstrating government's commitments to curb informal activities.

<sup>13</sup> "Albania: "Labor Market Assessment", World Bank, 2006.

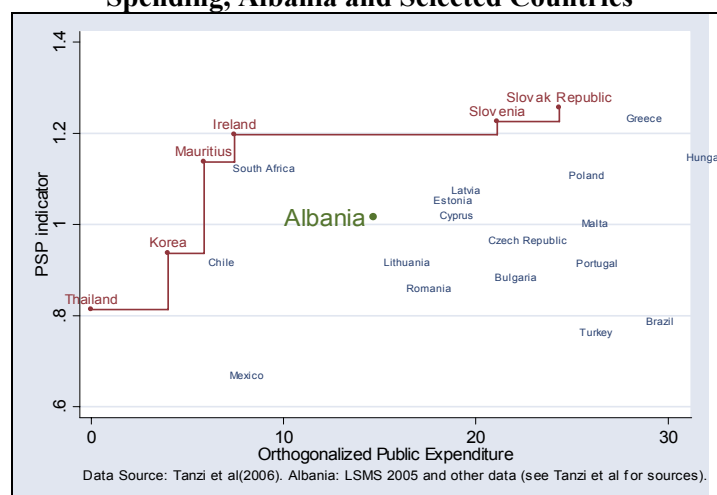
region. The 2004 unemployment rate was over 13 percent,<sup>14</sup> with two-thirds having been unemployed for at least 12 months. Data deficiencies make it difficult to accurately assess the labor market picture prior to 2001, but according to INSTAT, total employment (formal and informal) was only 11,000 higher in 2004 than it had been three years earlier.

**1.26 An increasing informalization of employment and the large emigration flows confirm the slack in employment growth, especially in the formal sector.** Three-quarters of the workforce is employed informally and, while informal employment is important both to the economy and to the welfare of many households, these workers are especially vulnerable and are often poor. Only 15 percent of the unemployed in 2002 had made the transition to formal sector employment by 2004, while only 10 percent of those who were out of the labor force in 2002 made a similar transition. By contrast, 38 percent of the unemployed found jobs in informal wage employment. Rising levels of external migration also provide strong evidence of inadequate job creation. The remittances flowing from this offshore employment are a critical source of income but migrants also represent a “brain drain” for a capacity constrained country like Albania.

### Public Sector Efficiency

**1.27 Furthermore, the public sector is making poor use of what resources it mobilizes.** Afonso, Schuknecht and Tanzi (2006) conducted a quantitative analysis of public sector efficiency for the 10 New Member States (NMS) using two broad groups of performance and efficiency indicators.<sup>15</sup> The inefficiency score for each country is defined as the ratio of its inputs and outputs over the inputs and outputs of a country that is on the efficiency frontier. An input efficiency score of 0.75 indicates that this particular country uses 25 percent more inputs than the most efficient producer to achieve the same output level. An output efficiency score of 0.75 indicates that the inefficient producer attains 75 percent of the output obtained by the most efficient producer with the same input intake (Annex 1.1: and Figure 1.13).

**Figure 1.13: Efficiency Frontier for Total Public Spending, Albania and Selected Countries**



**1.28** The authors find that **countries with lean public sectors and public expenditure ratios not far from 30 percent of GDP tend to be most efficient.** A small set of countries define, or are very close to, the theoretical production possibility frontier: Singapore, Thailand, Cyprus, Korea and Ireland. Using the same sample of fast growing EU-8 and other emerging markets Albania’s inputs and outputs are compared to the set of most efficient governments (Singapore, Thailand, Cyprus, Korea and Ireland).

<sup>14</sup> The rate of unemployment, using the standard ILO definition, fell from 10 percent in 2002 to about 6 percent in 2004. The 13.4 percent refers to an alternative definition of unemployment, which includes discouraged workers.

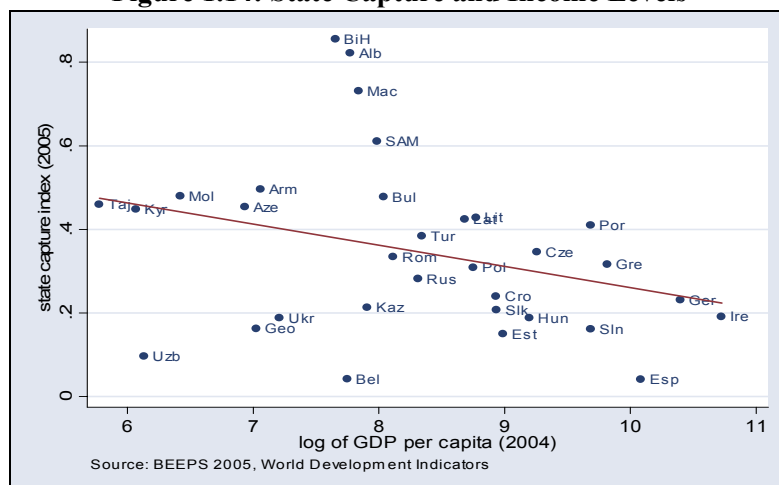
<sup>15</sup> The first group includes administrative, education, and health expenditure, each of which contained several sub-indicators. The second group includes income distribution (Gini coefficient), economic stability (measured by the average inflation rate and the variation of GDP growth in the most recent 10 years), and economic performance (measured by the average unemployment rate and GDP growth in the most recent 10 years).

1.29 **The results suggest that the government could achieve current outcomes with fewer resources, or could significantly improve outcomes with the same level of resources.** Albania could use around 70 percent fewer resources to attain the same outcomes if it were fully efficient. On the other hand, output scores suggest that Albania is delivering only around 80 percent of the output it could deliver if it were on the efficiency frontier (Annex 1.1:).<sup>16</sup> It also shows how the composition of spending and the way spending is planned and executed undermine its own efficiency. This is corroborated in individual sectoral analysis detailed in subsequent chapters of this report (Chapters 6 to 11).

### Governance and the Quality of Institutions

1.30 **To a large extent international evidence suggests that such low efficiency is a symptom of the weak governance that continues to plague Albania’s public sector.** In a further elaboration of the above research, Afonso et al (2006) find that **high education levels, a competent civil service and the security of property rights are critical to increasing public expenditure efficiency,** all elements in which Albania scores badly.

Figure 1.14: State Capture and Income Levels



1.31 In a recent report by the World Bank<sup>17</sup> **Albania ranks among countries with a very high level of state capture** (Figure 1.14)—that is, illicit, illegitimate and non-transparent forms of influence on state institutions—and **a medium level of administrative corruption**—that is, a measure of the amount of illicit and non-transparent gains that accrue to public officials in the implementation of existing laws, rules and regulations. The prevalence and severity of corruption has also been documented in a number of studies, including two recent surveys: the Business Environment and Enterprise Performance Survey (BEEPS) 2005, covering 29 countries in the Europe and Central Asia Region, and a USAID funded national survey on corruption perception in 2005. Both point to the pervasiveness of corruption across various institutions and levels of government. In the World Competitiveness Report Institutional Indicators, Albania ranked 102 in political institutions out of 117 countries, and 109 in the “diversion of public funds” indicator.<sup>18</sup>

1.32 **Corruption (as manifested in bribes) takes different forms, increasing the cost of doing business and undermining the cost-effectiveness of service delivery.** Despite a reduction of bribes as share of the annual sales of private firms (Figure 1.15), the frequency of paying bribes has increased (Figure 1.16), suggesting an increase in the type of transactions that entail bribe paying. This frequency in 2005 remains the highest among neighboring countries and other ECA countries, and is most common in taxes, customs, judicial decisions and public utilities, putting a heavy toll on businesses through increasing their costs.<sup>19</sup> In the health sector, many practices such as “gift offering” to doctors or nurses at state health facilities are very common.

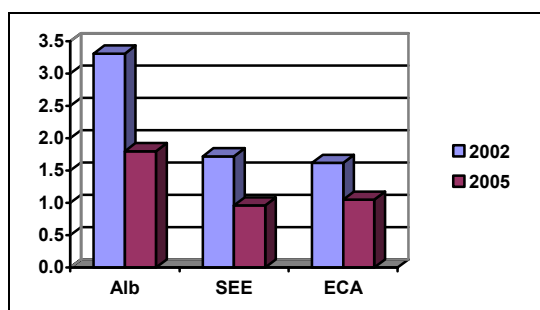
<sup>16</sup> The results derive from analysis using FDH technique.

<sup>17</sup> *Anticorruption in Transition: A Contribution to the Policy Debate*, The World Bank, Washington, D.C., 2006, pp. 14-16.

<sup>18</sup> World Competitiveness Report, 2005. Albania has been included for the first time in 2005.

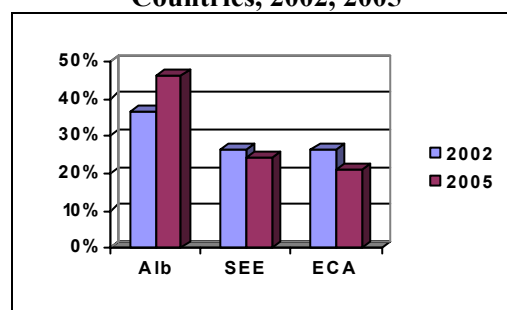
<sup>19</sup> According to the World Competitiveness Report ratings, Albania ranks 96, 100, and 107 in the indicators for irregular payments in public utilities, in tax collection and judicial decisions, respectively.

**Figure 1.15: Bribe Tax: Bribes as a Share of Annual Sales, Albania and Comparator Countries, 2002, 2005**



Source: BEEPS.

**Figure 1.16: Bribe Frequency: Percent of Firms Saying Unofficial Payments are Frequent, Albania and Comparator Countries, 2002, 2005**



1.33 **Furthermore, weak fiduciary arrangements, notably in procurement, continue to constrain the efficiency of resource use** (see Chapter 3).<sup>20</sup> The accountability framework does not provide significant control. This is further complicated by capacity constraints in human and technological resources that undermine the ongoing reform of the public financial management system. A recent Country Fiduciary Assessment Update (CFAU)<sup>21</sup> undertaken jointly with this report corroborates the finding that the fiduciary environment is risky and results in the misuse of public funds. The absence of orderly rules for budget execution and the lack of competition in contract award and management, including the regular resort to direct procurement, all contribute to a loose control environment. This is compounded by weaknesses in external scrutiny and oversight at the level of the Supreme State Audit and Parliament.

1.34 **Poor governance is negatively affecting the business environment and discouraging both domestic and foreign investment.** Owing to heavy government regulations (excessive inspections and licensing requirements) and ad hoc interventions that lead to corruption, the business sector is confronted with the high costs of doing business, such as contradictory legal and regulatory provisions or the lack thereof, and weak enforcement of laws. A weak legal base for property rights is compounded by the failures of the court system to deliver fair and timely decisions in commercial disputes and to uphold contracts. Here, too Albania ranks lowest in the region on measures of judiciary independence and effectiveness.<sup>22</sup>

1.35 **In recognition of the problem, the successive governments have taken a number of steps to reduce administrative corruption in recent years.** Anti-corruption measures taken by successive governments include the adoption of a National Strategy for Combating Corruption, and of a series of measures designed to strengthen control within key departments, notably tax administration and customs. The new Government has also placed the fight against corruption at the center of its program. There is both anecdotal and documented evidence that there has been progress in many areas, especially in the areas of public administration and public expenditure management (see Chapter 3). Moreover, continued progress with decentralization since 2000 has provided local elected authorities with further competence

<sup>20</sup> The World Bank Country Fiduciary Assessment Update (CFAU) focuses on the review and assessment of the adequacy and transparency of the budget implementation process, including procurement and review of the monitoring, reporting and audit systems for public financial flows.

<sup>21</sup> The Country Fiduciary Assessment Update 2006 reviews the fiduciary framework over the period April 2002-June 2006.

<sup>22</sup> “Judicial Systems in Transition Economies: Assessing the Past, Looking to the Future” The World Bank, 2005.

in resource allocation and service delivery, and has contributed to the involvement of communities in local decision making, thereby allowing for greater accountability at the local level.

1.36 **However, progress has been slow and recent trends risk undermining the hard-won achievements.** The *Law on the Status of the Civil Servant* (CS Law)<sup>23</sup> and its subsidiary legislation allowed for the creation of a largely depoliticized civil service; the creation of a credible independent redress mechanism for civil service management actions; and significant improvement in the attractiveness of a civil service position, with respect to both remuneration and the fairness of civil service management actions. The introduction of the civil service status and ensuing reforms has been gradual however (Chapter 5). This has limited the impact on the quality of public administration, as only 3.3 percent of central government employees are civil servants. As discussed in Chapter 5, the recent retrenchments of civil servants without always following due process constitutes a serious reversal and could undermine the credibility of the institutional strengthening efforts.

1.37 **These recent retrenchments exacerbate the problem of capacity weaknesses in the public sector, which remain a key constraint to improved governance and service delivery.** As highlighted throughout this report, capacity deficiencies span all sectors. These constraints cover activities as varied as expenditure planning and management, especially within a Medium-Term Budget Plan (MTBP) at the sector and national levels, social assistance targeting, and debt management. Nevertheless, capacity needs are accentuated by at least three factors: (i) the complexity of the second-generation structural reforms compared with the first-generation reforms; (ii) the SAA and EU pre-accession requirements in the longer term, which call for strengthened capacity in a number of areas and treat capacity enhancement as a requirement in itself; and (iii) the close link between capacity and governance.<sup>24</sup>

#### D. PUBLIC FINANCE AND MACROECONOMIC SUSTAINABILITY

1.38 **Continued fiscal consolidation will also need to remain at the core of the stabilization program.** The efforts by successive governments to improve revenue collection, and the decision to accelerate the privatization program and end subsidies and soft loans to state-owned companies resulted in a declining budget deficit, from 13.1 percent of GDP in 1997 to around 3.4 percent in 2005. General government expenditure was reduced from 31.4 to 27.4 percent of GDP over the same period, a significantly lower level than that in the region. Subsequently, primary imbalances were reduced, putting the **total public debt to GDP ratio on a declining path since 1998.**

1.39 **In the immediate future, the conduct of fiscal policy will be framed by the need (i) to contain the external current account deficit; (ii) to reduce public debt; (iii) to “lean against” a very rapid expansion in credit to the private sector; and (iv) to redouble efforts to improve revenue administration.** These factors are discussed in turn below and in greater detail in Chapter 2.

1.40 **First, Albania’s current account deficit has been widening against a very low, narrow and undiversified export base, limiting the scope for running fiscal deficits.** The current account deficit (excluding grants) increased from nearly 5.8 percent of GDP in 2001 to about 7.8 percent of GDP in 2005. This can be attributed almost entirely to an increase in the already high trade deficit (on goods and services) which increased from 22.5 percent of GDP in 2001 to 24.1 percent of GDP in 2005. Including grants, the current account is estimated at 6.5 percent of GDP. A surging private sector demand, fueled by strong credit growth and remittances, and the leveling of the growth in exports, caused the current account deficit to widen. This is even more worrying, given that Albania’s ratio of exports of goods and non-factor services to GDP remains the lowest among other transition economies (21.5 percent). The above

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<sup>23</sup> Law No. 8549, 11 November 1999.

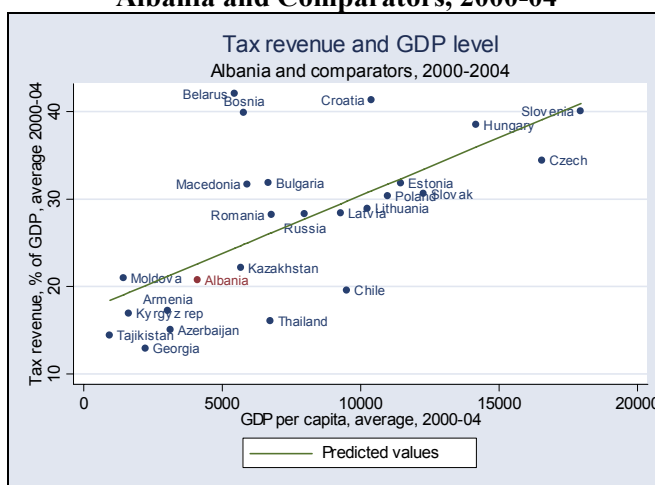
<sup>24</sup> “Bulgaria Public Expenditure and Institutional Review,” The World Bank, 2003.

heightens concerns about the sustainability of the external debt, as the availability of concessional external financing is expected to decline in the period ahead.

1.41 **Second, at 54.5 percent of GDP, the stock of public and publicly guaranteed debt is relatively high—among the highest in neighboring countries and high growth comparators.** Macroeconomic stabilization has contributed to a sustained decline in public debt from 85 percent at end-1997 to around 55 percent in 2005. The reduction resulted from a combination of deficit reduction, sound monetary policy that put interest rates on a downward path, and the settlement and rescheduling of arrears with external creditors. The use of privatization proceeds to retire parts of the domestic debt in 2004 also contributed. Reducing public sector debt and improving debt management capacity are critical as access to concessional borrowing declines. Albania does not yet have a sovereign credit rating but is preparing for it.

1.42 **Third, with the rapid growth of credit to the private sector, banks are likely to be less willing to finance the government than they have been in the past.** The Savings Bank privatization, along with other structural measures and the easing of monetary policy, contributed to a rapid pick up in private sector credit growth, albeit from a low base. As the newly privatized Savings Bank is no longer restricted to expand lending, it is likely to diversify its portfolio away from government securities toward loans to enterprises and households.<sup>25</sup> This, combined with the need for more extensive reliance on open market operations for monetary management, could put upward pressure on interest rates on Treasury bills, with implications for the government’s debt service costs. Also, with the growing competition in the banking system, there is a risk of deterioration in the credit portfolios. Finally, rapid credit growth risks fueling higher imports, widening the current account deficit and raising external debt.

**Figure 1.17: Tax Revenue and Income Levels, Albania and Comparators, 2000-04**



Source: WDI, GFS.

1.43 **Fourth, the revenue situation is likely to remain constrained.** Notwithstanding significant improvements since late 2005, Albania’s revenue generation efforts remain constrained by weak tax administration and large informal sector.<sup>26</sup> In any case, tax revenues at 22 percent of GDP are more or less at the expected level (Figure 1.17) which may call for some realistic expectations of future revenue growth. According to surveys, tax harassment remains a major issue for businesses.<sup>27</sup> Unsurprisingly, the informal sector remains very large and leads to tax evasion. Albania’s informal economy is estimated to be as large as 30 percent of its formal economy. Undeclared household income is estimated at 52 percent of GDP, the largest among transition countries. Moreover, the reduction of tariffs in the context of implementation of the Stabilization and Association Agreement with the EU will lead to further losses of budgetary revenues.

<sup>25</sup> The Savings Bank currently holds about 72 percent of the outstanding stock of Treasury bills.

<sup>26</sup> “Tax Administration in Albania,” The IMF, 2005.

<sup>27</sup> BEEPS, 2005.

## ANNEX 1.1: PUBLIC SECTOR EFFICIENCY

In this annex we follow closely Afonso et al (2006), to analyze public sector efficiency for Albania, the new EU member states, the EU candidate countries and countries with growth rates comparable to that of Albania, namely emerging markets in Asia. We are indebted to two of the authors, A. Afonso and V. Tanzi, for their support.

**The efficient use of resources in meeting public goals is critical for sustained economic growth and for the achievement of development outcomes.** We analyze the resources used in Albania and comparators, that is, their public sector expenditures as described in Table A1.1. Second, we look at the public sector outcomes, presented in Table A1.2, and at a set of Public Sector Performance (PSP) indicators of corruption, red tape, educational achievements, health outcomes, economic growth, etc.

**Albania has a relatively lean public sector by Eastern European standards but needs to keep its fiscal discipline.** In Table A1.1 we present the public expenditures by economic and functional classification for Albania and comparators. Albania has a medium-size government with its total expenditure at 32 percent of GDP in 1999-2003. The new EU entrants spend nearly 40 percent of their GDP in the public sector. The smallest governments are those of the emerging markets in Asia, namely, Korea and Thailand. Albania spends a higher proportion of its GDP on interest payments.

**Table A1.1: Public Expenditure in Albania and Comparators (% GDP)**

Country	Total expenditure	Govt consumption	Transfers and subsidies	Interest payments	Public investment	Education	Health
Albania	31.8	10.4	10.17	5.18	6.42	3.3	2.3
Brazil	46.6	19.5	17.1	8.2	1.9	4.6	3.3
Bulgaria	38.6	17.3	15.2	3.2	3.4	3.4	4
Chile	24.4	12.6	7.9	1.2	2.7	3.8	2.4
Cyprus	40.0	18	11	3.3	3	5.6	2.5
Czech Republic	40.6	22.7	15	1.2	3.4	4	6.2
Estonia	36.4	19.7	10.7	0.3	4.1	6.2	4.4
Greece	48.6	16.8	17	7.2	3.8	3.7	5.1
Hungary	50.2	22.4	15	4.6	3.8	4.8	5.3
Ireland	33	14.8	9.3	1.7	3.8	4.4	4.9
Korea	24.4	12.7	.	.	5.4	3.8	2.4
Latvia	36.6	21.4	12.7	0.9	1.3	5.8	3.5
Lithuania	33.3	20.3	11.1	1.5	2.6	5.9	4.5
Malta	45.0	20.7	14.5	3.8	4.4	4.8	6.2
Mauritius	24.7	12.9	3.8	7.5	3.8	2.1	.
Mexico	25.3	11.7	5.2	4.6	3.8	4.6	2.6
Poland	43.2	17.9	17.9	2.8	3.3	5.1	4.2
Portugal	46.2	20.7	14.3	3.1	3.7	5.7	6.2
Romania	33.7	15.7	13.7	2.3	1.9	3.4	3.8
Slovak Rep	43.8	20.0	14.2	3.5	2.9	4.1	5.2
Slovenia	42.1	20.2	18.6	2.3	2.9	.	6
South Africa	26.3	18.4	.	4.5	2.7	5.7	3.6
Thailand	17.8	11.2	.	.	7.7	5.3	2.3
Turkey	42.7	13.8	.	21.3	4.6	3.5	4

*Source:* Afonso et al (2006), ECA fiscal database for ECA countries. Albania data updated with information from this PER chapters on Health and Education.

**Public Sector Performance Indicators for Albania reflect its sustained economic growth but relatively low public administration performance.** Following Afonso et al (2006), we construct performance indicators that reflect the outputs in the public sector. We compile performance indicators from various indices in Table A1.4 giving equal weight to each of them, and report the results in Table A1.2. To calculate the administration sub-indicator, we take indices on corruption, red tape, the quality of the judiciary system, and the shadow economy. The human capital indicator measures performance in the education sector and for that we take an index of the quality of math and science education in Albania and the other countries. For health, we take the average of the infant survival rate and life expectancy. The allocative efficiency indicators, or the “Musgravian” indicators, are constructed as follows: the distribution indicator is equal to the Gini coefficient of inequality in the country; the economic performance indicator is the average of unemployment and real growth of GDP; and stability is the average of inflation (last 10-year average) and the coefficient of variation of GDP growth (the mean over the standard deviation of GDP growth over the last ten years). Some big government countries score higher than some small government countries, and therefore size of government is only a crude determinant of public sector performance. As compared to the new EU entrants, Albania has low human capital/education except for health but a very high performance for economic growth.

**Table A1.2: Public Sector Performance Indicators (2001-03)**

Country	Opportunity Indicators			Musgravian Indicators			Total public Sector Performance (equal weights)1/	Gov't Size
	Administration	Human Capital	Health	Distribution	Stability	Economic Perform.		
Albania	0.78	0.89	1.00	0.48	0.59	1.59	0.89	Medium
Brazil	0.89	0.72	0.95	0.64	0.76	0.79	0.79	Big
Bulgaria	0.82	1.09	0.99	1.20	0.06	1.19	0.89	Big
Chile	1.17	0.78	1.05	0.71	0.86	0.97	0.92	Small
Cyprus	.	.	1.08	.	1.43	0.56	1.02	Big
Czech Republic	1.05	1.20	1.04	1.22	0.63	0.71	0.97	Big
Estonia	1.26	1.20	0.98	1.02	0.75	1.16	1.06	Medium
Greece	0.99	1.00	1.08	1.10	2.22	1.06	1.24	Big
Hungary	1.14	1.24	0.99	1.23	1.45	0.88	1.16	Big
Ireland	1.21	1.16	1.06	1.04	1.53	1.22	1.20	Medium
Korea	1.07	1.02	1.02	1.11	0.73	0.71	0.94	Small
Latvia	1.03	1.05	0.98	1.10	0.98	1.37	1.08	Medium
Lithuania	1.03	1.13	1.01	1.10	0.36	0.92	0.93	Medium
Malta	1.15	1.07	1.08	.	1.02	0.70	1.00	Big
Mauritius	0.96	0.92	1.00	.	1.88	0.94	1.14	Small
Mexico	0.73	0.68	1.02	0.76	0.42	0.45	0.67	Small
Poland	0.95	1.02	1.02	1.11	1.18	1.40	1.11	Big
Portugal	1.15	0.70	1.05	1.00	0.98	0.64	0.92	Big
Romania	0.65	1.29	0.97	1.12	0.28	0.88	0.87	Medium
Slovak Republic	1.02	1.22	1.01	1.31	1.48	1.54	1.26	Big
Slovenia	1.13	1.16	1.05	1.17	2.01	0.88	1.23	Big
South Africa	1.01	0.61	0.66	0.66	1.65	2.18	1.13	Medium
Thailand	1.04	0.98	0.96	0.95	0.48	0.50	0.82	Small
Turkey	0.77	0.87	0.97	0.95	0.28	0.78	0.77	Big
Average 2/	1.00	1.00	1.00	1.00	1.00	1.00	1.00	

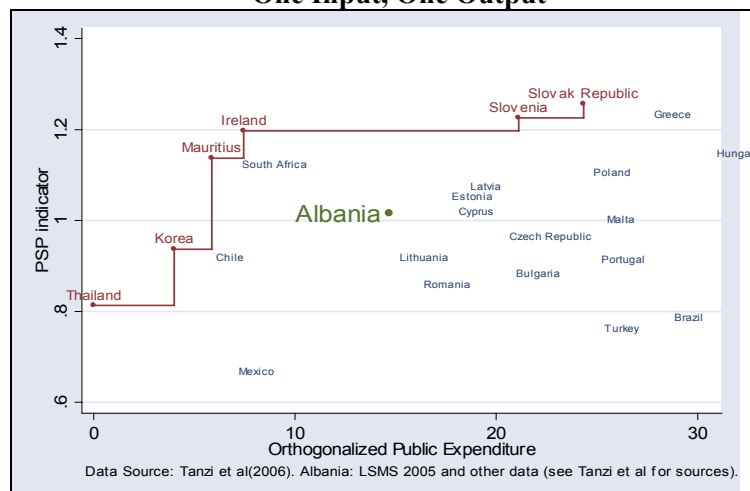
<sup>1/</sup>Each sub-indicator contributes 1/6 to total indicator.

<sup>2/</sup>Simple averages.

Source: Afonso et al (2006), World Economic Forum Competitiveness Report; ECA Fiscal database; Albania data updated with information from this PER chapters on Health, Education and Albania Poverty Update (2006).

Albania is relatively inefficient and can greatly improve the effectiveness with which it uses its limited resources. We take the analysis one step further by determining which countries are most efficient and measuring Albania's performance against them. We employ the Free Disposable Hull (FDH) method.<sup>28</sup> The FDH method imposes the last amount of restrictions on the data, as it only assumes free disposability of resources. The countries' inputs (public expenditure) and outputs (the performance indicators in Table A1.2) are plotted against each other.

**Figure A1.1: Theoretical Production Possibility Frontier: One Input, One Output**



The inefficiency score for each country is defined as the ratio of its inputs over the inputs of a country that is on the efficiency frontier. Similarly, we calculate the output efficiency score. An input efficiency score of 0.75 indicates that this particular country uses 25 percent more inputs than the most efficient producer to achieve the same output level. An output efficiency score of 0.75 indicates that the inefficient producer attains 75 percent of the output obtained by the most efficient producer with the same input intake (Table A1.3).

**Albania can still considerably improve the efficiency with which it uses its resources. It can achieve its current public output level with 70 percent less public expenditure.** This was estimated by establishing the most efficient way to produce a public output (the so-called production possibility frontier) and then by measuring how far below the efficiency frontier Albania is. Figure A1.1 presents the theoretical production possibility frontier associated with the set of results from the FDH analysis.<sup>29</sup> Using the FDH analysis, we calculate the input-oriented and output-oriented scores, which reflect excess input consumption to achieve a level of output and output shortfall for a given level of input, respectively. For Albania, the score reflects that it uses 3 times the input of the most efficient countries to attain a certain level of public good. Albania's scores are 0.3 and 0.8 for inputs and outputs, respectively (rather low scores that do not suggest that Albania is making efficient use of its limited resources). Albania could use 70 percent less in resources to attain its current outcome if it were as efficient as the Slovak Republic, Slovenia, Korea or Ireland. From the output perspective, the efficiency score suggests that Albania is only delivering 80 percent of the output it could deliver if it were on the efficiency frontier.

**From a policy perspective, one should not draw overly strong conclusions based on these results. However, it is apparent that Albania can still considerably increase the efficiency of its public spending by improving the outcomes and by restraining the resource use.** Afonso et al (2006) in a deeper econometric analysis suggests that high education levels, a competent civil service and the security of property rights are critical to increasing public expenditure efficiency.

<sup>28</sup> While Afonso et al (2006) use DEA method.

<sup>29</sup> The FDH analysis graphs countries by their inputs and outputs and estimates the efficiency score as input over output. The highest ranking country is assumed to be on the production possibility frontier and given a score of 1. Other country scores are measured against that. See Herrera and Pang (2005) for more details.

**Table A.1.3: Comparison of Country Scores and Ranks across Methods**

Country	FDH Analysis			
	Input-oriented		Output-oriented	
	Score	Rank	Score	Rank
Albania	0.273	14	0.799	15
Brazil	0.141	23	0.626	21
Bulgaria	0.194	20	0.741	18
Chile	0.695	8	0.978	8
Cyprus	0.330	11	0.850	13
Czech Republic	0.289	13	0.809	14
Estonia	0.336	10	0.881	12
Greece	0.885	6	0.981	7
Hungary	0.243	17	0.914	9
Ireland	1.000	1	1.000	1
Korea	1.000	1	1.000	1
Latvia	0.319	12	0.900	11
Lithuania	0.269	15	0.769	17
Malta	0.233	19	0.794	16
Mauritius	1.000	1	1.000	1
Mexico	0.582	9	0.593	23
Poland	0.240	18	0.904	10
Portugal	0.161	21	0.728	19
Romania	0.250	16	0.720	20
Slovak Republic	1.000	1	1.000	1
Slovenia	1.000	1	1.000	1
South Africa	0.833	7	0.991	6
Thailand*	1.000	1	1.000	1
Turkey	0.160	22	0.625	22

*Note:* The rankings across the two methods (FDH used in this annex and DAH used in Afonso et al) are very similar however the input and output efficiency scores show some differences because of the differences in the scale of input (the residuals of public expenditure regressed on GDP) and output (PSP indicators). The results should be interpreted as indicative of trends rather than at face numerical value for guidance of policy.

*Source:* World Bank staff estimates.