

INTERNATIONAL MONETARY FUND AND
INTERNATIONAL DEVELOPMENT ASSOCIATION

ALBANIA

**Joint Staff Advisory Note on Albania's National Strategy for
Development and Integration
(Poverty Reduction Strategy Paper)**

Prepared by the Staffs of the International Monetary Fund (IMF)
and the International Development Association (IDA)

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I. OVERVIEW

1. The Albanian authorities have prepared their poverty reduction strategy—the National Strategy for Development and Integration (NSDI) for 2007–13. The NSDI succeeds the Poverty Reduction and Strategy Paper (PRSP) presented to the Boards of the International Development Association (IDA) and the International Monetary Fund (IMF) in January 2002. The strategic priorities of the NSDI are: a commitment towards integration in the E.U. and NATO; the democratization of society; the consolidation of the rule of law; and the achievement of rapid and sustainable economic and social development. The NSDI is based on thirty six sector and cross-cutting strategies and it is being integrated into the three-year Medium-Term Budget Program (MTBP) which identifies policy objectives as intermediate steps to the achievement of the NSDI goals.

2. Good progress has been made in achieving a number of objectives of the previous PRSP, but outcomes fell short in several other areas. On the one hand, economic growth was maintained despite the energy crises, a result of policies aimed at facilitating the environment for private investment and expanding public investment in key economic infrastructure. In parallel, poverty was significantly reduced between 2002 and 2005. The Government also made some progress in the implementation of the Integrated Planning System (IPS) as a way to streamline the strategic planning and resource allocation processes and consolidate the linkages between the MTBP and the annual budget. However, outcomes on governance and strengthening of public administration leave room for improvement. Moreover, spending on health and education increased only marginally as a share of total public spending, while enrollment in secondary education showed limited progress.

- 3. The NSDI represents a significant improvement in process over the previous PRSP.** The main strengths of the current process are: (i) strong government ownership; (ii) a broader participatory process that lays the foundation for greater civil society participation in public policy making; (iii) a closer link between the NSDI, sector strategies and the MTBP; (iv) an improved poverty diagnosis; (v) the elaboration of a comprehensive development strategy that focuses on results; and (vi) ambitious plans for monitoring the overall effectiveness of Albania's public expenditures. In line with the previous Joint Staffs Advisory Note (JSAN), the NSDI presents a comprehensive approach to improved governance, encompassing public expenditure management, the removal of barriers for private sector development, decentralization, and judicial reform. Staffs also welcome the inclusion of Parliament in the consultations.
- 4. Nonetheless, there are key areas where the NSDI could more fully reflect recommendations of earlier JSANs.** In particular, the strategy needs to further stress the importance of a solid public administration founded on a rule-based civil service management system. It also needs to provide a candid assessment of the extent to which the current decentralization arrangements have or have not led to improved efficiency and equity in the delivery of services at the local level.

II. POVERTY DIAGNOSIS AND MONITORING

- 5. Following significant progress in poverty reduction, more emphasis on deepening the social inclusion agenda is warranted.** The most recent and comprehensive poverty assessment using the 2005 Living Standard Measurement Survey shows that headcount poverty declined from 25 percent to 18.5 percent between 2002 and 2005, the gap between the richest and poorest areas declined, and inequality rose only modestly. Sustained growth and migration (both internal and external) have had the strongest impact on poverty reduction. However, the gap between rural and urban areas has widened in absolute and relative terms, partly because family farms have low productivity and the means-tested income support program (Ndhima Ekonomike) has had only a modest impact in reducing poverty. Therefore, a greater commitment to raising rural incomes and more effective design of social inclusion programs is needed in order to accelerate the reduction of poverty in rural areas. Moreover, the NSDI could address more explicitly the emerging risks stemming from the ongoing increases in world food and energy prices on the poor. Future NSDI updates could usefully explain government's plans to mitigate these risks.
- 6. The government's considerable progress in poverty monitoring is welcomed.** The completion of a first-ever Labor Force Survey and a Household Budget Survey with better coverage in 2007 should significantly improve knowledge of the labor market and poverty conditions, which has so far been inadequate for use in policymaking. However, a more predictable resource commitment to the Institute of National Statistics (INSTAT) is necessary in order to consolidate the gains in developing capacity to monitor and evaluate

poverty reducing programs. The authorities need to adopt, finance and implement the statistical master plan.

III. MACROECONOMIC POLICIES AND FRAMEWORK

7. Despite a drought and disruption to domestic electricity production, Albania's macroeconomic performance remained strong in 2007, and the policy framework, including the floating exchange rate, was supportive of NSDI goals. Growth remained high at around 6 percent. Inflation was contained, although specific cost pressures pushed the inflation rate temporarily above the 2–4 percent target range. The fiscal framework aimed at small but efficient government and maintained a balance between reducing public debt and supporting development priorities. In 2007, net domestic borrowing was limited to 1.8 percent of GDP; and privatization receipts were used partly to finance public investment and partly to reduce debt, with the public debt ratio declining to 54 percent of GDP, down from 57 percent in 2005. Private sector credit has continued to grow very rapidly; and the banking sector has opened up to greater competition and foreign ownership. The authorities are cognizant of the risks and are taking prudential and supervisory actions to ensure that financial stability is maintained.

8. The analysis of developments underpinning macroeconomic projections could be strengthened further. The NSDI presents a set of macroeconomic projections and underlying assumptions. These projections could be improved by analytical work identifying the main determinants of growth; and could also be presented in a more complete manner, discussing, for example, the linkages between exports, growth, rising investment (including growing private credit) and the external account. This would enable better judgment as to the realism and consistency of the macroeconomic projections. The discussion could also focus on the risks to the macroeconomic outlook posed by the deterioration of the financial position of the public electricity company KESH, and by the accelerated public infrastructure spending.

9. While staffs support the thrust of the macroeconomic policies outlined in the NSDI, they note possible fiscal risks. The growth projections for the outer years are slightly optimistic, and the expected fiscal deficit in 2008 of 7.9 percent of GDP (an increase of around 3.3 percentage points of GDP) is significantly in excess of the deficit in the current EFF-PRGF program (5.2 percent of GDP). While the NSDI assumes a project implementation rate considerably higher than observed in the past—making the full execution of spending unlikely—it will nevertheless be important for government to use the mid-year budget review to effect any required adjustment in case the actual budget deficit is at risk of exceeding 5.2 percent of GDP. Staffs are also concerned about the potential fiscal fallout, including possible crowding out of key expenditures, from the financial situation of KESH, the public electricity company, and possible cost overruns from large public infrastructure projects.

10. It will be important that key economic priorities be established and clearly reflected in the authorities' expenditure plans without endangering debt sustainability. Indicative costing suggests that reprioritization will be needed to align medium-term budget plans with the NSDI. The strategy paper acknowledges that a number of the costings are very rough and preliminary, and costings currently exceed the authorities' macroeconomic projections for the 2011–2013 period by around lek 30 billion or 10 percent of the projected available resources. Further work will be needed to improve the authorities' capacity to cost policies, to prioritize more clearly, and to discuss the tradeoffs in the context of the integrated planning strategy. Moreover, a better understanding of, and follow up measures to address, weak absorptive capacity and bottlenecks for capital spending execution are warranted.

IV. PUBLIC SECTOR GOVERNANCE, ACCOUNTABILITY, AND BUSINESS ENVIRONMENT

11. Staffs welcome the authorities' efforts to modernize strategic planning and strengthen public investment management, but note that much remains to be done to enhance transparency and efficiency of public resource use. The introduction of the Integrated Planning System is expected to help better align the NSDI with the MTBP and the annual budget process. Staffs note however, the critical importance of implementing the new computerized treasury system for greater transparency in public resource use, as well as the need to further strengthen institutional capacities for evaluation and prioritization of public investment projects in the context of the MTBP. The NSDI correctly describes progress in devising procedures for public investment management, and highlights the limited capacities for investment planning and evaluation at line ministry levels. Unless the systems for appraisal and selection of capital spending are significantly improved, gains in expenditure efficiency will be limited and risks related to fiscal and debt sustainability may increase.

12. The NSDI recognizes the need to build a professional public administration and civil service by attracting and retaining qualified and skilled staff. While many of the suggested reforms are already adequately supported by the existing Law on Civil Servants (CSL), the important challenge remains to strengthen implementation and ultimately the credibility of civil service institutions for maintaining a rules-based administration. To make public administration an attractive career option for skilled staff, future NSDI updates should emphasize the need to: (i) reinstate competitive and transparent recruitment and selection procedures; (ii) reinvigorate due process protection; and (iii) accelerate the development of performance-based civil service management practices¹. Staffs suggest a gradual and prudent expansion of the coverage of the CSL once there is full compliance with the law for the narrow set of staff currently covered. They also urge the authorities to reconsider the proposed pay enhancements attached to postgraduate degrees and devise a less ad hoc and

¹ This concern has also been highlighted in the most recent EC Progress Report: *Albania 2007 Progress Report*, SEC(2007) 1429 (European Commission: Brussels, 6 November 2007): p. 8.

more fiscally sustainable means of adjusting the civil service salary structure to make it more competitive.

13. The regulatory and administrative reforms aimed at improving the business environment have progressed significantly. The NSDI presents the series of recent actions taken by the authorities to ease the regulatory burden, by reducing the time for registering a business, removing several unnecessary barriers in the area of licensing, tax, customs, land and construction, and introducing the regulatory impact assessment system for new reform measures. Staffs welcome these developments but urge the authorities to keep the momentum of reform, focus on limiting unfair practices and ensuring market competition, and further improve land tenure and the security of property rights to further spur domestic and foreign investments.

14. Indeed, the NSDI recognizes the importance of well-defined property rights and a well-functioning land market to the development of the economy and for attracting private investment. It outlines several important initiatives underway, including restitution, self-financing of the Immovable Property Rights Office, and completion of property registration. Staffs recommend that future NSDI updates could pay further attention to: (i) containing the high potential fiscal costs associated with restitution; (ii) guarding against the potential risk to financial stability should more available collateral add further fuel to lending; (iii) reducing the amount of time required to process land transactions; and (iv) supporting municipalities and other relevant bodies in the development, and transparent and fair enforcement of land use plans and zoning in order to minimize unplanned construction and its associated costs.

V. SECTORAL POLICIES

A. Energy Sector

15. The NSDI documents some of the key causes of the recent electricity crises. Since the end of 2006 Albania has faced an electricity crisis characterized by country-wide shortages that negatively affect the business environment and people's livelihoods, and have fiscal costs. The strategy correctly identifies the high losses in the country's distribution system, the dependency of Albania's electricity system on internal hydroelectric generation and the country's limited interconnection access to the region as key causes of the crisis. It also presents a very ambitious target for domestic electricity production by 2013. In this context, it would be useful for the NSDI to also highlight the need for safeguarding the country's valuable hydroelectric resources, through a program to ensure the safety of its dams.

16. The government's effort to establish an effective institutional and regulatory framework is commendable. A key measure of performance in this respect is the ability of the regulator to independently, correctly and transparently apply its methodologies and set cost-recovery tariffs. The regional increases in electricity supply costs will need to be reflected in electricity tariffs to ensure the sector's financial viability and to attract private

capital for projects that will address the problems of the sector in the medium term. An appropriate tariff will also help to meet the energy efficiency objective of the strategy.

17. The long-term sustainable solution to the electricity crises is a well-regulated, private-sector-dominated and diversified power sector that is fully integrated in a liberalized Southeastern European market. The NSDI stresses the government's strategy to privatize distribution as early as 2008. Staffs note however that an improved cash flow of KESH and an effective regulatory framework are critical to make the privatization process successful. The NSDI should reflect the risks for privatization stemming from a weakening financial position of KESH. Staffs also urge the government to maintain an orderly approach to planning and contracting private investment in the sector. Such an organized approach will help ensure least-cost solutions to Albania's energy crisis, while minimizing contingent liabilities for the state budget or KESH. The NSDI could better report on mechanisms for close coordination between donors and domestic stakeholders active in this sector.

B. Improving Key Infrastructure

18. Staffs welcome the priority given to transport in the NSDI, but caution that the range of proposed objectives may be overly ambitious for the implementation period of the NSDI and risks imposing substantial fiscal costs. The strategy of developing the key road corridors is a good one to pursue, is consistent with the Albania National Transport Plan (ANTP), and should add to growth in the long-term. However, the plans are costly, ambitious in timetable and design, and could therefore add to macroeconomic risks. A greater focus on project identification and prioritization, based on objective criteria, together with improved project management and cost control is needed. In addition, while staffs welcome the commitment to address the problems of Albanian Railways, they suggest significant investments in the railway sub-sector should only be made where there are positive net economic and social benefits.

19. The NSDI sets out a significant reform program for water and sanitation in Albania. It focuses on improving local accountability through decentralization, utility management with some private sector participation and motivating improvements in the financial performance of water utilities by gradually phasing out of operating subsidies and introducing performance-based investment transfers from central government. While staffs support the NSDI's emphasis on increased investment (particularly in sanitation) they consider the establishment of stronger incentives for improved management of the water utilities to be equally important, notably through the introduction of a performance-based system for allocating the operating subsidies, until their elimination. Further analytical work to assess the need for a targeted subsidy to mitigate the impact of tariff increases on poor consumers may be necessary. Staffs also encourage continued and transparent monitoring of the sector by the General Directorate of Water and Sanitation in order to strengthen local public information on utilities' performance and to effectively guide new investment transfers and development financing for the sector.

C. Delivering Social Services

20. **The NSDI clearly articulates the critical role education should play in stimulating economic growth, democracy and regional integration.** It addresses key issues, including the importance of improving attainment, quality and equity especially at secondary and tertiary levels. Performance indicators selected for monitoring are pertinent. Staffs recommend that the NSDI could also consider the role of local government in education provision, the need to reform technical and vocational education to strengthen linkages with the labor market and integrate it with general secondary education, and the need to highlight the government's plans in attending to the challenges raised by the new Law on Higher Education, in line with the Higher Education Master Plan.

21. **The NSDI highlights the key challenges in the health sector, as well as a coherent vision of the direction the sector should take in the future.** The emphasis on improved access to basic health services, higher quality and increased efficiency is clearly in keeping with various analyses of health sector needs and the latest poverty assessment. The current emphasis on reviewing the enabling health care and health financing legislation, and on ensuring transparency in the pharmaceutical sector, all represent essential building blocks for pursuing these objectives and the health sector strategy generally. Staffs urge that future updates of the NSDI focus on specific measures to reform health financing by considering: (i) a reduction in reliance on payroll tax contributions while ensuring predictability of health insurance financing; (ii) a gradual shift towards a population-based regional allocation of health sector funds; (iii) the use of hospital/primary health care maps as instruments to rationalize and guide future investments in health facilities; and (iv) measures to reduce corruption in the health sector, and increase transparency of the pharmaceutical sector.

22. **The NSDI correctly highlights the key issues in social insurance, including the importance of weak collection of contributions and the stagnant formal labor market as determinants of the high dependency rate.** Staffs recommend caution with regards to the NSDI's recommendation to move to a multipillar system for pensions. In many other countries, this has had a significant impact on the budget due to transition costs. In future revisions of the NSDI, staffs recommend emphasizing the need to focus the first stages of a pension reform strategy on (i) improving the administration of the current system to generate cost savings, and (ii) changing the benefit system, by improving the links between contributions and benefits so as to raise revenues from the increased incentive to contribute. This should generate the fiscal space with which the Government could, in the future, reduce contribution rates and stimulate growth in formal sector jobs. At that future date, the government could also look at all the preconditions necessary for introducing a funded pillar. In the meantime, staffs recommend minimization of ad hoc increases in special pension benefits which do little to encourage participation.

23. **The need to improve the coverage and level of benefits in Albania's social assistance—Ndhima Ekonomike—is clearly spelled out in the NSDI.** In addition, an

equally important focus should be improving its targeting as identified in the latest poverty assessment. This would need to go hand in hand with improving survey-based instruments to measure and monitor poverty. Other subsidy programs, such as the electricity compensation scheme and the proposed subsidies for water, should also be addressed in the strategy's discussion of social assistance. On the other hand, the strategy for the development of **social services** offered to vulnerable groups of the population is comprehensive. Staffs recommend that it also include a sound financing strategy for all residential and daily care services and supports strengthening the capacity of the local government units to enable them to successfully undertake these new tasks in a fiscally sustainable manner.

D. Cross-cutting Sectoral Policies

24. The comprehensive vision for rural development outlined in the NSDI is consistent with the EU's approach. The NSDI recognizes that land fragmentation, low productivity and competitiveness of agricultural production, shortage of off-farm income-earning opportunities and weakness in rural social service delivery are key structural problems hampering sector modernization and reduction in rural poverty. In strengthening agricultural production, staffs agree that a simple and transparent system for providing investment assistance to farmers is critical and may help to further develop rural credit markets without distorting the market. Emphasis on public resources for marketing agricultural products may not be warranted given the private sector's engagement in this area. There may also be benefits associated with providing better secondary and vocational education to rural families to facilitate employment and income growth outside of agriculture.

25. The NSDI recognizes the importance of spatial planning through an integrated approach designed in a transparent and participatory manner. The development of regulatory plans approved by commune and municipal councils to guide local development is appropriate. The NSDI could give further consideration to the clarification of the central government's role in spatial planning and to the coordination of sectoral planning with local efforts. Staffs commend the continued efforts to regularize property rights, and encourage the government to maintain full transparency and due process in the issuance and enforcement of permits in line with approved regulatory plans.

26. The development of tourism, based on the country's intrinsic, natural and cultural values, represents a key opportunity for Albania. The NSDI accurately describes the challenges related to the development of the sector (including inadequate infrastructure and solid waste management, and insufficient control over physical developments). In order for tourism to become a catalyst for regional economic growth, the Government will need to establish: (i) a strong regulatory environment for land use and physical developments (mentioned above); (ii) strong coordination of private and public activities including training, marketing, and standard setting; and (iii) mechanisms for sharing the benefits of tourism from national to local levels. These could be highlighted in future revisions of the NSDI.

27. The NSDI correctly identifies required reforms in its system of local governments.

The NSDI highlights the importance of stabilizing the formula for distributing intergovernmental transfers, setting controls over municipal borrowing and improving the efficiency of investment grant allocation by limiting political discretion in project selection. However, it does not sufficiently recognize the adverse impact of too much de-earmarking which has resulted in the under-funding of education and roads. Staffs recommend (i) enshrining the rules governing the level and distribution of transfers in permanent legislation; (ii) tightening of municipal debt ceilings; and (iii) adopting more specific criteria for allocating the competitive grants and providing sufficient technical resources for their evaluation. While in the education and health sectors, this might take the form of national sectoral investment plans, for small investments under the exclusive competence of local government, a more decentralized approach is warranted.

28. The anti-corruption elements of the NSDI are broad, and appear to be a general declaration of principles rather than a strategic framework for future action.

Staffs commend the focus on public education and coordination of efforts across different levels of government. However, the anti-corruption strategy and its translation in the NSDI would benefit from the following improvements: (i) an evaluation of the impact of past and ongoing efforts at improving governance and anti-corruption; (ii) a more succinct description of remaining problems; (iii) a clear statement of immediate priorities and a road map for how the results might be achieved; and (iv) a framework for monitoring and evaluation.

VI. IMPLEMENTATION RISKS

29. Staffs recognize several implementation risks related to possible political stalemate, macroeconomic vulnerabilities, and weak capacities.

Political stalemates, especially at times of upcoming local or national elections, can threaten progress towards the achievement of NSDI objectives. On the macroeconomic front, while the track record is strong, risks have recently increased due to impending election year pressures and recurrent electricity shocks that can affect growth and external sustainability if fundamental reforms in the energy sector are not accelerated. Moreover, despite improvements, exports remain heavily dependent on a few products and markets, and the export base needs to be expanded to assure long-term external sustainability. There are also serious risks associated with weak administrative capacity across Albanian institutions. While external technical assistance under the IPS Trust Fund will support the Government's ambitious plans under the NSDI, Staffs recommend building appropriate mechanisms to ensure transfer of knowledge and retention of experienced and competent staff to carry forward this agenda.

30. Staffs commend the authorities' intention to publish annual progress reports with outcome-level indicators and use them to build accountability, but encourage revisiting some of the proposed indicators.

Many of the NSDI's proposed monitoring indicators are sector output rather than outcome indicators, and several are missing baselines, as well as annual and medium-term targets. Staffs recommend revisiting the adequacy of the proposed

indicators in terms of: (i) consistency with sectoral strategies; (ii) suitability of measuring reforms' impact in certain sectors (e.g. energy, public administration, higher education and rural development); (iii) regular availability; and (iv) capacity to generate and monitor the indicators. Strengthening the monitoring role of the sectoral advisory groups is critical.

VII. CONCLUSIONS

31. Albania made significant progress in achieving key objectives of its previous PRSP. The NSDI sets out Albania's goals over the medium-term and provides a comprehensive and integrated strategy for achieving those goals. It was prepared through a participatory process and represents a significant improvement over the previous PRSP. As the authorities sharpen their strategic focus and strengthen implementation of the NSDI, they would benefit from addressing the following challenges highlighted earlier in this assessment:

- Maintaining an appropriate macroeconomic framework that takes into account the country's macroeconomic and fiscal risks arising from the transport and energy sectors.
- Translating the priorities identified in the NSDI into concrete and adequately costed expenditure plans that balance development needs with macroeconomic risks.
- Significantly strengthening the efficiency of public spending through adopting a measured approach to future public sector spending in transport consistent with the Albanian National Transport Plan.
- Embracing an approach to public administration reform based on improved compliance with the civil service law, including through reduced turnover of qualified staff, transparent and competitive recruitment, and respect of due process protection, with a view to ensuring a more stable, capable and depoliticized staff.

32. Staffs look forward to an update of the NSDI and to its Annual Progress Report exercise in the near future. They hope that future updates: (i) take into consideration the proposed recommendations in this JSAN; (ii) identify realistic measurable targets; and (iii) evaluate performance transparently against these benchmarks. In this way, the progress reports can contribute to prioritization of reform efforts, especially if done hand-in-hand with the efforts to evaluate performance against the Albania-EU Action Plan for SAA implementation.

33. In considering the NSDI and associated JSAN, Executive Directors may wish to focus on the following issues:

- a. Do Directors agree with the staffs' proposed advice on the NSDI?
- b. Do the Directors concur with the priority areas for implementation identified by the staffs?