

Report No. 29257-AL

Albania

Sustaining Growth Beyond the Transition

A World Bank Country Economic Memorandum

December 27, 2004

Poverty Reduction and Economic Management Unit
Europe and Central Asia Region



Document of the World Bank

CURRENCY AND EQUIVALENT UNITS
(Exchange Rate Effective as of November 22, 2004)

Currency Unit = Lek
US\$1.00 = 97.51 Leks

GOVERNMENT FISCAL YEAR
January 1 to December 31

WEIGHTS AND MEASURES
Metric System

ACRONYMS AND ABBREVIATIONS

ARCS	Administrative and Regulatory Cost Survey	NSSED	National Strategy for Social and Economic Development
AMC	Albanian Mobile Communication	OECD	Organization for Economic Cooperation and Development
ANALTIR	International Freight Transporters Association	PDA	Port of Durres Authority
ATM	Autonomous Trade Measures	PISA	Program for International Student Assessment
ATP	Autonomous Trade Preferences	PIT	Personal Income Tax
CEEC	Central and Eastern Europe an Country	PRSC	Poverty Reduction Support Credit
ESAF	Enhanced Structural Adjustment Facility	REBIS	Regional Balkans Infrastructure Study
EU	European Union	ROW	Rest of the World
FIAS	Foreign Investment Advisory Service	SAA	Stabilization and Association Agreement
FTA	Free Trade Agreement	SAP	Stabilization and Association process
GDP	Gross Domestic Product	SEE	South East Europe
GRD	General Roads Directorate	SITC	Standard International Trade Classification
HSC	High State Control	SST	Social Security Tax
IAIS	International Adult Literacy Survey	TEU	Twenty Equivalent Unit
ICAO	International Civil Aviation Organizations	TFP	Total factor productivity
IDA	International Development Agency	TIMSS	Third International Mathematics and Science Study
IFI	International Financial Institutions	TOT	Terms of Trade
IMF	International Monetary Fund	TTFSE	Trade and Transport Facilitation in Southeast Europe
IPRS	Immovable Property Registration System	TTP	Total Factor Productivity
LSMS	Living Standards Measurement Survey	VAT	Value-Added Tax
MTEF	Medium Term Expenditure Framework	WDI	World Development Indicators
MLGD	Ministry of Local Government and Decentralization	WEI	World Economic Indicators
MTT	Ministry of Transport, Telecommunications and Post	WTO	World Trade Organization

Vice President:	Shigeo Katsu
Country Director:	Orsalia Kalantzopoulos
Sector Director:	Cheryl W. Gray
Sector Manager:	Bernard Funck
Team Leader:	Célestin Monga

CONTENTS

ACKNOWLEDGMENTS	1
EXECUTIVE SUMMARY	I
CHAPTER 1: INTRODUCTION	1
CHAPTER 2: SOURCES, PROSPECTS AND CONSTRAINTS TO GROWTH	7
1. Background: A Short Story of Transition	7
2. What is Driving Albania's Growth Performance?	17
3. Sectoral Potential for Growth	25
4. Long Term Growth: Prospects and Constraints	33
CHAPTER 3: TRADE AND INTEGRATION	41
1. Trade and Foreign Investment in Albania.....	41
2. Policies to Boost Trade Integration.....	48
CHAPTER 4: THE ROLE OF MIGRATION AND REMITTANCES	57
1. Patterns of Internal and External Migration.....	57
2. Macroeconomic Impact.....	63
CHAPTER 5: MOBILIZING LABOR RESOURCES	69
1. Profile of the labor market	69
2. Inadequate Supply and Low Demand for Human Capital	78
CHAPTER 6: REMOVING PUBLIC INFRASTRUCTURE BOTTELNECKS	89
1. Poor Quality of Infrastructure	89
2. Public Infrastructure Priorities	100
CHAPTER 7: GOVERNANCE FRAMEWORK FOR GROWTH	107
1. Governance and institutional challenges.....	107
2. Policies to Improve Governance and Strengthen Institutions	114
CHAPTER 8: MACROECONOMIC FRAMEWORK FOR GROWTH	121
1. Macroeconomic and Financial Constraints	121
2. Policies to maintain macroeconomic stabilization	128
CHAPTER 9: CONCLUSION	133
ANNEX	135

Text Boxes

- Box 1: Selected Promising Agricultural Products
- Box 2: A CGE Model for Trade Simulations: Data Sources
- Box 3: FIAS Recommendations for Removing Administrative Barriers to Investment
- Box 4: Dealing with Inconsistencies in Labor Market Statistics
- Box 5: Human trafficking in the Balkans
- Box 6: Tax Reforms Proposed by the IMF

List of Figures

- Figure 1: Albania Real GDP (1990=100)
- Figure 2: Fiscal Consolidation, 1997-2003
- Figure 3: Size of the Central Government (1999-2002 average)
- Figure 4: How the Budget Deficit Has Been Financed, 1997-2003
- Figure 5: Real Interest Rate, 12-month Deposit, 1993-2003
- Figure 6: Remittances, in Millions of US Dollars, 1994-2002
- Figure 7: External Transfers, in Millions of Leks, 1992-2002
- Figure 8: Current Account Deficit, 1991-2003, (percent of GDP)
- Figure 9: Gross National Income per Capita, 1990-2003
- Figure 10: GDP Composition, by Expenditures, 1990-2003
- Figure 11: Value Added from Agriculture, as Share of GDP, 2000
- Figure 12: Sectoral Contribution of GDP, 1990-2003
- Figure 13: Relative Contributions to GDP Growth, 1982-2003
- Figure 14: Regional Tourism Trends, 1997-2001
- Figure 15: Savings-Investment Balance, in percent of GDP
- Figure 16: Foreign Direct Investment in Albania, in millions of US\$
- Figure 17: FDI by Sector, 2001 (% of Total)
- Figure 18: FDI by Country of Origin, 2001 (percent of total)
- Figure 19: FDI in SEE Countries, 2003 (in million of US\$)
- Figure 20: Urban Adult Male Population by Migration History and Region, April 2001
- Figure 21: Employment-related Temporary Emigration of Albanian Men: Rates (left scale) and Average Duration (right scale), 1997-2001.
- Figure 22: Albanian Men - Short-term Labor Emigrants by Age and Education, April 2001
- Figure 23: Effect of District Poverty Rate and Marital Status of Albanian Men on the Predicted Probability of Temporary Work-related Emigration
- Figure 24: Effect of Place of Residence and Age on Predicted Probability of Temporary Work-related Emigration
- Figure 25: Remittances and the Trade Balance, 1993-2002
- Figure 26: Remittances, in Millions of Leks, 1994-2002
- Figure 27: Albania's Increasing Trade Deficit
- Figure 28: Demographic Dependency Ratios in Albania and Selected Countries, 2002
- Figure 29: Activity, Employment and Unemployment Rates (percent). Men Aged 15-59 and Women Aged 15-54
- Figure 30: Registered Unemployment in Albania, 1993-2003 (end of period): Total Number of Unemployed (left scale); Number of Unemployed with University Education (right scale)
- Figure 31: Unemployment Rates by Sex and Residence: 1989 and 2001 (Population Census data)
- Figure 32: Unemployment rates by Residence and Gender, April 2002
- Figure 33a: Unemployment Risk for Economically Active Albanians by Age Group and Residence, April 2002—Men
- Figure 33b: Unemployment Risk for Economically Active Albanians by Age Group and Residence, April 2002—Women
- Figure 34a: Unemployment Risk for Economically Active Albanians (students and pensioners excluded) by Years of Schooling and Residence. April 2001--a) Men, aged 25-34
- Figure 34b: Unemployment Risk for Economically Active Albanians (students and pensioners excluded) by Years of Schooling and Residence. April 2001--b) Women, aged 15-64

- Figure 35: Unemployment Risk for Economically Active Albanian Women (students and pensioners excluded) by Age and Educational Attainment, April 2001
- Figure 36: Geographical Mapping of the Poverty Headcount
- Figure 37: Traffic Deaths per 10,000 Vehicles
- Figure 38: Level of Obstacles Faced by Businesses in Albania in Various Areas
- Figure 39: Government Revenue and Tax Revenue in a Sample of Countries
- Figure 40: CPI-Based Real Effective Exchange Rate, 1994-2004
- Figure 41: Annual Growth Rate of the Money Supply, 1994-2003
- Figure 42: Labor Productivity , 1992-2003, Thousand Leks/Employee
- Figure 43: exports to GDP, 1993-2003 (percent)

List of Tables

- Table 1: Albania versus Other SEE Countries
- Table 2: Main Economic Indicators, 1990-2003
- Table 3: Progress on Structural Reforms-2003
- Table 4: Agricultural Production, 1993-2003—Field Crops (thousand tons)
- Table 5: Livestock, 1998-2003 (thousands)
- Table 6: Sectoral Composition of GDP, 1990-2003
- Table 7: Albania Growth Accounting Results I (without adjustment for permanent scrapping of significant part of communist capital)
- Table 8: Panel A: Albania Growth Accounting Results II Assuming significant part of communist capital is permanently scrapped during 1990-92
- Table 8: panel B: Albania Growth Accounting Results II Assuming capital share of 0.50 and permanent Scrapping of Communist Capital
- Table 9: Composition of trade with the EU and ROW in 1996, 1998, 2002 and 2003 (in percent and thousands of US dollars)
- Table 10: Factor Intensity of Albania's Trade with the European Union, 1996-2003
- Table 11: Customs Revenue Collected, 2001-2003 (US\$ millions)
- Table 12: Revenues from the Tourism Industry, 1999-2002
- Table 13: Comparison with Higher Growth and Slower Growth Countries
- Table 14: Estimated Neoclassical Growth Equation
- Table 15: Predicted Long Run Growth Rates for Transition Economies
- Table 16: Performance of SEE-5 economies in EU markets in 1993-2003
- Table 17: Trade in Textiles/Clothing and Footwear, 1996-2003 (in thousand of US \$ and percent)
- Table 18: Trade in parts and share of EU (in 000 of US dollars and percent)
- Table 19: FDI inflows. Total and Total per capita over 1990-023, Average Annual per Capita in 1993-96, 1997-2000 and Annual per Capita in 2000-03 (in US dollars)
- Table 20: Annual FDI Inflows in Million of US Dollars and in Percent of GDP, 1993-2003
- Table 21: Implications of the SAA with the EU
- Table 22: International Trade Implications Under Short-Run Scenarios (percentage change relative to 2000 performance)
- Table 23: Output Changes under Short Run Scenarios (percentage change relative to 2000)
- Table 24: Implications of the Liberalization of Tariff on Imports from SEE
- Table 25: Implications of the Adoption of the CET on Industrial Products
- Table 26: Implications of Trade Liberalization with the EU, the SEE and the Rest of the World
- Table 27: Flows during 1989-2001 and 2000-2001 between the Coastal, Central, and Mountain Zones and Tirana City, (percentage of stocks in the beginning of the period). Men Aged 15+ and Living in Albania in April 2001

Table 28:	Willingness to Move Abroad Temporarily or Permanently among Albanians Who Had Not Moved in 1997-2001 (April 2002, percent of population aged 15-64)
Table 29:	Determinants of Willingness to Move Abroad among Albanians Who Had not Moved in 1997-2001 (direction of effect; 0 if not significant)
Table 30:	Currency Outside the Banking System as a percentage of Ms, SEE
Table 31:	External Assistance to Albania, 1991-2002
Table 32:	Net Economic Dependency Ratio in the EU and Selected Countries, 2002
Table 33:	Labor Market Status of Albanian Population Aged 15-64, April 2002 (percent)
Table 34:	Unemployment Rates in Albania, 2001-2003: Men Aged 15-59 and Women Aged 15-54 (Percent)
Table 35:	Employment, Unemployment and Labor Force Participation in Albania, April 2002 (population aged 15-64), in percent
Table 36:	Enrollment rates by level of education
Table 37:	School Expectancy for WEI Countries (2000), OECD countries Including Regional Comparators (2001), and for Albania (1998) Country or Country Group School Expectancy
Table 38:	Educational Attainment of 25-64 Year Old Population in Albania, the EU, and Selected Countries of Central and South-Eastern Europe, 2002 (percent distribution)
Table 39:	Average Earnings by Ownership Sector, Employee Gender and Education, 2002
Table 40:	Wage Ratio by Education, Ownership Sector, and Gender, 2002
Table 41:	Educational Distribution of Total Employment and of Employees, 2002
Table 42:	Labor Force Participation by Gender and Education (Population Aged 15-64)
Table 43:	Stages of Economic Development
Table 44:	Forecast Traffic Growth Rates, 2001-2006 (in percent)
Table 45:	Condition of the Road Network, 2003
Table 46:	Public Transport Expenditures (US\$ millions)
Table 47:	Comparison of International Road Fatality Rates, 2002
Table 48:	Excise Taxes on Petroleum Products, 2003 (US\$/l)
Table 49:	Estimated Road Expenditures and Revenues, 2001 (US\$ millions)
Table 50:	Average Railway Revenues per Traffic Unit (US\$)
Table 51:	Financial and Operational Indicators in the Water Sector, 2001
Table 52:	Direct Operational Subsidies to the Water Sector, 1993-2004 (million Leks)
Table 53:	Corruption Index in SEE Countries, 2001-2002
Table 54:	Tax Rates: Albania versus Other Transition Countries
Table 55:	Reported Unofficial Payments by Procedures
Table 56:	Corruption Pressure Indicator
Table 57:	Institutional Indicators: Albania versus Other Transition Countries
Table 58:	Legal Effectiveness and Extensiveness Index
Table 59:	Governance: Changing Roles for Major Stakeholders
Table 60:	Government Revenue as Percentage of GDP, Southeast Europe
Table 61:	Estimates of the Size of the Shadow Economy in Central and Southeast Europe
Table 62:	Albanian Tariffs on Imports from the EU
Table 63:	Albanian Tariffs on Imports from Neighboring Countries covered by FTAs
Table 64:	Albanian MFN Tariffs and the CET on Manufacturing Products
Table 65:	Bank Credit to the Private Sector, South East Europe (% of GDP)
Table 66:	Currency Outside the Banking System, SEE, 1992-2002 (as a percentage of MS)
Table 67:	External Assistance to Albania, 1991-2002
Table 68:	Trade as a Share of GDP, 1998-2002 (percent)
Table 69:	Geographic Pattern of Albania's Exports and Imports in 1996-2003 (in percent)

ACKNOWLEDGMENTS

This report was prepared by Célestin Monga based on the findings of a larger study carried out by a World Bank team and to be published as a research project (Background Studies). The team, which was led by Mr. Monga, included Faruk Khan, Zhicheng Li Swift, Marta Muco (macroeconomics); Bartek Kaminski, Alia Moubayed, Maryla Maliszewska and Anna Kolesnichenko (trade); Mihails Hazans (labor market issues); Sue Berryman (education); Nils Junge (agriculture); Peter Parker (transport); Susanne Szymanski (water); Iftikhar Khalil (electricity); Katelijn Van den Berg and Adriana Damianova (tourism); Brian Levy, Gary Reid (governance); and Joao C. Oliveira (decentralization). The team also relied on previous work and contributions from Xiaofang Shen, Juella Haxhiymeri, Jolanda Trebicka, Frauke Jungbluth, Mehnaz Safavian, Hormoz Aghdaey, Olivier le Ber, Periklis Saragiotis, Andreas Rohde, Monika Huppi, Verdon Staines, Mansour Farsad, Mukesh Chawla, and Nand Shani.

Robert M. Solow (MIT) and Robert J. Barro (Harvard University) served as advisors on this task. Norman Loayza, Alexandre Abrantes, and Hedi Larbi acted as peer reviewers. Report formatting and production were coordinated by Mismake Galatis and Armanda Çarçani. Emily Evershed (consultant) edited the draft report. The work was carried out under the general direction of Bernard Funck and Orsalia Kalantzopoulos.

The team acknowledges a close collaboration with the European Commission, the International Monetary Fund, and the International Labor Office. Helpful material and suggestions were received from the Ministry of Finance, the Bank of Albania, the Institute of Statistics (INSTAT), and Dr. Lindita Xhillari and Dr. Ylli Çabiri from the Human Development Promotion Center. The Bank team would like to express their sincere gratitude to various ministries, government agencies, and international organizations whose help facilitated the preparation of this draft. Finally, a special thanks to Ms. Milva Ekonomi and her colleagues at INSTAT for their excellent cooperation. The draft report was discussed with all stakeholders and revised on the basis of these discussions.

EXECUTIVE SUMMARY

Albania's cumulative growth since the fall of the communist regime in 1990 has been impressive and among the highest of all transition economies. Yet the country remains one of the poorest in Europe, with a GDP per capita of about US\$1,900 in 2003. *Several factors explain the growth performance: First, macroeconomic stabilization and structural reforms* have provided an environment conducive to economic growth over most of the past ten years. Fiscal consolidation took place, reducing the government deficit excluding grants from 12.2 percent of GDP in 1999 to 4.4 percent in 2003.¹ A prudent monetary policy was implemented, evidenced by stable inflation expectations, higher confidence in the local currency, and foreign exchange reserves at a comfortable level. Trade has been liberalized. The privatization of small and medium enterprises has been completed, and only a few enterprises in the sectors of heavy industry, mines, metallurgy, and the services sector remains that need to be privatized.

The second factor explaining growth performance is total factor productivity. Structural reforms were also implemented in key sectors of the Government's development strategy (education, health, and energy). This has led to the reallocation of resources from low productivity sectors like agriculture to high productivity sectors (services, construction). As a result, economic growth in Albania during transition has been driven primarily by high rates of total factor productivity growth (i.e., by the improved allocation of resources). During the initial years of transition, the disorganization or chaos resulting from the removal of central controls and coordination produced negative total factor productivity growth rates as output fell and large parts of the capital stock were idled. Subsequently, as the economy achieved macroeconomic stability and introduced structural reforms, the reallocation of resources to more productive activities allowed the economy to generate rapid growth with low rates of investment, so that total factor productivity growth rates increased. Growth accounting reveals that during the period 1993-2003, total factor productivity growth contributed 6.14 percent of the annual average annual real GDP growth (6.27 percent).

The third factor is the remittances from migration. Albanian growth has been fueled by remittances and an apparently large, though difficult to quantify, injection of resources from various informal activities. Official estimates indicate that remittances are the largest source of foreign exchange, greater than the combined value of exports and foreign direct investment (FDI), currently constituting 14 percent of GDP. The amount of remittances from Albanians living abroad and recorded by the banking system is estimated to be over US\$ 200 million per year. This stimulus has generated a domestic boom in non-tradable activities—principally construction and services. Since 1990, approximately one-fifth of the total population of the country has left and is living abroad, and there have been large-scale movements of population from rural to urban areas. Information from Greece and Italy, the two principal receiving countries, puts the number of Albanians who are legal residents in these countries at approximately 600,000 in 2000-2001, or one-sixth of the Albanian population.

While Albania's performance has been impressive, there are concerns about the sustainability of high rates of economic growth in the future. The evidence from the growth accounting exercise indicates that total factor productivity growth from post-transition reallocation is gradually coming to an end. At the same time, the contribution of capital accumulation has only picked up modestly. This suggests that in order to sustain high GDP growth going forward, Albania must seek to raise its investment and secondary school enrollment rates, increase the

¹ The data for GDP used in this report are those reported by INSTAT in July 2004.

degree of trade integration, and improve institutional quality (governance). Worryingly, total factor productivity growth has slowed significantly in recent years while the contribution of factor accumulation was negligible. Neither remittances nor earnings from illegal activities constitute a solid basis for long-term economic development. There are signs, already, of a decelerating trend in the level of remittances. Furthermore, there are concerns about the financing of the country's investment needs over the medium term. The likelihood that Albania's access to concessional financing sources will decline, as well as expectations for dwindling external support and inflows from abroad, presents major risk factors that must be mitigated with the help of the donor community.

There are also several macroeconomic constraints to sustained growth, and macroeconomic vulnerabilities remain. These include the following:

- Albania's *external position* is still fragile. The current account deficit, excluding official transfers, was 7.6 percent of GDP in 2003. Without the high levels of remittances, it would be even higher. While FDI has been growing over recent years, its level is still low, especially when compared to other SEE countries.
- *Fiscal sustainability* is at risk because of the low tax revenue-to-GDP ratio (about 23 percent of GDP, significantly lower than that of other SEE and CEE countries, which average 42 percent and 38 percent of GDP, respectively). Tax administration is weak. Tax collection is below targets and tax harassment is a major issue for businesses. The social security contribution is still unsatisfactory (less than 35 percent of employees in the private firms are covered). Tax evasion and tax avoidance in the household sector is sizable—undeclared household income is estimated at 52 percent of GDP, the largest among SEE and CEE countries. Albania's informal economy is estimated to be as large as 30 percent of its formal economy, which is a key impediment to generating revenue from channels other than international trade.
- Despite a declining trend over recent months, *real interest rates* are still high and contribute to the appreciation of the Lek, which is now hurting competitiveness.
- *Expenditure management and prioritization remain weak*. Public sector employment is high (18 percent of total employment). Funding for some non-discretionary items (operations and maintenance, subsidies and transfers, and capital expenditures) is often subject to resource availability. Despite progress in recent years, public expenditure management is still inefficient and needs more transparency.
- *Poverty* (monetary poverty and access to basic services such as water, health, education) *remains pervasive*. One-quarter of the Albanian population, or close to 780,000 individuals, falls below the poverty line. *Unemployment* remains widespread, and is especially high in urban areas.

Governance indicators from recent surveys show a deterioration of performance over the 1996-2002 period. They indicate: (i) a moderately reduced government effectiveness; (ii) significant reductions in regulatory quality and rule of law; (iii) a reduction in the "control of corruption"; (iv) increases in bribe magnitudes; and (v) increase in state capture. While the progress in the depoliticization of the civil service was a positive accomplishment, it has been compromised on a few occasions since late 2002. Improvements in the business climate—a key ingredient to foreign direct investment and higher exports—is slow. The 2003 FIAS report identified four specific

areas of administrative barriers to investment that stand out as most problematic: customs procedures, tax administration, land and construction permits, and sector licensing. Across these areas there are pervasive concerns related to the ineffective dispute resolution mechanisms (e.g., the appeals systems).

There are also structural and sectoral bottlenecks to competitiveness and growth. Albania's educational attainment—measured by average years of schooling of 8.5 years—is lower than that in most transition economies. The secondary school enrollment rate has declined significantly (38.7 percent in 2002 versus 79 percent in 1990) and is lower than in other countries in the region. Enrollment rates fall very drastically after the compulsory eight years of schooling. Public spending on education has declined as well, from 5 percent of GDP in 1991 to 2.8 percent of GDP in 2003. While this negative trend is due to a general decline in public spending, public education spending in relation to GDP is still lower than in other countries in the region.

In addition, high input costs and the poor quality of infrastructure hinder the development of trade: The export share of GDP is among the lowest for all transition economies. Despite the formal opening of Albania's trade regime, only 17 percent of GDP is generated by the export of goods and services, the lowest percent in the region. Albania compares negatively with other SEE countries in terms of input and factor costs.

- The on-going **power sector** crisis puts at risk Albania's macroeconomic performance and its economic growth and poverty alleviation prospects. This crisis was initially triggered as a result of excessive demand resulting from a failure to curb illegal use of electricity and non-payment of bills. Since the summer of 2000, the crisis was aggravated by the impact of a drought on Albania's predominantly hydropower-based system, as a consequence of which domestic generation fell significantly. From being a net exporter of electricity until 1997, Albania has had to import increasing quantities of electricity (from 300 GWh in 1998 to over 2,200 GWh in 2002). In spite of the large electricity imports, frequent load shedding has to be resorted to as financial and transmission constraints have limited the electricity imports. Although significant progress has been made since the beginning of 2001 in addressing these issues as a result of the implementation of an Action Plan agreed by the Government with the donors, the adverse impact on the economy has been significant: (i) GDP has been effected as a consequence of both the reduced domestic hydropower generation and the impact of load shedding on industrial production; (ii) load shedding and the unsatisfactory quality of electricity supply have acted as a disincentive to direct foreign investment, necessitated the widespread purchase and use of costly back-up generators, and caused damage to electricity-using equipment; and (iii) scarce budgetary resources have had to be diverted from other priority needs to subsidize electricity imports.
- Water supply in almost all urban areas is intermittent because of the bad condition of Albania's water infrastructure and some underlying institutional problems. Inadequate maintenance and repair, and lack of metering operational control, have resulted in excessive water losses, estimated to be greater than 50 percent of water production in all cities. The collection rate is low and average tariffs are far below the cost recovery level. A major obstacle for tourism development is the unreliable water supply and the pollution of beach areas by sewerage.
- The transport system is adequate in extent perhaps, but not in condition. The poor state of infrastructure represents a major constraint to trade, foreign direct investment, tourism, growth, and the provision of social services for the poor. The absence of a

general Transport Master Plan and clear development sector strategies contributes to inefficiencies in the sector (including the construction of roads which are narrow and sub-European in standards). Transit costs are high and constitute an impediment to the development of international trade, as higher logistics costs translate into higher import and export prices. Manufacturing firms suffer delays from inefficient and complex customs procedures, administrative or regulatory bottlenecks, or the lack of modern systems of information technology and cargo handling in both maritime and inland transport.

The Government's key medium-term objectives articulated in the National Strategy for Social and Economic Development (NSSD) are to sustain growth, reduce the number of people living in poverty, improve infrastructure and build human capital. Sustained growth in four sectors with major trade potential and spillover effects throughout the Albanian economy could boost the prospects for growth: agri-business (the main source of income for poor households); transit trade; exports of light manufacturing; and tourism. The CEM outlines, below, a policy agenda to help Albania improve growth and competitiveness in these four sectors and beyond.

Policies to Maintain a Stable Macroeconomic Framework

The current savings-investment picture reflects Albania's uncertain external outlook. The Albanian authorities will have to pursue domestic and external balance and will need substantial capital inflows (preferably foreign direct investment) to finance its current account in a sustainable manner. Maintenance of a stable macroeconomic framework is an important prerequisite to sustained growth.

- Continued adherence to *fiscal discipline* to further reduce the budget deficit will be necessary in the coming years. Given the country's low revenue collection performance, fiscal policy should also aim at a broader and more secure revenue base.
- *Major improvements are needed in public expenditure management.* Key measures to be considered include: (i) ensuring that the Medium-Term Expenditure Framework (MTEF), adopted in 2000, which aims to improve the strategic resource allocation and the efficiency of resource use, is fully integrated with the NSSD process and other initiatives, such as the Stabilization and Association process and fiscal decentralization; (ii) adopting budget rules to improve allocative efficiency in sectors where major investment projects are under consideration (transport, water, social sectors); (iii) adopting rules to limit the growth of non-priority recurrent spending; (iv) strengthening transparency and auditing procedures and ensuring that the High State Control (supreme audit institution) is adequately funded; and (v) undertaking a comprehensive public expenditure review in order to analyze equity issues and the effectiveness of public resources. Investments for the power sector do not require budgetary allocations but, given the substantial investment requirements of this critical sector (about US\$ 1 billion over the next decade) and the impact of these investments on the limits on non-concessional lending, these will have an impact on investments in other sectors. Furthermore, the continuation of the implementation of power sector reforms is critical to the gradual reduction and eventual elimination of subsidies from the budget. Creation of an equalizing fund to ensure that profits resulting from favorable hydrology are set aside to cover additional costs for imports necessary during subsequent periods of adverse hydrology should be an essential part of these reforms.

- Given the still low inflation expectations and the comfortable level of reserve coverage, it appears that *the policy of lower interest rates* adopted by the Bank of Albania in recent months can be maintained. While the Albanian monetary authorities should closely monitor developments in international interest rates and energy prices which could spur inflation, and should therefore exert caution regarding any change in policy, their immediate objective should be to limit the appreciation of the Lek.

Policies to Mobilize Human Resources

To sustain growth, Albania will have to shift its economic activities increasingly toward investment-driven growth—and ultimately toward innovation-driven growth. Both types of growth, especially innovation-driven growth, will ultimately require more human capital than the average Albanian is now obtaining. The following policies are proposed:

- *Increasing the quality of human capital.* In the short to medium term, two policy actions are particularly important for improving quality. One is for the government to participate routinely in international assessments of learning and to publish the results. These assessments let countries benchmark themselves against standards that frame the kind of human capital that their economies will ultimately need. The second is a thorough and systematic revision of the curriculum, as the curriculum defines what gets taught and learned and how. However, major curricular changes would be ineffective unless complemented by corresponding changes in the following: (i) all textbooks, teacher guides, and learning materials; (ii) teachers' classroom practices; and (iii) measures of learning outcomes. It should be noted that new textbooks and changes in teachers' classroom practices will be significantly expensive.
- *Increasing the demand for education through least cost options. Increasing the quantity of human capital.* The government has already changed the length of compulsory education, and grade 9 will become compulsory for the school year 2004-05. However, the problem of low demand for education remains, especially among poor families and rural families. Many of the policy options for increasing the demand for education—e.g., building schools to reduce distance or providing subsidies for the poorest families—are expensive. To target scarce resources effectively, demand analyses that identify the most important demand factors for different subgroups should be conducted. Using community planning exercises to let families allocate a hypothetical budget to factors that are most important to them can help the government customize and thereby increase the effectiveness of policy interventions.

Policies to Boost Trade and Integration

Albania's long-term vision is to join the European Union (EU). The country's relationship with the EU is currently based on the Stabilization and Accession Process (SAP), which provides a framework and the prospect of future membership to countries in the Balkans. While the SAP does not define an accession timetable, it constitutes a strong catalyst for reforms. Albania has benefited from the overall SAP cooperation framework, including preferential trade concessions, financial assistance, and the prospect of a far-reaching contractual relationship with the EU

through a Stabilization and Association Agreement (SAA) which would replace the current Trade and Cooperation Agreement, in place since December 1, 1992.²

Albania has recorded an impressive export performance over recent years but is still lagging behind other SEE countries in terms of openness (as measured by the ratio of trade to GDP). In order to take full advantage of its geographic location, and the potential for stronger trade relations with its neighbors and the EU, the following measures should be adopted:

- *Maintaining the commitment to a liberal multilateral trade regime, and accelerating regional and European integration.* Apart from the political benefits of the SAA process, such as providing the policy lock-in mechanism to pursue further reforms and the incentive to create a stable business environment that would encourage foreign investment, the elimination of the remaining barriers to trade can lead to significant expansion of trade and income. Trade liberalization should proceed along all dimensions, as the biggest gains are to be realized when Albania lowers its barriers to trade with respect to all trading partners.
- *Implementing the policy agenda agreed with FIAS to remove administrative barriers to investment.*

Policies to Improve Public Infrastructure

The implementation of the ambitious infrastructure agenda is also a pre-requisite for sustained growth. There are also important linkages between Albania's progress in the implementation of vital reforms in the infrastructure sector (such as those for the power sector) and its ability to play an active and responsible role in regional cooperation (such as the development of a functioning regional electricity market) on the one hand and the country's progress in the Stabilization and Accession Process on the other.

- In the transport sector, priorities are as follows: (i) completing the Transport Master Plan and sector strategy; (ii) strengthening the prioritization and economic analysis of proposed investment projects (specifically, public investments should only be undertaken after careful consideration of economic analysis [satisfactory economic rate of return, preparation of a realistic financing plan, judgment that the investment cannot be undertaken by the private sector, or as part of an agreed public service obligation for a specific social service which the Government agrees to subsidize]); (iii) setting pricing for public infrastructure services to ensure full cost recovery including external costs, equity between transport modes, and adequate protection of the environment; (iv) restructuring the railways system along EU guidelines before new investments are made; (v) launching the specialization of port facilities.
- In the electricity sector, measures must be taken to avoid load shedding when possible, for example through the provision of additional domestic generation and by importing additional electricity. This will require the sustained implementation of the Power Sector Action Plan and sector reforms already agreed with the donors. The subsidy provided by the Government to help the national electricity company KESH pay for imports has served an important role by limiting the load shedding to the levels

² Negotiations for an SAA started in January 2003. Their duration and outcome will depend on the progress made by the Albanian authorities in the implementation of key reforms outlined in the Partnership Agreement and assessed every year in the EC's Annual Report.

experienced to date. As this is to be terminated by the end of 2004, it is critical that KESH's financial performance is improved significantly so that load shedding can be minimized/eliminated.

- The authorities should also accelerate the implementation of the national and a rural water sector strategy. This would involve the rehabilitation of the obsolete water supply and sewerage networks; the extension of services to the poor and under-served; the transformation of the water utilities into self-financing entities; an increase in private sector participation in the water sector; the enabling of local governments to provide safe and sustainable water and sanitation services; and the introduction adequate collection and treatment of wastewater.

Policies to Improve Governance and Strengthen Institutions

Albania's efforts over the past decade aimed at improving governance and strengthening institutions suggest that a three-pronged approach will be required in order to significantly improve these keys to economic growth and poverty reduction:

- Redouble the efforts to ensure managerial integrity within the public administration
- Redouble and diversify the efforts to ensure reliable, predictable and fair enforcement of the rule of law, including both rules governing the actions of public sector entities and their staff (in both their regulatory roles and their service provision roles) and rules governing private sector actors
- Establish and nurture mechanisms that can facilitate a more effective service delivery voice – i.e., mechanisms that increase the odds that citizens and firms that are the direct targets of particular regulations or public services will both know how and find it easy to pressure the state to perform its regulatory and service delivery functions more fairly and effectively.

CHAPTER 1: INTRODUCTION

Albania's growth experience has been a success story among transition economies but GDP per capita is still only 6.5 percent of EU-15 average

Albania's cumulative growth since 1990 has been impressive and is among the highest of all transition economies (after Poland and Slovenia) yet the country remains one of the poorest in Europe. From US\$ 680 in 1990, real GDP per capita fell sharply during the early 1990s but has been growing steadily over recent years, to an estimated \$ 1,805 in 2003. Figure 1 depicts the trajectory of real GDP in Albania since 1990.

Figure 1: Albania Real GDP (1990=100)

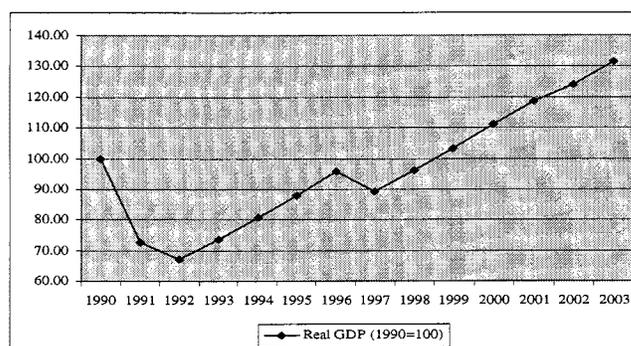


Table 1: Albania versus Other SEE Countries

	Total Area thousands Km2	Populatio n million	GDP 2003 current \$ bns	GDP growth (%)		GDP capita Atlas \$	GNI per capita, 2003 Atlas \$
				2002	2003		
Albania	28.8	3.2	6.1	4.7	6	1,938	1,740
BH	51.1	4.1	7.0	3.5	4.6	1,687	1,540
Bulgaria	110.9	7.9	19.9	4	5	2,539	2,130
Croatia	56.5	4.4	28.8	5	4.2	6,486	5,350
FYR Macedonia	25.7	2	4.7	0.3	3	2,298	1,990
Moldova	33.9	3.6	2.0	7.2	5	541	590
Romania	238.4	22.4	57.0	4.7	4.9	2,616	2,310
Serbia-Montengro/1	102.2	10.7	20.7	4	5	2,501	1,910

Source: The World Bank database (SIMA) with recent country teams' updates, Area: "Country Profile, 2003" EIU

Note 1/: Indicators for Serbia & Montengro exclude Kosovo except for area and population

Growth patterns have evolved during the past decade

Albania's growth experience since transition can be divided into four separate episodes. Immediately after transition, real GDP contracted sharply by a cumulative 39 percent between 1990 and 1992. Recovery began in earnest in 1993 as Albania instituted a successful macroeconomic stabilization program (by bringing its budget deficit, money growth, and inflation rate under control), liberalized prices and external trade, and privatized agricultural land. Between 1993 and 1996,

the economy grew at a rapid annual rate of 9.3 percent. Most of the growth during this period was driven by agriculture, services, and to a lesser extent, construction (the latter was still a small share of GDP).

In 1997, the collapse of the pyramid schemes brought widespread anarchy and a sharp contraction in real output by 7 percent. Albania was able to recover swiftly from this crisis so that growth returned in 1998. Between 1998 and 2001, the economy grew at an average annual rate of 7.4 percent, and in 1999 real GDP exceeded its level in 1990 for the first time.³ This growth was driven during 1998-99 by a strong performance in manufacturing and services. During 2000-01, manufacturing growth slowed significantly, the growth of services increased, and growth in construction accelerated substantially. In 2002, an energy crisis and poor weather slowed growth across the board, so that the economy grew by a mere 4.7 percent. In 2003, the growth rate picked up somewhat to 6 percent, aided by a significant increase in domestic hydropower production.

Structural transformation has taken place, as the contribution to agriculture to GDP has declined

Since 1990, Albania has experienced a significant structural transformation away from industry and into services. A large part of this structural transformation took place during the early years of the transition: from 1990 to 1992, the share of industry in GDP fell from 39 percent to 20 percent, the share of agriculture increased from 23 percent to 34 percent, and the share of services increased from 33 percent to 44 percent. Since 1992, the share of industry has stayed steady around 20 percent, the share of agriculture fell back down to 25 percent in 2003 (part of this due to changes in national accounts), and the share of services rose to 54 percent in 2003. Within the industrial sector, construction has expanded dramatically throughout, from about 3 percent of GDP during 1990-92 to 9.4 percent in 2003. The substantial structural transformation suggests that transition in Albania has indeed brought about a reallocation of resources toward more productive activities. In addition to this reallocation across economic sectors, the private sector's share of GDP has risen from 5 percent in 1990 to about 75 percent in 2002.

A look at the sectoral contributions to growth in Table A*6 in Annex reveals that during the pre-transition period 1982-89, the industrial sector was the greatest contributor to growth, with more modest contributions from agriculture and services. The contraction of 1990-92 was driven predominantly by a sharp contraction in the industrial sector. the shift in output composition away from the industrial sector

³ The GDP growth rates in Table 1 of the annex are from the *World Development Indicators* 2003, while the sectoral composition and sectoral growth rates are from the World Bank Live Database (LDB) for Albania. The LDB contains recent revisions to the national accounts, which suggest a sharper contraction of real GDP in 1997 and faster growth during 1998-01. Growth rates for other years are not affected. Since the recent revisions are still preliminary and the subject of a number of points of concern, we have used the WDI 2003 in most of our analysis. The recent revisions do, however, present a more accurate picture of the sectoral composition of GDP, which is why we have used the LDB numbers for this purpose in Table 1. Here and in our subsequent analysis, we have also used the real GDP growth rates and investment rates for 2002 and 2003 from the LDB to extend our real GDP and investment series to 2002 and 2003.

reflected a massive write-off of heavy industrial capital in cities like Elbasan and Skoder. In Elbasan alone, for example, 12,000 former industrial jobs disappeared, leaving behind a large industrial wasteland. This – and probably other employment changes linked to the ending of the collective farm system – created or perpetuated massive and sustained underemployment and unemployment in the country. During the subsequent recovery of 1993-96, out of an average annual GDP growth of 9.2 percent, the contribution of agriculture was 2.8 percent and the contribution of services was 4.8 percent. While construction was growing at very robust rates throughout this period, its still small size meant that its contribution to GDP growth was a modest 0.8 percent. In spite of its small size, construction accounted for half the contribution of the industrial sector to growth, which suggests that growth in manufacturing was negligible during this period.

The crisis of 1997 brought contractions in all three broad sectors of the economy. In the post-crisis period, out of an average annual GDP growth of 7.4 percent during 1998-2001, the contribution of construction was 1.4 percent and the contribution of services was 5.6 percent. The contributions of agriculture and manufacturing were negligible. During the two most recent years 2002-03, preliminary data suggest that the overall slowdown in growth has been associated with smaller contributions from construction and services, while the contributions of agriculture and manufacturing have increased slightly. While gaps and frequent changes in the national accounts make it very challenging to follow the sectoral contributions to growth over time in Albania, the numbers do indicate that construction and services have been significant contributors to growth throughout the post-transition period, while agriculture was a significant contributor during the initial 1993-96 period. Although manufacturing does not appear to have been a significant contributor to growth, as in other sectors, it is certainly possible that higher productivity activities *within* manufacturing have expanded and contributed to growth while lower productivity activities have contracted.

Tables A*1 and A*2 in the Annex provide a comparison of Albania's growth trajectory with those of other transition countries for the 1990-2002 period.⁴ Table 2 presents each country's real GDP for each year, relative to its real GDP in 1990 (real GDP in 1990 = 100). Depending on whether real GDP in 2002 is above or below real GDP in 1990, each transition country is placed in the "positive growth" or "negative growth" group. The comparison shows that Albania's cumulative growth of 24 percent since 1990 has been greater than that of any other transition economy, except for Poland and Slovenia where cumulative growth since 1990 has been 46.7 percent and 27.3 percent, respectively. Table A*2 presents additional information about the depth and duration of the initial decline in output and the strength of the subsequent recovery, for each country. Albania's initial decline in output was

⁴ All transition economies for which real GDP data was available for the entire 1990-2002 period were included in the comparison. That excluded Bosnia-Herzegovina, Serbia-Montenegro, and Azerbaijan.

deeper than that of any other transition economy. However, its initial decline was short in duration and its growth rate since initial recovery has been greater than that of any other transition country.⁵

Growth has also been fueled by remittances from migration and some illegal activities—which raises questions about its sustainability

While Albania's growth has been impressive—especially since 1998 (an average growth rate of 6.8 percent compared to 4.7 percent in the SEE region)—there are concerns about the sustainability of the high rates of economic growth in the future: Albanian growth has been fueled mainly by remittances (of an economically active population of 1.7 million, approximately 700,000 work outside the country, mainly in Greece) and a large, though difficult to quantify, injection of resources from informal and transnational activities. This stimulus has generated a domestic boom in non-tradable activities—principally construction and services.

Neither remittances⁶ nor earnings from illegal activities constitute a solid basis for long-term economic development. Furthermore, Albania's growth has so far relied heavily on agriculture—which employs around 50 percent of the labor force—, a sector whose contribution to GDP has declined over recent years. Finally, there are concerns about the financing of the country's investment needs over the medium-term. Albania's graduation from IDA eligibility in 2005, as well as expectations for dwindling external support and inflows from abroad present major risk factors that Albania needs to mitigate and adjust to with the help of the donor community.

Under the Stabilization and Accession Process, Albania is negotiating a Stabilization and Accession Agreement with the EU

Albania's long-term vision is to join the European Union (EU). The country's relationship with the EU is currently based on the Stabilization and Accession Process (SAP), which provides a framework for and the prospect of future membership to countries in the Balkans. While the SAP does not define an accession timetable, it constitutes a strong catalyst for reforms. Albania has benefited from the overall SAP cooperation framework, including preferential trade concessions, financial assistance, and the prospect of a far-reaching contractual relationship with the EU through a Stabilization and Association Agreement (SAA) which would replace the current Trade and Cooperation Agreement, in place since December 1, 1992. Negotiations for an SAA started in January 2003. Their duration and outcome will depend on the progress made by the Albanian authorities in the implementation of key reforms outlined in the Partnership Agreement and assessed every year in the EC's Annual Report.

⁵ The FSU economies all experienced deeper and longer declines compared to most ECE countries and only two FSU countries—Turkmenistan and Uzbekistan—had exceeded their 1990 real GDP by 2002.

⁶ As noted by Levy (2003), "One limitation is that, given the current magnitudes, the scope for continuing growth in the number of Albanians employed outside the country is limited. A second limitation is the worldwide empirical pattern that over time temporary migrants tend to settle in their host countries, and remittances decline. A third limitation is that the most determined and entrepreneurial tend to migrate, depriving a society of a key source of dynamism." For a recent review of the literature on remittances, and a unified framework for analyzing their impact on economic growth, see Chami et al. (2003).

***Recent Progress
towards the SAA has
been slow***

According to the EC, reform in Albania over the past 12 months has been limited. The 2004 Annual Report notes that “despite progress made during SAA negotiations in discussing the text of the future agreement, many of the reforms necessary to guarantee its proper implementation have not been carried out. Of particular concern are those issues central to the rule of law. These include the fight against organized crime and corruption, and the functioning of the judicial system. Albania deserves credit for a number of initiatives, including its general constructive role in the region, the reduction of smuggling and trafficking in human beings over the Adriatic and Ionian Seas and the initialing of a Community Readmission Agreement. But results have fallen short of expectations in the key areas of organized crime, corruption, judicial system and public administration reform.”

This report⁷ has the following aims: (i) to provide a brief panorama of Albania’s economic performance since 1991, focusing on the impact of the results of the stabilization program and other structural reforms carried out during the first decade of transition; (ii) to understand the key determinants of growth; (iii) to identify the underlying constraints facing the Albanian economy; and to discuss the medium-term policy agenda.

The remainder of the report is organized as follows. Chapter 2 explains the sources of the remarkable growth during the last decade. It also explore prospects and constraints to growth. Chapter 3 analyzes the potential of trade and integration. Chapter 4 examines the role of migration and remittances. Chapter 5 analyzes the challenges of mobilizing labor resources. Chapter 6 stresses the need to remove public infrastructure bottlenecks to growth. Chapter 7 discusses the governance and institutional framework. Chapter 8 presents the macroeconomic framework for growth. Chapter 9 provides concluding remarks.

⁷ This CEM is based on a larger study to be released as *Background Papers*.

CHAPTER 2: SOURCES, PROSPECTS AND CONSTRAINTS TO GROWTH

Albania's transition from a communist system into a market economy has been so far a rather successful one, although the country is still one of the poorest in Europe. This chapter presents the macroeconomic picture and discusses the sources, prospects, and constraints to growth.

1. Background: A Short Story of Transition

(i) Macroeconomic Stabilization

The country began market economic reforms from an extremely centralized economic system. As elsewhere in Eastern Europe, a significant decline in production characterized the initial phase of transition. As a result, the country's macroeconomic situation worsened (see Table 2). Output declined by about 50 percent from the end of 1990 to mid-1992.⁸ External debt quickly rose to 30 percent of GDP. Foreign exchange reserves were almost completely exhausted. The budget deficit reached 44 percent of GDP by the end of 1991 and widened to more than 50 percent in the first half of 1992. Monetary expansion was found to be an easy way to finance the large budget deficit, and the money supply doubled. At the beginning of 1992, broad money reached a record 69 percent of GDP, while pressure for wage increases intensified. At the end of 1991, inflation was at three-digit levels with a 104.1 percent change from the previous year, and by early 1992, monthly inflation was 10 percent to 15 percent.

Sound macroeconomic policies have provided a good environment for strong growth

These difficult initial conditions quickly changed after Albania implemented a series of successful stabilization programs. Each one had its own characteristics although in general their goals were similar: low inflation and stable prices, sustainable growth and lower budget deficits, improvement in the external position, and financial sector reform. The first stabilization measures in Albania began with a one-year reform program from mid-1992 to mid-1993 that introduced fiscal and monetary control combined with a comprehensive price and exchange system. The program was supported by international financial institutions, including a *stand-by* arrangement with the IMF. Initial efforts were mostly aimed at stabilizing the deep macroeconomic imbalances, and had a strong "monetarist" component.

The reduction of inflation to below 20 percent was a key objective. Money growth was designed to be the principal nominal anchor of the program, supported by a fiscal policy that had as a central objective the elimination of the huge monetary deficit financing by the end of the program period. In addition, incomes policy through controlling the wages at the state-owned sector of economy remained an important second anchor, giving this program a heterodox character. The one-year

⁸ Macroeconomic data from 1990 to 1992 are from "Albania," *IMF Economic Review* 5 (1994).

emergency program paved the way for a deeper reform program aiming at liberalizing the economy liberalization. Its success had a significant psychological effect. Although some reforms were difficult, Albania overcame the huge food shortages filling the shelves with basic needs for its citizens.

Table 2: Main Economic Indicators, 1990-2002

INDICATORS/YEARS	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
GDP														
in current prices, in mil lek	16,813	16,404	50,697	125,334	184,393	229,793	314,878	333,071	412,326	474,291	530,906	610,417	677,674	746,318
% change in constant prices	-10.0	-28.0	-7.2	9.6	8.3	13.3	9.1	-7.0	12.7	10.1	7.3	7.6	4.7	6.0
GDP per capita, in USD			211.0	381.5	610.8	737.8	808.0	684.0	906.5	1080.9	1184	1337	1555	1938
Inflation														
average		35.5	226	85.0	22.6	7.8	12.7	42.0	20.9	0.4	0.0	3.1	5.2	2.4
end period		104.1	226.6	30.9	15.8	6	17.4	42.1	8.7	-1.0	4.2	3.5	1.7	3.2
Fiscal deficit (excluding grants)														
in % of GDP	-6.1	-20.7	-58.6	-13.7	-9.0	-10.2	-12.8	-13.1	-12	-12.2	-9.2	-8.2	-6.7	-4.5
Trade Balance (goods only)														
in million USD		-308	-470.5	-489.9	-459.7	-475.0	-678.3	-519	-621	-846	-821	-1027	-1155	-1336
Current Account Balance														
in million US\$(exc. off. tran.)		-213	-50.8	-14.7	-31.2	-26.6	-62.4	-253.7	-195	-272	-274	-263	-435	-469
remittances, in mil USD		8	148	230	377.9	384.6	499.6	266.9	452.3	368.1	439	543	597	782
Foreign Direct Investment														
in million USD			32	58.0	52.9	70.0	90.1	47.5	45	41.2	143.0	204	135	178
Unemployment														
in % of total labor force		9.1	26.5	21.7	19.5	12.4	12.4	14.9	17.8	18.4	16.8	16.4	15.8	15

Sources: Albanian authorities, INSTAT, Bank of Albania, IMF and WB publications.

An Enhanced Structural Adjustment Facility (ESAF) program concluded with the IMF was introduced in July 1993. It focused on the stabilization of the economy, and initiated price and trade liberalization and the privatization and restructuring of state enterprises. The primary goals included: decreasing the budget deficit and applying a hard budget constraint; reducing and monitoring inflation through strict control of money growth and a tight credit policy; maintaining a restrictive income policy; reducing the foreign debt; introducing a floating exchange regime and maintaining domestic convertibility of the Lek; creating a two-tier banking system and a system of non-bank institutions; and initiating a legal framework to establish a market economy.

Under the program, monetary policy was based on direct instruments of monetary control. This decision was dictated by the poor state of the banking system, the external debt situation and the need to finance the large budget deficit. Another key component of the monetary policy was the introduction in 1992 of a flexible exchange rate policy. Under this regime, the exchange rate was allowed to float freely, with occasional intervention to prevent large fluctuations. The main reason for implementing a flexible regime was the lack of foreign exchange reserves. After substantial, though gradual, depreciation in 1991-92 the exchange rate remained relatively stable with an appreciation at the end-1993, and mid-1994 and a slight change in the first months of 1995. By the end of 1995 and during the first months of 1996 a slight depreciation of domestic currency occurred. Central bank interventions had a significant influence on the operation of the market, especially in the parallel market.

Fiscal deficit reduction was a key

One of the most important targets of the stabilization program in Albania was the reduction of the fiscal deficit and the gradual alignment

feature of the initial stabilization program

of revenues and expenditures in the budget. The dramatic worsening of the fiscal position in 1991, when the cash deficit reached almost 60 percent of GDP, was the result of the sharp decline in output, the increases in wages and social protection, the soft budget constraint on firms and the weakness of financial discipline. During the first half of 1992 this large deficit was financed totally by the domestic banking system. Only by the end of 1992, after the short-term program began applying austerity measures, did signs of improvement appear. In 1993 the deficit decreased again, reaching around 16 percent of GDP. The new tax system, introduced gradually from 1991 to 1993, started to yield positive results. The elimination of enterprise subsidies also had a positive impact on stabilization efforts.

After the 1993-95 recovery, growth resumed but was halted by the 1997 Pyramid scheme crisis and its sociopolitical consequences

During 1993-95, Albania's macroeconomic situation improved markedly: the country grew by an average of 9 percent in real terms while inflation fell to single digits and external imbalances were reduced. However, in 1996, the positive macroeconomic trend was reversed as a result of increased political tension in the country and rising expenditure prior to the May 1996 general elections. At the same time, there was a sharp decline in revenue collection. Macroeconomic policies weakened as the domestically financed deficit increased by over 4 percentage points to almost 11 percent of GDP in end-1996, and inflation tripled to more than 17 percent.

The 1997 crisis of pyramid schemes⁹ and the 1999 Kosovo war negatively affected progress in the implementation of the stabilization program. Rioting and civil unrest intensified to near civil war, with the government losing control of large sections of the country. "State institutions ceased to function, and economic activity came to a virtual standstill. Disruptions reduced supply, especially in industry and construction, while the loss of savings in the failed schemes depressed demand. The Lek depreciated by more than 40 percent during the first half of the year 1997, as remittances from abroad declined markedly, foreign aid virtually ceased, and international trade slowed significantly." (Jarvis 1999).

The 1997 crisis led to a sharp depreciation of the Lek and serious fiscal imbalances

As a result, the Lek depreciated by more than 40 percent in 1997 as remittances declined, international trade slowed, and foreign aid was abruptly diminished. Albania experienced serious external imbalances and inflation rose again to 42 percent at the end of 1997 on a year-on-year basis, reflecting the large depreciation of the national currency. At the same time, the decrease in output and the tense political situation caused a drop in tax collection, aggravating the already high fiscal deficit. These problems were made worse by the fact that the authorities initially financed the budget deficit mostly through domestic borrowing, pushing domestic debt to reach unprecedented levels and creating a new

⁹ Pyramid schemes were companies that claimed to be engaged in profitable investments, and that attracted large volumes of funds from private depositors with the promise of very high returns. In fact, the funds were rarely used for solid investments, but served to pay interest on existing debt or for fraudulent transfers abroad. The slow progress in banking sector reform compounded the problem. See Jarvis (1999).

long-term fiscal problem, that of the burden of interest rates.

An ambitious stabilization program was adopted in 1998

With assistance from the international community, the Albanian Government eventually confronted the crisis through a new stabilization program launched in 1998. The program aimed at restoring macroeconomic stabilization, strengthening administrative capacity, and restarting structural reforms. While fiscal policy struck a balance with the need to bring the budget deficit under control, monetary policy sought to create a stable price environment.

The government has brought down its deficit at an average of 2 percent of GDP annually from 1999 to 2003

Fiscal policy focused more on the improvement of the revenue side of the budget, in contrast to the emphasis on expenditure reduction in the previous program. Gradual fiscal consolidation was evident with the decline of the budget deficit from -13 percent of GDP in 1997 to -4.5 percent in 2003 (see Figure 2). This reduction in the deficit was facilitated by the efforts to improve revenue collection as well as the decision to accelerate the privatization program and to end subsidies and soft loans to state-owned companies (with the exception of a few companies like KESH). During the same period, domestic borrowing was also significantly reduced.

Figure 2: Fiscal Consolidation, 1997-2003

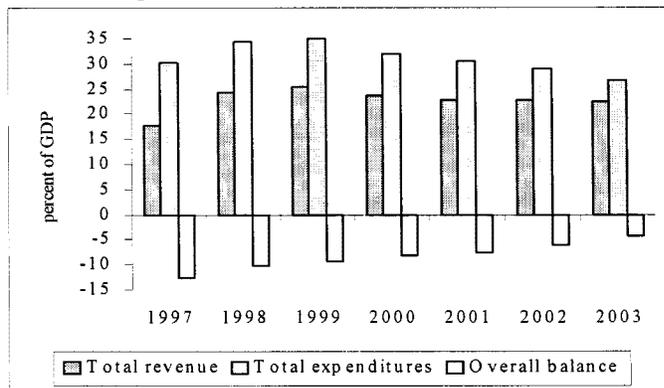
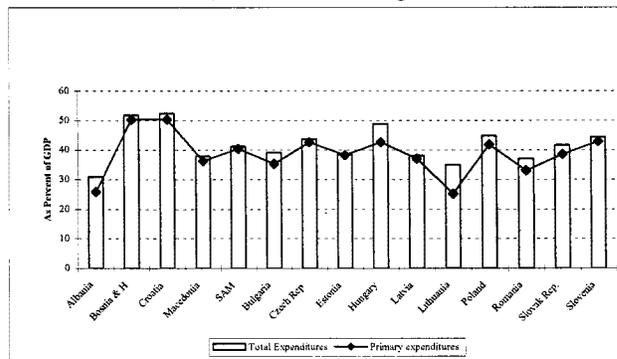


Figure 3: Size of the Central Government (1999-2002 average)



The size of government is

Albania's general government expenditure was reduced from 34 to 29 percent of GDP in 1999-2002, making it significantly smaller than that

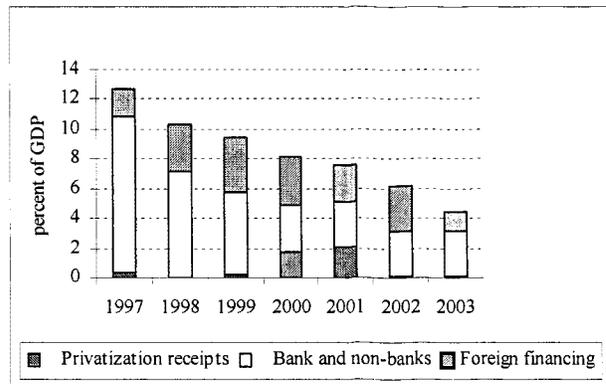
relatively small and the level of public debt is still manageable

for the other countries in the region. It is about 10-15 points less than the levels in its neighboring countries (Figure 3). Taking into account Albania's substantial interest payments, primary expenditures have been kept at even lower levels than that recorded in other SEE and CEE countries. Likewise, the level of public debt in Albania has been contained, from 69 percent of GDP in 1997 to 62 percent in 2003.

Deficit financing has shifted from domestic borrowing to a more balanced combination

Since the 1997 crisis, Albania's fiscal deficit has been financed through both foreign and domestic sources. On an average, foreign donors financed about 45 percent of the deficit. Domestic banking and non-banking institutions financed another 45 percent, while privatization receipts covered 10 percent (Figure 4).

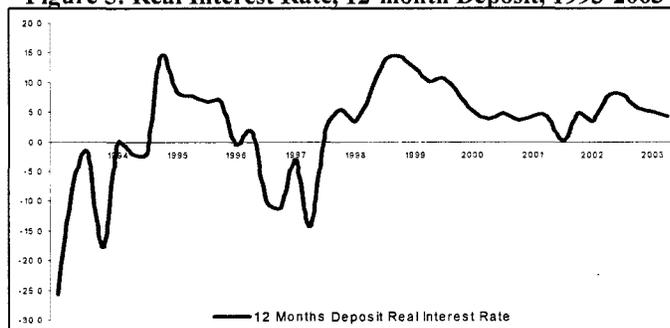
Figure 4: How the Budget Deficit Has Been Financed, 1997-2003



Interest rates have been the main channel used in monetary policy, although through direct control instruments from 1992 to 2000

Monetary policy has been tight since 1997, as evidenced by high real interest rates which stabilized the exchange rate by creating a high demand for Lek assets and facilitated a trend reduction in the velocity of money consistent with low inflation. Four policy instruments were identified by the Bank of Albania as channels to affect the real economy: interest rates; the exchange rate; the volume of credit; and inflation expectations. While none of these channels seems to be a fully effective tool for monetary control in Albania, changes in their nominal value have been effectively translated into positive monetary developments since 1997.

Figure 5: Real Interest Rate, 12-month Deposit, 1993-2003



Real interest rates have been positive over the past decade

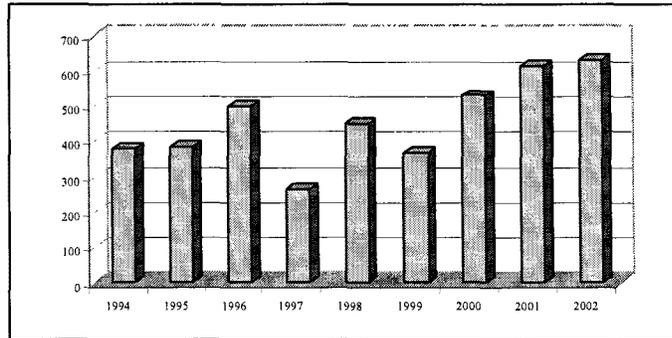
Throughout the first decade of transition, control of interest rates was a key feature of the stabilization programs. The Bank of Albania has consistently used interest rates as an intermediate target to achieve its inflation goal. Real interest rates turned positive in the first quarter of 1993 when inflation declined, but they remained under central bank control until the banking system began consolidating and monetary policy moved gradually towards the use of indirect instruments¹⁰. The tight monetary policy created a high demand for Lek assets, facilitated the reduction in the velocity of money, and stabilized the exchange rate.

The rapid success of the stabilization program contributed to restoring confidence in the Albanian economy. This brought substantial remittances (over US\$ 400 million on average in 1992-2002) and other private transfers which compensated for the insufficient lending by the banking system and fueled strong growth. In 2002, officially registered remittances amounted to US\$ 632 million (about 15 percent of GDP) but true figures are even higher, as many transactions are made in cash. Despite a declining trend, donor support has averaged over 4 percent of GDP since 1997, funding mostly infrastructures and helping to reduce domestic borrowing.

¹⁰ The Bank of Albania started to eliminate direct control over interest rates in early 2000. Within a year, the three controlled interest rates on 3 month, 6 month and 12 month deposits were replaced with indirect instruments of monetary policy.

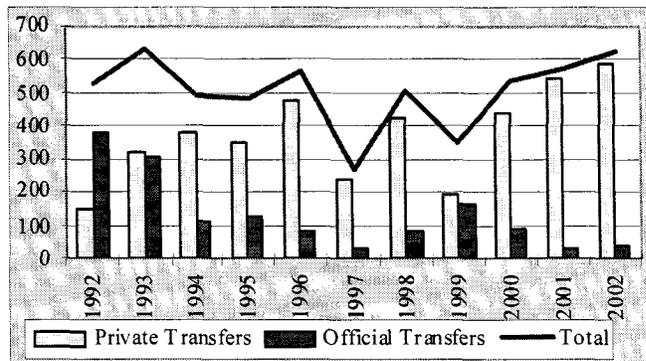
High volumes of remittances have contributed to the financing of the trade deficit

Figure 6: Remittances, in Millions of US Dollars, 1994-2002



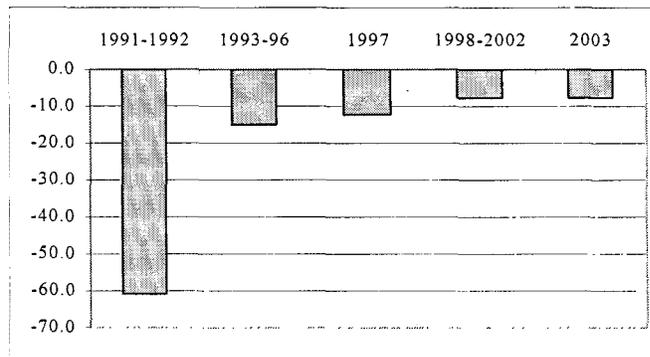
The capital account has been dominated by non-debt creating and concessional financing

Figure 7: External Transfers, in Millions of Leks, 1992-2002



Given Albania's low domestic savings, the continuous remittances, the non-debt creating external financing (official transfers, grants, and concessional loans, all averaging 4-5 percent of GDP), and the foreign direct investment (amounting to 2-3 percent of GDP) have been important factors in strengthening the balance of payments. While the sustainability of these forms of financing is uncertain, Albania has reduced its current account deficit from 61 percent of GDP in 1991-92 to 7.6 percent in 2003 (Figure 8).

Figure 8: Current Account Deficit, 1991-2003 (percent of GDP)



(ii) Structural Reforms

Privatization of strategic and small and medium-size enterprises has proceeded well and contributed to growth

Structural reforms have advanced significantly since the late 1990s. In the three years following the launching of structural reforms (1993-96), the Albanian economy grew at around 9 percent annually. This was largely the result of the broad dismantling of price and trade controls, the privatization and distribution of agricultural land, and the privatization of agricultural retail and small enterprises. Immediately after the 1997 collapse, a new banking law was passed and a privatization strategy was developed. Since then, trade has been liberalized, the privatization of small and medium enterprises has been completed, and there are only a few enterprises in the services sector that need to be privatized.

Sound financial sector reform has boosted confidence in the economy

In addition, the authorities pursued a financial sector policy designed to strengthen, and increase confidence in, the banking sector. This included limiting the growth of intermediation by preventing lending (and the potential creation of high levels of non-performing loans) by the Savings Bank, which accounted for more than 50 percent of the banking sector, until it was privatized in 2003. More recently, lending to the private sector has been increasing at a healthy rate, with a low level of non-performing loans (credit to the economy for the first six months of 2004 was 7.4 percent, compared to 6.8 percent in 2003).

Going forward, intermediation is expected to expand more rapidly, with the privatization of the Savings Bank and the lifting of the seven-year moratorium on its lending activities. Other major banks are also expected to pursue more aggressive lending activities and new product development. In addition to the banks, lending through microfinance institutions and 130 Savings and Credit Associations is effective in serving those segments of the population that do not have easy access to bank financing. Albania now boasts a healthy, 100 percent privately owned, competitive banking sector poised to provide improved services to businesses and households.

In parallel with these developments, the Bank of Albania has pursued significant structural reforms aimed at consolidating the financial sector. It has substantially strengthened its supervisory capacity through the implementation of a more risk-based supervision process. A Deposit Insurance Agency has been established and is functioning properly. Substantial progress has been made in improving the payments system. The new interbank settlement system for large payments has been fully operational since January 2004 and the fully automated bulk clearing system is expected to be completed by mid-2005. In addition, efforts are under way to strengthen the legal framework on insolvency and bankruptcy procedures. A collateral registry for movable property has been functioning well for over three years.

The successful involvement of the private sector in the

Albania has also made progress in privatizing and deregulating transport operations. Inter-city road freight and passenger transport has been successfully privatized. The pilot privatization of 40 percent of the

transport sector has benefited the country

Urban Transport Enterprise (Tirana) took place in 1996. The development of the road transport industry has followed EU recommendations. Road transport is now regulated by a Road Code which established a General Directorate of Transport Services responsible for technical control and vehicle inspection, licensing, driver qualifications and vehicle registrations. This form of organization has improved vehicle inspections and road safety and has improved the collection of circulation and registration taxes. Albania is a member of an international freight transporters association, ANALTIR. Albania has also adopted a Railway Law based on European practice. Albanian Railways is a limited liability company operating under the Ministry of Transport, Telecommunications and Post (MTT), and has separated out a number of non-core activities. A Port Law was passed in 1993 which transforms Durres Port into a quasi-Landlord Port, although further improvements are needed to permit the Port of Durres Authority (PDA) to operate as an independent company, to grant larger operating concessions, and to establish its own tariff structure. Two quasi-private stevedoring companies have been established, although further work is required to establish their commercial independence. Separate organizations have been established to administer civil aviation, control air traffic and manage Rinas Airport under the overall authority of MTT. There are two private airlines. Albania is a member of ICAO and other civil aviation organizations.

While the privatization process has been slower than anticipated in some cases (Albtelekom and the oil companies), Albania compares favorably with most countries in the Balkans in terms of overall progress on structural reforms (see Table 3).

Table 3: Progress on Structural Reforms-2003

	Enterprises			Markets Trade			Financial institutions		Infrastructure
	Large scale privatization	small scale privatization	Governance and enterprise restructuring	Price liberalisation	trade and Foreign Exchange system	Competition Policy	banking reform and interest rate liberalisation	securities market and non-bank financial institutions	infrastructure reform
Albania	2+	4	2	4-	4+	2-	2+	2-	2
BH	2+	3	2	4	4-	1	2+	2-	2+
Bulgaria	4-	4-	3-	4+	4+	2+	3+	2+	3-
Croatia	3+	4+	3-	4	4+	2+	4-	3-	3-
FYR Macedonia	3	4	2+	4	4+	2	3	2-	2
Moldova	3	3+	2-	4-	4+	2	2+	2	2
Romania	3+	4-	2	4+	4	2+	3-	2	3
SAM	2+	3	2	4	3+	1	2+	2	2

Source: EBRD, Transition Report 2003

Note: These indicators reflect a qualitative classification based on policy measures taken, institutional development, and performance. A rating of 4+ indicates performance comparable to advanced industrial economies

Land reform has transformed farming and contributed to the development of a market economy

Albania has perhaps moved further than any other country in the region to introduce sweeping land reforms as a necessary precursor to the development of land markets.¹¹ As a result of this reform, the rural landscape has been dramatically transformed since 1990 with all collective farms disbanded, and approximately 98 percent of agricultural land (546,000 ha) distributed to smallholders. This has

¹¹ See World Bank (2002), Albania: Rural Development Strategy.

transformed farming from a collectivized, command structure to a fully private sector with smallholder families farming small and fragmented plots for their own consumption and the market. Pasture land and forests have mostly not been part of the privatization process. Only recently has state ownership been transferred to communities and private persons.¹²

Key elements of the land reform have included: (i) the development of a comprehensive legal and regulatory framework for land administration and land market development; (ii) the establishment of an Immovable Property Registration System (IPRS) for real property titling and registration; and (iii) a comprehensive, donor-supported program to provide first time registration to new land owners. To date, 29 laws and regulations regarding the administration of real property have been passed in Albania. The legislation currently in place provides an adequate legal and regulatory framework to support a functioning land market. A systematic process of first time registration is proceeding. About 55 percent of distributed rural land, or about 1.6 million rural land parcels, have been surveyed, mapped, titled, and registered.

Trade-related distortions have been substantially removed and spurred exports

Having formally abolished state monopoly over foreign trade, a distinctive feature of central planning, Albania has consistently pursued the policy of multilateral liberalization. In 1993, it initiated the procedures required to accede to the WTO and submitted a Memorandum on the Foreign Trade Regime in January 1995. On September 8, 2000, it became a member of the WTO and therefore committed itself to the observance of a variety of multilateral disciplines embodied in GATT/WTO Agreements. Although the status of an economy in transition allows for longer transitional periods for their full implementation, Albania's commitments have already been quite extensive.

External tariffs have decreased steadily

The maximum tariff rate has declined from 30 percent in 1991 to 10 percent at its current level, while the average rate has come down from 19 percent to 7.2 percent. Albania has four bound rates, of 0, 2, 5 and 10 percent. The policy environment for the agriculture sector is characterized as relatively distortion-free with no price controls, limited subsidies and a liberal trade policy. *Tariffs for agricultural inputs, which are so important for production, are low.* In agriculture, a differentiated tariff system is in place, with minimal tariffs for agricultural inputs: in 2001 applied tariffs for selected seed, biological material, livestock genetic material, agro-business inputs, fisheries inputs and agricultural mechanization were only 2 percent. At the time of WTO accession, the top tariff rate (of 20 percent) applied to 38 percent of all agricultural products.

¹² Although land reform is considered fairly well advanced, large portions of agricultural land are either refused or abandoned—which decreases the land share per household and constraint agricultural development. This is the case notably in the Shkodra region, where the average land share per household is about 1.3 ha. In fact, because about 29% of the land there is either refused or abandoned, the average land share per household is actually smaller than 1.3 ha. See HDPC (2004).

The Stabilization and Association Process could foster EU accession prospects

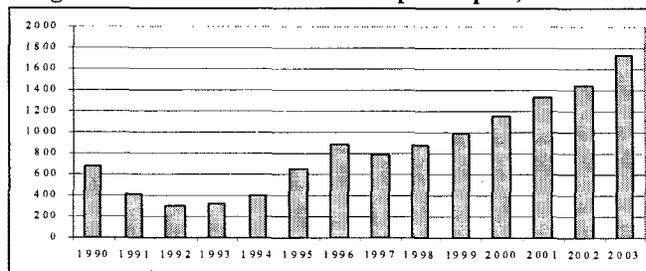
Albania's external policy environment has dramatically changed over the last four years, which has created new opportunities. Participation in the Stabilization and Association Process (SAP), launched by the EU in the aftermath of the Kosovo war in 1999, has introduced a regional dimension to Albania's foreign trade policy. In exchange for EU assistance, the prospect of EU accession, and the continuation of preferential access to EU markets, Albania and the with SEE-5 governments have to upgrade their institutions and governance to European standards and engage in mutual regional cooperation including other Stability Pact member-countries. The SAP seeks to reduce the complexity of the current commercial logistics through promoting simplification and greater transparency in customs procedures and free trade among SEE-8 countries as well as between them and the EU. By the end of 2004 Albania will have FTAs in effect with all SEE-8 economies. As for its most important trading partner, the EU, Albanian GSP status was transformed to that of Autonomous Trade Preferences (ATPs) in October 2000, and negotiations on the Stabilization and Association Agreement were launched in early 2003.

2. What is Driving Albania's Growth Performance?

(i) Growth from the Demand Side and Sectoral Contribution

Albania has developed new sources of growth on both the supply and demand sides, and underwent a large structural transformation that led to the reallocation of resources from low-productivity to high-productivity sectors.

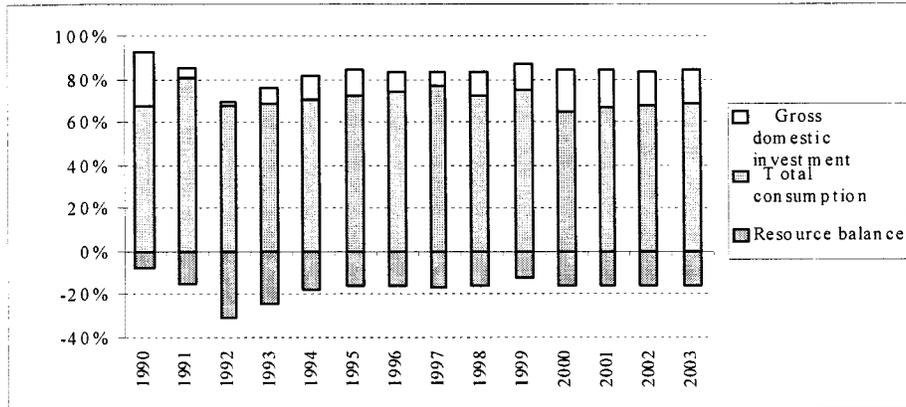
Figure 9: Gross National Income per Capita, 1990-2003



The economy has undergone some major structural transformations during the first decade of transition

GDP composition by expenditures changed during the early 1990s: domestic absorption (public and private consumption, and investment) initially increased rapidly with the liberalization of the economy, in parallel with an increasingly negative contribution of net exports to growth. But since the mid-1990s, thanks to fiscal consolidation, the rate of increase in domestic absorption has been curtailed (Figure 10)

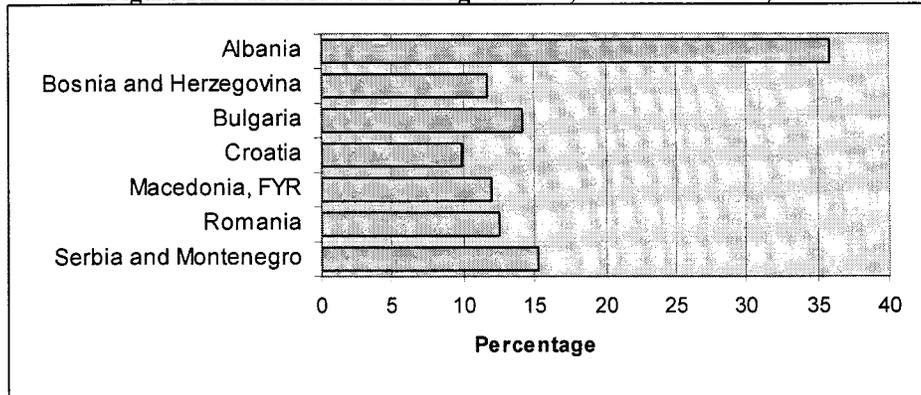
Figure 10: GDP Composition, by Expenditures, 1990-2003



The sectoral composition of GDP has changed dramatically, although agriculture remains the key contributor to growth

Albania stands out among Western Balkan countries as a largely agricultural economy with 57 percent of the population living in rural areas and 26 percent of its output produced by this sector. While the percentage of urban population is comparable with that of Bosnia and Herzegovina, the share of agriculture in the GDP is by far the largest. The application of new calculation methods to assess the contribution to GDP of various sectors resulted in a decline of the value-added from agriculture in 1999. Nevertheless, the sector still plays a much larger role in the Albanian economy than it does in any other European country, including its neighbors in South East Europe (SEE), with about one-third of GDP coming from agricultural production (Figure 11).

Figure 11: Value Added from Agriculture, as Share of GDP, 2000



Source: WDI

After the expected early slumps in production related to the turmoil of the post-communist years, the agricultural sector has experienced a

The agricultural sector—which is characterized by low average land share per household, subsistence farm production, low market access due to poor road infrastructure, limited use of agricultural inputs, and weak processing capacity—virtually imploded after the fall of communism with state control and subsidies shrinking dramatically. This led to the abandonment and destruction of irrigation systems, the fall in input availability and the almost complete collapse of marketing

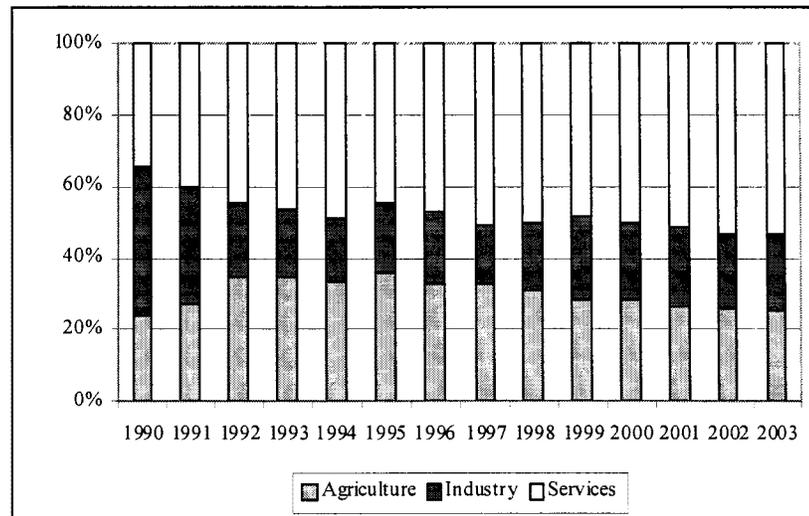
prolonged period of steady expansion

and agro-processing.¹³ Liberalization policies led to the rapid break-up of 550 state and collective farms, and the privatization of 94 percent of farmland by 1994, and over 460,000 privately owned farms by 1996. Although this may have hampered productivity increases, allotting small land parcels did provide an important form of social security to the rural population and may well have averted the famine that threatened in 1992. In the meantime, almost half of the landowners do not sell produce on the market,¹⁴ and many use their farms for subsistence or have let the land lie fallow.

The agricultural sector in Albania provides the income basis for almost half of the Albanian population and serves as an employment safety net for an even larger share. After the expected early slumps in production related to the turmoil of the early post-communist years, the Albanian agriculture sector has experienced a prolonged period of steady expansion. Growth rates have been among the highest in Europe in fact, even as the sector's share in total GDP has declined in recent years (Figure 12).

Despite a decline, the agricultural sector still contributes substantially to GDP

Figure 12: Sectoral Contribution of GDP, 1990-2003



The relative contributions of industrial field crops and agro-processing have changed

The agriculture sector has seen dramatic changes as production patterns have shifted. Steep declines in industrial field crops (rice, cotton, wheat, tobacco) have been balanced by increases in livestock and associated forage crop production. Agro-processing (olive oil, flour milling) and horticulture (olives, fruit production) have also witnessed significant increases. A brief look at some key product categories demonstrates the type of changes taking place in the agriculture and agro-business sectors.

Table 4: Agricultural Production, 1993-2003—Field Crops (thousand tons)

¹³ World Bank, 2003, Albania Poverty Assessment.

¹⁴ Ninka, Eniel and Collana Appunti. 2003. "Social and Economic Development in Transitional Countries. Territorial Differences in Albanian Districts."

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Cereals	665	646	645.35	503.7	602	602.8	498	565.8	502.5	518.9	488.5
Vegetab & melon	580	590	685	785	572.3	604.6	610.4	620	651	668.5	675
Potatoes	101	89	134	132	126.7	145	161.9	161	163.7	163.1	158.2
white beans	23	18	25	25	20	22.7	26	25.2	22.1	24.5	17.8
Tobacco	13	3.8	5.7	6.3	7.9	7.4	7.3	6.2	4.1	2.6	1.4
Sunflower	2	1	1.6	1.5	2.2	2.6	2.7	2.9	2.7	2.6	1.3
Sugar - beets	27	60	67	74	50.9	55.7	39.9	42	38.5	39.2	-
Soybean	1	0.1	0.2	0.3	0.2	0.1	1.2	0.6	0.8	0.4	0.5
Forages	3 237	3 800	3 800	3 970	3 672	3 844	4 494	4 730	4 750	4716	4986

Source: INSTAT--Statistical Yearbook for Agriculture, 2003

While the production of industrial crops has declined, the production of fruit and vegetable production is expanding. Table 4 shows the cereal and tobacco production decline over the period, even while potato production has increased by 60 percent, and vegetables and melons by 12 percent. Tomatoes, cucumbers and salad greens have also seen significant growth. A large number of greenhouses have been erected in recent years.¹⁵

Livestock and agro-processing have been on the rise

Livestock now accounts for half of all agricultural production. As seen in Table 5, livestock production is considerably more significant now than it was in the pre-transition period. As a proportion of total agricultural production it increased from 31 percent in 1989¹⁶ to approximately half of the total sector output at present. Most rural households own one to three cows. Significant increases in beehives and poultry, which lead the growth in the sub-sector, are apparent.

Table 5: Livestock, 1998-2003 (thousands)

	1998	1999	2000	2001	2002	2003
Cattle	705	720	728	708	690	684
Sheep	1872	1941	1939	1906	1844	1903
Goats	1051	1120	1104	1027	929	1015
Pigs	83	81	103	106	114	132
Equidae	221	215	204	194	181	170
Poultry	4862	5023	5291	5422	5826	6104
Beehives	57	67	76	82	92	111

Agro-processing is experiencing dynamic growth. The agro-processing sector has been growing more rapidly than the agriculture sector as a whole, by an average of 9 percent over the past three years. There are 1,972 firms operating in the agro-processing sector, of which about 87.6 percent have less than 5 employees. In 2002, bread and related products made up 37 percent of the total production, followed by flour milling (14 percent), milk products (12 percent), and meat products (7 percent). The largest increases over the previous year were in fish processing (87 percent), olive oil production (76 percent), alcoholic beverages (51 percent) and meat production (42 percent).

The outdated industrial sector

Albania did not have to deal with the legacy of outdated industrial structures to the same extent as other SEE-8 economies. On the eve of

¹⁵ Keyser, John C. 2004. "Phase I Synthesis Report. Regional Comparative Advantage Analysis."

¹⁶ Development Alternatives International/USAID. 2003. "Economic Assessment of Investment Potential in the Albanian Agriculture Sector."

suffered the most from the fall of communism

the collapse of communism, the country was the least developed economy in Europe. Its small industrial base, further devastated during the turmoil accompanying the collapse of a communist regime in 1990-92 and during the 1997 uproar over the collapse of a pyramid savings scheme, contrasted sharply with those of the more highly developed economies of the former Yugoslav republics or former CMEA members—Bulgaria and Romania. While the latter still face the task of restructuring inherited industrial capacities, Albania has been largely spared from this particular burden of conversion and industrial restructuring.¹⁷ The private sector share of 75 percent in 2002 puts Albania at the top of SEE economies including both Bulgaria (70 percent) and Romania (65 percent) and well above FYROM (60 percent) and Bosnia and Herzegovina (45 percent) (EBRD 2002).

Construction and services have compensated for the decline in manufacturing

Transportation, construction, and services have also contributed substantially to growth over recent years, compensating for the declining share of manufacturing. After a 30 percent decline in 1992, construction averaged an annual growth rate of almost 18 percent between 1992 and 2003 (Table 6). Moreover, some construction activities are under-reported, or even occur in the informal sector—which suggests that their contribution to GDP is still underestimated. Services have averaged 8 percent of the annual growth rate during the same period, while industry averaged only 3.6 percent.

Table 6: Sectoral Composition of GDP, 1990-2003

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
% of GDP														
Agriculture	23.2	26.4	33.7	34.0	33.7	35.0	33.0	32.7	31.1	28.8	28.0	26.7	26.1	25.3
Industry	39.3	32.4	20.5	19.2	18.4	19.0	20.2	16.4	18.8	23.2	21.7	21.5	21.0	20.8
Construction	2.8	2.7	3.1	3.7	3.8	4.3	4.7	4.6	4.9	5.3	6.8	9.0	9.2	9.4
Manufacturing							14.4	11.8	13.9	16.6	15.5	15.3	14.7	
Services	32.8	38.8	43.7	46.0	49.1	43.4	46.8	50.9	50.1	48.0	50.3	51.8	53.0	53.9
% annual growth rate														
GDP	-9.6	-27.5	-7.2	9.6	9.4	8.9	9.1	-7.0	7.9	7.3	7.8	6.5	4.7	6.0
Agriculture	3.6	-17.4	18.5	10.4	8.3	13.2	3.0	-9.7	4.9	0.4	4.5	3.0	2.3	3.0
Industry	-6.0	-40.2	-41.3	2.5	4.7	12.6	15.9	-25.8	26.1	34.2	0.5	7.2	2.0	5.0
Construction		-29.9	7.0	30.0	15.0	21.2	18.4	-10.5	18.0	17.8	37.2	43.9	7.1	8.5
Manufacturing								-25.1	29.5	29.6	0.7	6.5	0.3	
Services	-35.2	-14.1	4.4	15.5	16.6	-3.8	17.8	-0.6	8.1	4.3	12.7	11.1	7.1	7.9

Source: WDI 2003 for GDP growth rates. Albania Live Database for sectoral composition and sectoral growth rates

Informal activities—some of them illegal—also explain Albania's strong growth performance during the past decade. Information from the banking system indicates that the volume of illegal U.S. currency circulating in Albania (US\$2.4 billion) is almost as large as the US\$3 billion equivalent of Albanian currency. A forthcoming World Bank report also points out that Albania is a major route for human trafficking in SEE. At least 1,200 Albanian minors were identified as trafficked to Italy and Greece for purposes of begging and forced labor

¹⁷ Albania had 76 large enterprises (more than 250 employees) in 2000, as compared with 194 in FYR Macedonia and 1,032 in Serbia and Montenegro. EBRD Survey of National Authorities quoted in Falcetti et al. 2003.

between 2000 and 2003.¹⁸

(ii) Growth from the factor side

Total factor productivity has been the main engine of growth

On the factor side, economic growth in Albania during transition has been driven primarily by the high rates of total factor productivity (TFP) growth (i.e., by the improved allocation of resources), although the TFP growth rate has slowed significantly in recent years. The growth accounting methodology makes it possible to decompose the observed growth of real GDP into the contributions of factor accumulation (i.e., the contributions from growth in the capital stock and labor force) and total factor productivity (TFP) growth.¹⁹

We develop a growth accounting framework for Albania (see vol. 2) for the period 1982-2003. The results are presented in Table 5. We present the results for several sub-periods: the pre-transition period of 1982-89, the contraction period of 1990-92, and the recovery period of 1993-2003. We further divide the recovery period into three separate episodes of growth: 1993-96, 1998-2001, and 2002-03.

**Table 7: Albania Growth Accounting Results I
(without adjustment for permanent scrapping of significant part of communist capital)**

	Average Annual		Contribution from:			
	Real GDP growth (%)		Capital Growth	Labor Force Growth	TFP Growth	Factor Growth
1982-89	2.17		2.20	1.93	-1.97	4.13
1990-92	-15.26		0.47	0.78	-16.50	1.24
1993-03	6.27		-0.05	0.18	6.14	0.13
1993-96	9.25		-0.54	-0.51	10.30	-1.05
1998-01	7.35		0.05	0.56	6.75	0.60
2002-03	5.35		0.78	1.07	3.50	1.85

A number of interesting points stand out. First, during the transition period, most movements in real GDP were driven by movements in TFP. During the sharp contraction of 1990-92, TFP fell dramatically at an average annual rate of -16.5 percent. During the subsequent recovery of 1993-2003, when the economy grew at an average annual rate of 6.27 percent, the average annual rate of TFP growth was a robust 6.14 percent, whereas the contribution of factor growth (i.e., the combined contributions of capital growth and labor force growth) was a mere 0.13 percent. This result—that the initial contraction and the subsequent growth in real GDP were primarily driven by large negative and subsequently large positive rates of TFP growth—is consistent with

¹⁸ See Clert et al., 2004.

¹⁹ There now exists a small body of growth accounting work for transition economies, although none of this work covers Albania (for example, De Broeck and Koen (2000) for growth accounting work on the FSU countries and Campos and Coricelli (2002) for growth accounting work on a number of ECE countries).

the findings of De Broeck and Koen (2000) and Campos and Coricelli (2002) for other transition economies.

During the initial years of transition, the disorganization or chaos resulting from the removal of central controls and coordination—as described by Blanchard and Kremer (1997)—produced large negative TFP growth rates as output fell and large parts of the capital stock were idled. Subsequently, as the economy achieved macroeconomic stability and introduced structural reforms, the reallocation of resources to more productive activities allowed the economy to generate rapid growth with low rates of investment, so that TFP growth rates were high.²⁰

It is important to document in detail the pattern of growth in Albania, and to understand how much progress has been made in the fundamental sources of growth and the structural determinants of growth—and thus, about how much progress remains to be made on these fronts

The results of the growth accounting exercise are confirmed by sensitivity analyses. One concern about the measurement of the capital stock for a transition economy is that during the initial contraction a significant portion of the communist capital stock may not only be temporarily idled, but may actually be permanently scrapped. If so, this would cause the contribution of capital accumulation to be underestimated during the subsequent recovery. In order to address this concern, we apply a one-time adjustment for the permanent scrapping of a significant portion of the communist capital stock—in particular, we contract the capital stock by the same rate as output between 1990 and 1992, so that the (K/Y) ratio is not allowed to rise during the course of the contraction. We then repeat the growth accounting exercise using our new adjusted capital stock series. The results are presented in Table 8, panel A. Panel B tests for sensitivity by also changing the capital share from 0.3 to 0.5. The essence of the result remains unchanged—while the contribution of capital growth during recovery does rise somewhat, most of the growth still appears to have been driven by TFP growth.

In panel A, during the average annual real GDP growth of 6.27 percent between 1993 and 2003, the contribution of TFP growth was 5.42 percent, while the contribution of factor growth was a mere 0.85 percent (of which the contribution of capital growth was 0.67 percent). We will treat the results in Table 8, panel A as our benchmark growth decomposition, although the essence of the results discussed also hold true with a higher capital share of $\alpha = 0.50$ (Table 8, panel B) and without adjustment for the permanent scrapping of communist capital (Table 8).

²⁰ While this result may have been expected, it is necessary to see it confirmed by the data. Furthermore, it does remind policymakers that the impressive growth rates of the past decade in Albania have primarily been a result of the substantial reallocation and structural transformation that accompanied transition. This point will be nontrivial when we discuss the prospects for sustaining the impressive growth rates of the past decade going forward.

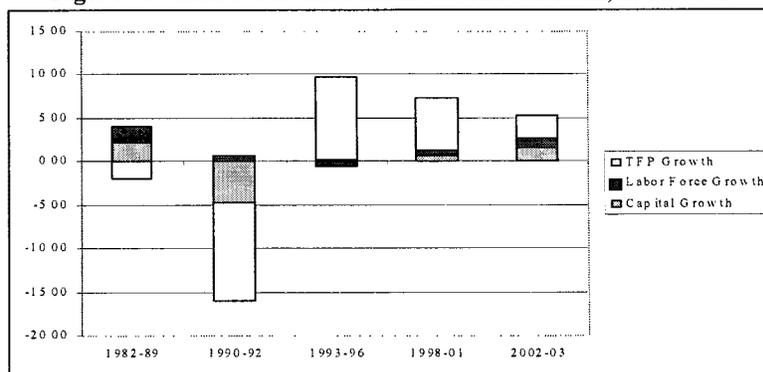
Table 8 Panel A: Albania Growth Accounting Results II
 Assuming significant part of communist capital is permanently scrapped during 1990-92

	Average Annual Real GDP growth (%)	Contribution from			
		Capital Growth	Labor Force Growth	TFP Growth	Factor Growth
1982-89	2.17	2.20	1.93	-1.97	4.13
1990-92	-15.26	-4.85	0.78	-11.19	-4.07
1993-03	6.27	0.67	0.18	5.42	0.85
1993-96	9.25	0.10	-0.51	9.66	-0.41
1998-01	7.35	0.78	0.56	6.01	1.34
2002-03	5.35	1.62	1.07	2.66	2.69

Table 8 panel B: Albania Growth Accounting Results II
 Assuming capital share of 0.50 and permanent Scrapping of Communist Capital

	Average Annual Real GDP growth (%)	Contribution from			
		Capital Growth	Labor Force Growth	TFP Growth	Factor Growth
1982-89	2.17	3.70	1.38	-2.91	5.07
1990-92	-15.26	-7.94	0.55	-7.87	-7.39
1993-03	6.27	1.12	0.13	5.02	1.25
1993-96	9.25	0.17	-0.37	9.44	-0.19
1998-01	7.35	1.31	0.40	5.65	1.70
2002-03	5.35	2.71	0.76	1.88	3.47

Figure 13: Relative Contributions to GDP Growth, 1982-2003



A second interesting point emerges when one examines how the growth decomposition changes over time within the recovery period 1993-2003. In more recent years, the TFP growth rate has been sharply lower: 2.66 percent for 2002-03 and 6.01 percent for 1998-01, versus 9.66 percent for 1993-96 in Table 8, panel A. This is accompanied by a modest rise in the contribution of capital growth from a negligible 0.10 percent during 1993-96 to 0.78 percent during 1998-2001 and 1.62 percent during 2002-03 (as well as an increase in the contribution of labor from -0.51 percent during 1993-96 to 0.56 percent during 1998-

01 and 1.07 percent during 2002-03). As a result of this modest increase in the contribution of factor accumulation, growth during 1998-03 did not decline as much as it might have otherwise. Looking at the year-by-year decomposition (not presented in the tables), one finds the same trend: declining TFP growth in recent years, accompanied by a modest rise in the contributions of capital and labor force growth.

Total factor productivity has been the main source of growth since 1993

To conclude, the evidence from Albania suggests that growth during the past decade has been driven primarily by the substantial reallocation of resources that occurs in the aftermath of transition (i.e., TFP growth from source (i)). This has been made possible by the fact that Albania was swift in achieving macroeconomic stabilization and moved to liberalize prices and external trade and privatize agriculture and SMEs soon after transition. On the other hand, the evidence indicates that this fundamental source of growth during transition—TFP growth—has slowed significantly in recent years. Thus, the evidence indicates that TFP growth deriving from substantial post-transition reallocation is gradually drawing to a close. At the same time, the contribution of capital accumulation has only picked up modestly.

3. Sectoral Potential for Growth

Lessons of history and economic theory suggest that it is unrealistic to attempt to predict which particular sector of an open economy could become the major source of growth in the future (see Easterly 2001). However, the structure of the Albanian economy is unlikely to undergo drastic changes in the short- to medium-run. Therefore, it is appropriate to highlight where the country could expect substantial contribution to income generation in the immediate future: the agri-business industry; transit trade; exports of light manufacturing; and tourism.

The growth potential in agriculture seems to be strong

Albania has some advantages for the development of its agriculture. Among these are (i) a favorable geographic location relative to the European Union, particularly to Italy and Greece, (ii) comparably low wage levels, (iii) a relatively educated rural population, many of whom have worked in other European countries for some period of time, (iv) creativeness among Albanian farmers in adapting rapidly to changing circumstances, and (v) fertile soils and favorable climate in some regions. Based on these advantages, the major opportunities for growth in the agriculture sector are in the production of higher value crops, livestock, processing, and some agricultural niche markets.

Both agriculture and agro-processing clearly face significant challenges to achieving regional standards, particularly in the areas of institutional capacity, technology, skills and know-how, access to resources and quality of inputs and outputs. In addition, the farming sector remains highly fragmented and burdened by restrictions in access to land and land use. Yet, because the agricultural sector in Albania provides the income basis for almost half the Albanian population and serves as an employment safety net for an even larger share, it should be a centerpiece of the country's the medium-term agenda.

Increased competition due to trade liberalization is unlikely to have a major negative impact on poverty

Trade barriers have been declining gradually over the past decade and further adjustments will probably be marginal. Since most of the Albania's small farmers do not sell on the market, price changes should not have a large impact on their ability to produce, although lower market prices may increase their propensity to buy rather than produce for own consumption. On the other hand, the productivity of subsistence farmers will be strengthened by the same measures which would strengthen competitiveness as a whole--i.e., improvements in infrastructure and institutions. Some growing sub-sectors, such as livestock rising (including honeybees, chickens), and olive oil, may induce more farmers to orient their production toward higher return production areas. Economic growth in the economy as a whole will provide rural Albanians with alternatives to subsistence farming. The Albanian population is highly mobile, and will continue to migrate internally and abroad in search of employment opportunities.

Box 1: Selected Promising Agricultural Products

Horticulture. Greenhouse production has spurred domestic vegetable production, especially of tomatoes and cucumbers. Greenhouses allow producers to grow fruits and vegetables during the region's off-season, especially during the fall months when it has relatively more sun than neighboring countries. The production of fruits contracted by 37 percent from 1989 to 1999, from 11 percent to 5 percent as a percent of total agricultural production. This was largely due to lower price, better quality imports. However, exports are expected to rise again as the large number of new plantations begin producing.

Alcoholic beverages. Wine and cognac have long been produced in Albania, which has an ideal climate for grape growing. Many are still grown on pergolas, which limits their productive capacity, and average wine quality is fairly low still, but with build-up in experience, this sector, given sufficient technical assistance and supported with good marketing has medium and long term potential.

Livestock. Livestock has increased from 31 percent to 50 percent of agricultural production since 1989. Dairy cows are raised throughout the country, while sheep and goats are common in the hills and mountainous areas while herds are larger in the south. While owning livestock is important for maintaining subsistence levels, profitability increases considerably with increase in herd size. Larger herd size is found to be more important than improved management.

Olive oil. The potential for the olive trees cultivation is considerable, since minimal care is required during the early years of growth and trees grow well even in poor soils. Olive trees are very sensitive to microclimates and grow well along the coastline area between Saranda and Shkodra. Domestic olive oil production increased reached USD 5 million in 2002, an increase of 76 percent over the previous year. This is occurring even as olive oil imports, from Greece and Italy increase. At the same time, a large part of the olive growing industry is battling pestilence, heavy competition from neighboring countries, and still recovering from the devastation of large tracts of olive trees in the nineties. Although some USD 168 million worth of olive oil was exported in 1999, this figure dropped has to almost nil since then.

Herbs. Currently the largest export group is herbs, oilseeds and similar products. Albania's low labor costs favor production, as herbs are typically harvested by hand. Out of the countries 360 species, 15 percent are of medicinal aromatic or spice value and an estimated 75 percent of sage imported by US comes from Albania. Cultivated herbs. With medicinal herbs, development should move toward the cultivation of these

herbs rather than their collection in the wild, which risks a depletion of the resource in nature. However, Albania's current export of over USD 10 million worth of herbs and oilseed is one third of what it reportedly was in the late 1980's.

Honey. Honey production increased more than ten-fold between 1989 and 2000. The number of beekeepers rose from 10,116 to 15,120 in 2002 compared to the previous year. Of these, 63.6 percent own up to 10 beehives, 29.2 percent have 10-20 beehives and 7.2 percent have 20-50 or more than 50 beehives. The last category has increased by about 45 percent in 2002 over previous year. Number of beehives in total, during 2002, increased by 12.2 percent compared to previous year (92,000 and 82,000 beehives respectively). Production of honey, with an average yield of 11.8 kg/beehive increased 41 percent (from 1.183 tons in 2001, in 1.232 tons in 2002).

Sources: Jungbluth and Lugg. 2002. MAF. Annual Report. 2003. Keyser, John C. 2004. and Civici. CEEBIC net.

Export of light manufacturing could be another important source of growth

Thanks to its proximity to the EU, Albania is well positioned to take advantage of these opportunities offered by the contemporary global economy. The fragmentation of industrial production and the creation of distribution networks spanning across continents have characterized international trade over the past decade. Technological progress and information revolution has made possible to divide the industry's value chain into smaller functions that can be contracted out to independent suppliers. This worldwide trend (outsourcing) offers a unique opportunity for producers in small countries to move from servicing their limited local markets to supplying large multinational firms and indirectly their customers all over the world. But these do not come by default. They require availability of cheap backbone services, (i.e., transport, telecommunications, customs, logistics providers), assuring the smooth operation of linkages among stages of the production process driven by "just-in-time" arrangements.

The analysis of Albania's trade with the EU, the SEE countries, and the rest of the world confirm the country's potential in the export of light manufacturing. Manufactured goods accounted for 88 percent of Albania's EU-oriented exports, compared with 56 percent in to ROW, with the EU taking up 95 percent of all manufactured exports. Foods, agricultural and industrial raw materials accounted for about one third of ROW exported and 12 percent of EU-oriented exports (see Table 9).

Light manufacturing, mostly of unskilled labor intensive products (leather and clothing) accounts for about 85 percent of EU-destined exports of manufactures. Given the country's labor endowment, low wage levels, and geographic location, this trend can be maintained in the medium-run. Natural resource and unskilled labor intensive, almost evenly split, account for more than 90 percent of Albanian EU-oriented exports (Table 9).

Table 9: Composition of trade with the EU and ROW in 1996, 1998, 2002 and 2003 (in percent and thousands of US dollars)

EXPORTS Product group	Exports to European Union				Exports to Rest-of-World				Share of EU	
	1996	1998	2002	2003	1996	1998	2002	2003	in 2002	in 2003
Foods	10.1	9.1	2.8	5.2	16.8	18.4	12.0	11.5	73.7	86.4
Agricultural raw materials	9.0	8.2	5.5	3.9	9.4	15.8	21.9	22.6	75.1	70.6
Industrial raw materials	7.3	10.7	3.3	3.2	37.6	36.0	1.4	16.2	96.5	73.6
Petroleum	1.9	0.4	0.1	0.4	8.9	9.9	6.6	7.9	10.9	42.9
Manufactures	71.6	71.6	88.2	87.2	26.6	19.5	55.6	40.3	95.0	96.8
Machinery	0.8	2.4	1.3	2.4	6.8	8.0	20.1	15.3	43.0	68.9
Textile & fabrics	1.3	0.7	0.8	0.3	0.2	0.7	0.3	0.1	96.6	98.6
Leather	23.0	20.8	32.3	29.0	3.0	2.5	5.4	4.8	98.6	98.8
Iron and steel	5.4	0.9	0.1	4.2	3.8	1.6	1.1	3.1	55.8	95.0
Clothing	27.1	35.1	41.3	36.5	3.8	2.1	2.8	3.0	99.4	99.4
TOTAL ('000 US dollars)	181,536	192,121	290,164	417,274	29,605	15,552	24,241	29,822	92.3	93.3
IMPORTS Product group	European Union				Rest-of-World				Share of EU	
	1996	1998	2002	2003	1996	1998	2002	2003	in 2002	in 2003
Foods	29.9	25.5	17.3	16.3	48.2	33.2	27.2	26.6	61.3	56.5
Agricultural raw materials	1.0	1.5	1.1	1.1	0.6	1.1	0.7	0.8	79.6	73.8
Industrial raw materials	1.2	1.4	2.3	1.9	0.6	0.6	1.2	1.3	82.6	75.6
Petroleum	2.6	3.2	2.8	3.3	0.4	0.7	6.9	7.6	50.0	47.6
Manufactures	64.9	67.7	71.9	73.7	49.3	61.0	57.8	59.2	75.5	72.5
Machinery	17.2	10.6	17.5	17.3	15.8	7.3	13.3	13.3	76.6	73.4
Textile & fabrics	6.5	6.9	6.1	7.2	3.3	3.5	2.5	2.3	85.6	86.8
Leather	5.4	5.7	4.1	4.1	2.3	3.9	3.8	3.4	72.6	71.6
Iron and steel	1.7	3.2	2.7	2.2	3.8	5.6	6.8	8.9	49.9	34.6
Clothing	4.8	7.2	7.6	8.4	0.7	1.2	3.9	3.4	82.9	84.0
TOTAL ('000 US dollars)	713,500	686,284	1,074,945	1,265,189	224,989	154,474	434,121	598,615	71.2	67.9

Source: Derived from the UN COMTRADE database as reported by Albania.

The footwear and textile/clothing industries have been bright spots in Albania's external trade—and there is room for further increase in market shares

The clothing and footwear industries have been the quintessential engines of growth for many CEEC-10 countries during the initial stages of transition. They have accounted for a significant share of value added and manufacturing employment, with consequential implications for poverty reduction. With labor costs going up, many of the outward processing operations in the clothing sector moved to other countries in Central and South East Europe through the 1990s. *These products now dominate the exports of some SEE economies including Albania.* Textiles and clothing together with footwear and leather products play a huge role in Albania's EU-oriented exports accounting for almost three-thirds of Albania's exports to the EU over the last seven years. Their aggregate value, including leather products, was US\$ 261 million in 2003, up from US\$ 158 million in 1998. Their share peaked in 1999 at 65 percent and fell to 58 percent in 2002 and rebounded to 64 percent following a strong increase in exports in 2003.

There is a potential for expansion in trade with SEE countries. Albania's SEE trade has undergone significant change and displays unusual features on the side of both exports and imports. In the 1990s, the composition of trade with other SEE-8 economies indicated the predominance of inter-industry trade, with Albania importing mostly industrial products and exporting ores, mineral and metals (Kaminski 2003). But this has not been the case in the 2000s. Instead of

specializing in low processed industrial raw materials, Albania has emerged as an exporter of manufactures while importing mainly the former, albeit it has remained a large net importer across all these product categories. The share of manufactures in its SEE-8-oriented exports is currently about 69 percent, while that share in Albania's imports from SEE economies is 18 percent. These exports have been highly concentrated, with construction and mining machinery accounting for 49 percent and 14 other four-digit SITC sectors accounting for another 41 percent of total exports. Imports are less concentrated. The largest item was electricity, which accounted for 20 percent of total imports from SEE-8 in 2002.

Table 10: Factor Intensity of Albania's Trade with the European Union, 1996-2003

Factor Intensity Product	1996	1997	1998	1999	2000	2001	2002	2003
Exports to EU (\$ '000)								
Natural Resources	102212	70857	98275	147232	120466	133492	131527	195264
Unskilled Labor	66820	39968	81984	157469	108126	126091	136728	180166
Capital Intensive	3616	3885	5278	13888	4283	5325	4681	11162
Skilled Labor	6562	5562	6585	14689	10028	12361	16893	30651
All above products	179210	120272	192121	333278	242904	277269	289828	417243
Composition of Exports to EU (%)								
Natural Resources	57.0	58.9	51.2	44.2	49.6	48.1	45.4	46.8
Unskilled Labor	37.3	33.2	42.7	47.2	44.5	45.5	47.2	43.2
Capital Intensive	2.0	3.2	2.7	4.2	1.8	1.9	1.6	2.7
Skilled Labor	3.7	4.6	3.4	4.4	4.1	4.5	5.8	7.3
Net Exports to EU (Exports as % of Imports)								
Natural Resources	29.8	29.0	29.2	35.1	32.7	30.7	28.0	37.1
Unskilled Labor	60.9	48.0	64.2	92.8	78.6	83.0	74.2	80.3
Capital Intensive	2.5	3.8	5.2	10.4	3.1	2.3	2.2	4.3
Skilled Labor	6.7	6.8	5.4	9.2	6.0	7.2	8.1	11.9
All above products	25.7	23.4	28.0	37.7	30.0	28.0	27.0	33.0

Source: Based on EU as reporter from UN COMTRADE Statistics.

As a result, Albania's SEE-destined exports in terms of factor intensities have shifted from natural resource intensive products to, paradoxically, capital-intensive products (Table 11). Capital intensive goods accounted for 61 percent of SEE-oriented exports in 2002. While, as we shall see below, unskilled labor intensive products dominate in EU-oriented exports, their share in SEE-oriented exports has been miniscule, except in 1998.

Trade facilitation also offers growth opportunities to Albania

Trade facilitation is the science and art of improving the environment for international trade. Trade facilitation was originally limited to the logistics of moving goods through customs. It is now more broadly concerned with the whole environment in which trade transactions take place. Albania could enormously improve its competitiveness and

benefit from trade facilitation if a number of economy-wide issues were addressed, including improving the protection of property rights, enforcing legal transactions, improving administrative efficiency, reducing corruption, completing privatization, completing financial sector reforms, and increasing labor productivity.²¹

Given the increasing predominance of 'just-in-time' production systems, reliable and low cost transport systems make it possible for firms in industrialized countries to outsource stages of production to geographically dispersed locations such as Albania. Transit costs in developing countries are often two to four times those of developed countries. Higher logistics costs translate directly into higher import and export prices particularly in small economies. In the case of products which have a high import content, small differences in transaction costs can determine whether the export venture is commercially profitable or not. Manufacturing firms cannot afford delays from inefficient and complex customs procedures, administrative or regulatory bottlenecks, or the lack of modern systems of information technology and cargo handling in both maritime and inland transport.

While there are no specific studies for Albania, cross-country empirical studies indicate that easing the movement of goods and services improves export competitiveness. For example, Wilson, Mann and Otuki (2003) estimated that enhancing global trade facilitation capacity would increase world trade by around US\$377 billion (9.7 percent). About 28 percent of this gain would come from improving port efficiency, 9 percent from improving customs procedures, 22 percent from improving the regulatory environment, and 41 percent from improving services including e-business usage.²² The study noted that the greatest beneficiaries would be exporters.

Another indication of how much Albania could gain from trade facilitation is the recently improving trend in customs revenue from the implementation of the Trade and Transport Facilitation in Southeast Europe (TTFSE) Project, one of eight in the SEE region. The objectives of the project (financed by IDA and the EU) are to reduce non-tariff costs to trade and transport and to reduce smuggling and corruption at border crossings. Table 12 shows a 27 percent improvement in customs revenue collection in 2001-2003. However, the increase in customs revenue was less than the increase in trade volume during the same period, in contrast to the experience of the other six countries where customs revenue increased faster than trade volume. Albania has been successful in reducing waiting times at some inland border crossings. For example, the average entry waiting time at the Qaf Thana border declined from 80 minutes in 1999 to 30 minutes in 2003. A group of follow-up TTFSE projects are planned. It is particularly important to establish a cargo tracking system at Durres Port to reduce smuggling.

²¹ Completing the privatization of land based telecommunications is a priority in the infrastructure sector.

²² Source: World Bank, *Global Economic Prospects 2004: Realizing the Promise of the Doha Agenda*.

**Table 11: Customs Revenue Collected, 2001-2003
(US\$ millions)**

	2001	2003	Improvement (%)
Albania	349	442	27
Bosnia-Herz.	353	514	46
BiH – RS	160	224	40
Bulgaria	1,156	1,844	60
Croatia	2,121	4,444	110
Macedonia	324	512	58
Romania	1,892	3,384	79
Total	6,354	11,365	79

The tourism industry can contribute significantly to the economic growth and poverty alleviation of Albania

The tourism sector also has good potential and is considered by the government, as both a key contributor to macroeconomic performance and a potential catalyst for sustained economic growth. The tourism industry is labor intensive and currently constitutes a major source of government revenue. Furthermore, it provides substantial linkages to other sectors like construction, production of construction materials, transport, furniture, agriculture, food and souvenirs

The tourism industry can contribute significantly to economic growth and poverty alleviation in Albania, especially in the coastal areas where there is a big potential. In fact, the number of tourists has been growing steadily over recent years. A total of 155,422 tourists visited the country during the first nine months of 2003 coming through different border points. This was 27 percent higher than the number for 2002 for the same period. While no data are available on the number of jobs in the tourism industry, it is clear that the tourism industry can have a positive impact on the creation of jobs in Albania where unemployment is high.

Comparative data on tourism indicates that Albania does not yet exploit its full potential, as neighboring countries seem to perform much better

The number of tourists visiting Albania and the total amount of their expenditures they spend there remain, however, much lower than in other SEE countries (Figure 14). However, the increase for Albania is the highest for all these countries in the past five years. This is even more visible when looking at tourist revenues. The revenues generated by the tourism industry represent about 10 percent of GDP since 2000 (Table 12). The table shows the revenues of non- Albanian tourists and the percentage of the GDP.

Figure 14: Regional Tourism Trends, 1997-2001

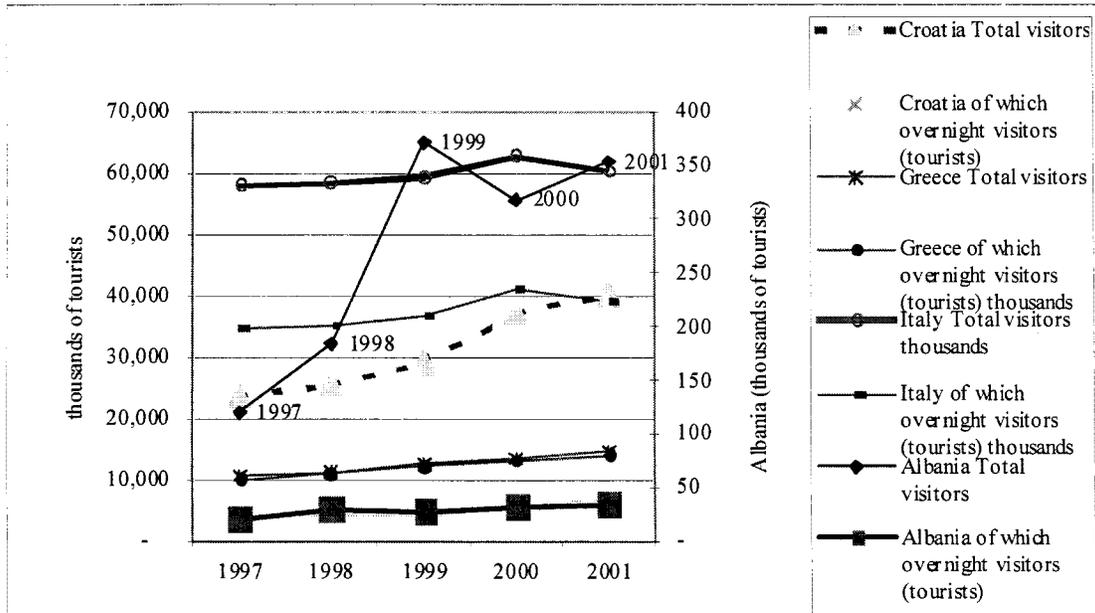


Table 12: Revenues from the Tourism Industry, 1999-2002

Year	Tourism revenues million US\$	GDP million US\$	Tourism as % of GDP	Tourism as % of all Services in GDP
1999	211	3,615.75	5.84	31.4
2000	389.5	3,851.50	10.11	31.8
2001	446.3	4,216.00	10.59	32.2
2002	486.9	4,700.40	10.36	32
First half of 2003	209.3	5,703.00	n/a	n/a

Source: Bank of Albania, 2004.

Following an aggressive communication campaign (“*Albania: Europe’s last secret!*”), the government has recently prepared a strategy aiming at boosting tourism.²³ The main economic objectives of tourism development are to generate jobs, accelerate economic and social development, and develop a sustainable and environmentally friendly tourism. It is the vision of the government that the country will become a major tourism destination on the Mediterranean Coast and will have a competitive position in the international tourism market. Furthermore, the government envisages sustainability and awareness for environmental issues as a major part of the tourism development strategy.

The government strategy acknowledges that Albania’s current performance is sub-optimal. It notes that “the existing structure of the hotels in Albania (mainly those of the coastline area) corresponds to

²³ Ministry of Territory Adjustment and Tourism (2003).

that of a capacity with up to 20 rooms. Hotels of this size are not able to work with bigger tourist groups organized in package tours by the western operators. Such hotels capacities match only the demand of individual clients or small-organized groups of tourists.” The insufficient and unreliable water supply is another major obstacle for tourism development. For example in the coastal city of Durrës, which is the second biggest city in Albania with the biggest accommodation capacity for tourists in Albania, water is only available once every two days for not more than a couple of hours. Clearly, the implementation of the remaining structural reform agenda could boost the contribution of tourism to growth and poverty reduction.

4. Long Term Growth: Prospects and Constraints

The growth accounting framework identifies four major determinants of TFP growth for Albania²⁴: capital accumulation (investment), secondary school enrollment rates, the degree of trade integration, and institutional quality. Each of them will play a crucial role in Albania’s economic future, yet progress has been lacking along these dimensions in Albania:

- As noted above, the contribution of capital accumulation to growth during most of the transition in Albania has been negligible. During the two most recent years, 2002-2003, the contribution of capital accumulation to growth increased modestly to 1.62 percent. This is still significantly below the contribution of capital accumulation to growth in the high growth economies of East Asia. Bosworth and Collins (2003) report that for seven East Asian economies, which grew at 6.7 percent between 1960 and 2000, the contribution of capital accumulation was 3.28 percent.
- As TFP growth deriving from large-scale post-transition reallocation draws to a close, it is important for Albania to generate TFP improvements from alternative sources. Educational attainment is one such alternative source of TFP improvements.
- A higher degree of trade integration allows an economy to specialize in the production of those products in which its relative productivity is highest and also facilitates the transfer of technology and ideas from more advanced economies.
- Better institutional quality reduces transaction costs and allows a private manufacturing sector to develop in those products in which the economy is naturally most productive.

Investment, school enrollment, trade

The important role of investment, school enrollment, trade integration, and institutional quality in economic growth is also underscored by the

²⁴ See the Background Studies volume for a theoretical exposition.

integration, and institutional quality are the key factors of success

neoclassical growth model with human capital. In such a model, investment and school enrollment rates are key determinants of the steady-state level of output per worker. Given current levels of output per worker, a higher steady-state level will generate faster growth. Another important determinant of the steady state is the level of technology, which can itself depend on the degree of trade integration and the quality of institutions. Thus, if a country seeks to generate high rates of growth, it must ensure that its investment, school enrollment, trade integration, and institutional quality are at levels sufficient for that purpose.

Comparison of Growth Determinants with High Growth and Slower Growth Countries. In order to form an assessment of whether the current levels of school enrollment, investment, and trade integration in Albania may serve as bottlenecks to generating rapid growth going forward, we undertake a comparison with groups of high growth and slower growth countries. Our first comparison group includes all non-oil, non-transition countries with populations exceeding one million in 1995, and for which PPP-based real GDP figures are available for the 1980-2000 period.²⁵ This yields a group of 87 countries, which we divide into two sets: the **high growth countries** are those for which the growth rate of real GDP per capita during 1980-2000 was above the seventy-fifth percentile of all growth rates and the **slower growth countries** are the rest. The list of 21 high growth countries (with 1980-2000 per capita growth rates above 2.25 percent) and 66 slower growth countries (with growth rates below 2.25 percent) is presented in Tables A*3-4 in the Annex.

Table 14 presents the average secondary enrollment rate, investment rate, trade share of GDP, and export share of GDP for the high growth and slower growth set of countries, as well as for Albania. The levels of these steady-state determinants for Albania are significantly below the averages for the high-growth countries and comparable to (or even somewhat lower than) the averages for the slower growth countries. This provides some evidence that the current levels of secondary enrollment, investment, and trade integration in Albania are not sufficient for the purposes of generating rapid growth going forward.

One concern in comparing Albania with the group of all countries is that Albania's current level of GDP per capita may be less than the average for the high growth group in 1980. If so, then Albania today would be able to generate high growth even if it had a lower steady-state (i.e., lower values of the steady-state determinants) than those countries. In order to address this concern, we form a second comparison group of countries for which real GDP per capita in 1980 is similar to Albania's real GDP per capita today. The list of this group of similar countries is presented in Table A*2 of the Annex. Again, the

²⁵ We take PPP-based real GDP numbers from the Penn World Tables (PWT), version 6, because the PWT makes this measure available for a wider set of countries than the WDI. We need *PPP-based* real GDP per capita because our second comparison group is limited to countries with income levels similar to Albania.

average secondary enrollment, investment, trade share, and export share for the high growth and slower growth countries within this list of similar initial income countries are presented in Table 13.

Table 13: Comparison with Higher Growth and Slower Growth Countries

	Secondary School Enrollment Rate	Investment (%of GDP)	Trade (%of GDP)	Exports (%of GDP)
All Countries				
High Growth	54.2	25.0	67.3	32.3
Slower Growth	47.1	19.7	58.2	26.5
Countries with Similar (Y/L)				
High Growth	54.9	27.4	81.9	39.6
Slower Growth	40.7	21.3	60.6	27.5
Albania	45.1	18.3	58.5	18.1

Notes: Figures for Albania are 1999-2001 averages. Growth in comparison countries is for 1980-2000--for those countries, enrollment rates are averages for 1980 and 1990, and investment, trade, and export shares are averages over the entire 1980-2000 period.

Albania's secondary enrollment rate is significantly below the average for the high growth group, although somewhat higher than the average for the slower growth group

The idea behind this test is that, given similar initial levels of output per worker, the high growth countries experienced high growth because their steady-state levels of output per worker were sufficiently above their initial levels of output per worker. Thus, in order for Albania to experience high growth over the medium to long term, its levels of the steady-state determinants must be similar to those of the high growth group. However, Table 13 shows that Albania's secondary enrollment rate is significantly below the average for the high growth group, although somewhat higher than the average for the slower growth group. Albania's investment rate and measures of trade integration are not only significantly below the averages for the high growth group, but also somewhat below the averages for the slower growth group. This provides evidence that the current levels of school enrollment, investment, and trade integration in Albania are likely to serve as bottlenecks to generating rapid growth going forward. Thus, raising investment and school enrollment rates and increasing the degree of trade integration must be key policy priorities for Albania going forward.

In addition to the comparisons above, we can also use an estimated neoclassical growth equation to obtain a rough forecast of Albania's long run growth rate, given its investment and school enrollment rates and its current level of GDP per capita.²⁶ This forecast can be

²⁶ We estimate the following neoclassical growth equation:

$$ygrowth_i = \alpha_0 + \alpha_1 \ln\left(\frac{I}{Y}\right)_i + \alpha_2 \ln(sec_i) + \alpha_3 \ln(n_i + g + \delta) + \alpha_4 \ln(y_{0,i}) + \varepsilon_i$$

where *ygrowth* is the growth rate of real GDP per capita between 1980-2000, *y*₀ is the initial real GDP per capita in 1980, (*I/Y*) and *n* are the average investment and population growth rates for 1980-2000, *sec* is the average secondary school enrollment rate for 1980-96, and *g*+*δ* (the rates of technological progress and

compared with predicted growth rates for other transition economies to compare Albania's long run growth prospects with those of these other transition economies. In addition, we can find out what Albania's predicted growth rate would be under a counterfactual scenario where its investment and school enrollment rates are higher.

A theoretical framework for estimating coefficients that can be used to predict Albania's long-run growth prospects

The predicted long run growth rates will, of course, depend on the particular specification of the neoclassical growth equation used in the exercise. We follow Fischer, Sahay, and Vegh (1998) and Denizer (1997) in using a specification which includes only the very basic variables—investment, secondary school enrollment, population growth, and initial income. These are the same variables used by Mankiw, Romer, and Weil (1992) and Levine and Renelt (1992).²⁷ The objective here is not to include all variables which may plausibly matter for growth in Albania, but rather to assess what Albania's investment and school enrollment rates, along with its current level of GDP per capita, imply for its long run growth potential. The estimated coefficients, along with robust standard errors, are presented in Table 13.

Table 14: Estimated Neoclassical Growth Equation

Dependent Variable: Growth of Real GDP per capita 1980-2000		
	Estimated Coefficient	Standard Error
Constant	-21.93**	3.66
ln(I/Y)	3.09**	0.75
ln(sec)	0.76**	0.35
ln(n+g+d)	-7.47**	1.43
ln(y ₈₀)	-1.11**	0.32
Observations	83	
R ²	0.53	

Note: Equation estimated using robust standard errors. ** denotes estimated coefficient is statistically significant at the 5 percent level.

All estimated coefficients are statistically significant at the 5 percent level. The included variables together explain 55 percent of the variation in per capita growth rates. By including only the very basic variables, we wish to minimize controversy about whether or not a variable should be included in the estimated equation. The underlying theory is, of course, that investment, secondary enrollment, and

depreciation) is assumed to be a uniform 0.05 for all countries. The average secondary school enrollment rate is for 1980-96 only because, as pointed out earlier, the *WDI* data on secondary school enrollment rates after 1996 are not comparable with the same before 1996.

²⁷ Unlike Fischer, Sahay, and Vegh (1998) and Denizer (1997), we do not simply use the estimated coefficients from Levine and Renelt (1992). The Levine and Renelt estimations were implemented using a much earlier version of the Penn World Tables. Given changes in the data in newer versions, it is inappropriate to directly apply the coefficient estimates from Levine and Renelt to more recent data for transition economies. Thus, we estimate the basic neoclassical growth equation ourselves using the more recent data source.

population growth are determinants of the steady state and that a steady state level of GDP per capita above the initial level of GDP per capita will generate faster growth. Data for real GDP per capita are obtained from the Penn World Tables (version 6.1), while data for all other variables are obtained from the *WDI* 2003. All non-oil, non-transition countries with populations exceeding 1 million in 1995 are included in the estimation.

Next, we apply the estimated coefficients from Table 14 to the current levels of investment, school enrollment, population growth, and real GDP per capita in the transition economies to obtain predicted future long-run growth rates for these economies. The results are presented in Table 15. The results indicate that if Albania's investment, secondary enrollment, and population growth rates stay at their current levels, then its long-run per capita GDP growth rate from this point forward will be approximately 2.16 percent. This is significantly lower than the predicted long-run per capita growth rate for most other transition economies (except for the Kyrgyz Republic and Tajikistan). The average predicted long run growth rate for all transition economies is 3.69 percent. The low predicted growth rate for Albania is all the more surprising, given that its current real GDP per capita is significantly below the average for all transition economies.

While the low predicted growth rate for Albania is partly due to its higher population growth rate, it is also due to its low investment and secondary enrollment rates. For example, if Albania's investment rate were to rise to 30 percent and its secondary enrollment rate were to rise to 80 percent, then its predicted long-run per capita growth rate would rise to 4.13 percent. A predicted per capita growth rate of 4.13 percent does not mean that the growth rate is expected to be a uniform 4.13 percent for every year from this point forward. Rather, since each country is converging to its steady state, the growth rate during the initial years is expected to be higher than 4.13 percent.

Table 15: Predicted Long Run Growth Rates for Transition Economies

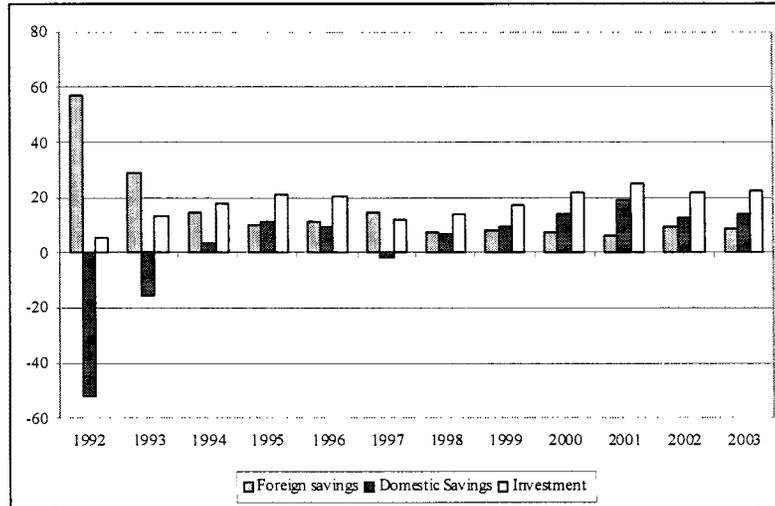
	Real GDP per capita (PPP-based \$) 2000	Gross Domestic Investment (% of GDP)	Population Growth Rate	Secondary School Enrollment Rate	Predicted Long Run per capita Growth Rate	Standard Error of Predicted Growth Rate
Albania	3,350	18.3	0.85	45.1	2.16	0.33
Armenia	2,791	18.5	0.16	42.7	3.30	0.51
Azerbaijan	2,793	22.7	0.83	35.6	2.88	0.29
Bulgaria	5,785	18.9	-1.00	76.2	4.90	0.74
Belarus	8,408	23.8	-0.35	70.9	4.01	0.41
Czech Republic	13,673	29.2	-0.24	81.1	4.04	0.40
Estonia	9,588	26.7	-0.43	78.0	4.43	0.43
Croatia	8,524	23.1	0.02	80.1	3.43	0.32
Hungary	10,444	29.0	0.32	101.8	3.65	0.28
Kazakhstan	7,394	20.5	-1.09	55.4	4.81	0.69
Kyrgyz Republic	3,014	18.1	0.94	40.8	2.07	0.33
Lithuania	7,242	21.6	-0.52	63.2	4.08	0.49
Latvia	7,648	27.3	-0.78	73.8	5.29	0.55
Moldova	2,082	22.3	-0.26	38.0	4.74	0.62
Macedonia, FYR	5,135	19.3	0.62	67.3	2.45	0.32
Poland	9,229	24.7	-0.03	95.8	3.76	0.32
Romania	4,287	19.2	-0.15	71.9	3.81	0.54
Russia	8,013	17.8	-0.51	70.0	3.43	0.52
Slovak Republic	11,417	28.8	0.08	84.0	3.73	0.33
Slovenia	15,756	28.1	0.11	96.6	3.37	0.32
Tajikistan	1,321	14.5	0.83	29.0	2.15	0.63
Ukraine	4,624	19.4	-0.80	59.3	4.68	0.69
Average	6,933	22.3	-0.06	66.2	3.69	0.46

Note: Investment, population growth, and secondary school enrollment rates are averages for 1999-2001.

The savings-investment picture reflects Albania's difficulty in raising its long term growth rate

Domestic investment in Albania fell rapidly at the beginning of transition but improved during the last 10 years reaching almost 25 percent of GDP in 2001—still lower than in the pre-transition times (Figure 15). Domestic savings, at about 14 percent of GDP in 2003 are insufficient to sustain the levels of capital accumulation envisaged above.

Figure 15: Savings-Investment Balance, in percent of GDP



While Albania should have no difficulty in meeting its current and future external debt, the projected decline in concessional financing—as the country ceases to be eligible for IDA resources—raises concerns about the financing of its current account. Inflows of foreign direct investment picked up in recent years—reaching 3 percent of GDP in 2002—because of large privatizations and also some greenfield investment, especially in the oil sector. But the sustainability of FDI trends remains to be seen, as progress in the improvement of the business climate is slower than anticipated.

To conclude, the evidence from the growth accounting exercise suggests that in order to sustain high GDP growth going forward and to improve prospects for EU accession, Albania must forge ahead on two fronts: (i) raise the rate of capital accumulation; and (ii) accelerate structural reforms in order to generate greater improvements in TFP from alternative sources. Therefore, the policy agenda for the medium term should focus on removing barriers to trade and integration; analyzing the role of migration and remittances; the mobilization of labor; public infrastructure; maintaining a stable macroeconomic framework; building the governance and institutional framework for growth. We review each of these topics in the next chapters.

CHAPTER 3: TRADE AND INTEGRATION

Trade is the first pillar of Albania's growth strategy. This section reviews the country's performance over the past decade and identifies constraints to the development of trade, investment, and integration.

1. Trade and Foreign Investment in Albania

Albania has recorded an impressive export performance during the past decade

Despite Albania's lagging behind other SEE-6 countries in terms of openness as measured by the ratio of trade to GDP, the development of global trade links has been playing an increasingly important role in the country's economic growth performance. The average growth in real trade was 6.8 percentage points higher than the average growth in real GDP over 1990-2001 (WDI 2003). No other SEE-5 economy has attained similar levels of growth in integrating into external markets—the closest was FYROM with 5.9 percentage points, but with a negative average growth rate in real GDP.

During the first four years of transition, Albania had the strongest export performance in EU markets among all former centrally planned economies, matched only by Estonia. The average rate of growth in 1993-96 was 65 percent for Albanian exports, 63 percent for Estonia (in 1994-97), 21 percent for the SEE-5 countries, and 13 percent for Latvia. Albania's exports fell by 11 percent in 1997, but so did Latvia's in 1998 (8 percent). The war in Kosovo was responsible for the contraction of SEE-5 exports in 1999—their value fell by 11 percent.

Table 16: Performance of SEE-5 economies in EU markets in 1993-2003

	Share in EU external imports											Index, 2003
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	1998=100
Albania	0.017	0.024	0.028	0.033	0.028	0.030	0.029	0.028	0.034	0.035	0.036	117.2
Bosnia & Herzegovina	0.007	0.002	0.004	0.011	0.024	0.034	0.044	0.049	0.056	0.060	0.068	203.9
Croatia	0.369	0.398	0.341	0.295	0.259	0.251	0.229	0.198	0.212	0.217	0.237	94.6
Macedonia, FYR	0.113	0.113	0.103	0.071	0.071	0.083	0.075	0.072	0.060	0.056	0.062	75.1
Serbia/Montenegro	0.003	0.001	0.006	0.081	0.149	0.144	0.070	0.076	0.100	0.127	0.123	84.9
<i>Albania's share in SEE-6 EU-oriented exports</i>	3.39	4.40	5.74	6.71	5.35	5.60	6.45	6.52	7.45	7.13	6.76	120.7
Memorandum: Albania's trade with EU (in million of US dollars)												
Exports	97	147	203	251	224	248	246	267	331	336	420	169.2
Imports	481	514	683	941	595	617	724	738	970	1,029	1,210	196.2

Source: Derived from the UN COMTRADE database and IMF Direction of Trade statistics as reported by the EU.

While Albania's export growth to EU markets has decelerated somewhat in recent years (2000-2002), its rate is still impressive when compared to other transition. Although the average of 11.6 percent puts Albania below Estonia (at 18.4 percent) and even below the average for the CEEC-10 of 11.4 percent, it is well above the average of 8.0 percent for the SEE-5 economies (see Table 16). The average growth rate for

SEE-5 economies is rather low in view of the EU embargo on trade with the then Federal Republic of Yugoslavia and instabilities in the region that artificially suppressed trade in the 1990s. In this context, Albania's performance looks quite impressive, although it was below the growth of Bosnia and Herzegovina.

The EU has become the major destination of Albania's foreign trade

Albanian trade has been reoriented toward the West. Once trading primarily with Yugoslavia and the communist bloc, Albania has undergone a significant reorientation toward trade with Western Europe: the vast majority of Albanian trade is now with the EU. Albania exported some 93 percent of goods to the EU in 2003, with Italy (75 percent) and Greece (13 percent) being the main destinations, while exports to South East Europe countries accounted for 0.8 percent of total exports, the majority to Yugoslavia and Macedonia. The situation for imports is similar, with close to 70 percent of Albania's imports coming from the EU in 2003.

Albania has fared well in comparison with SEE-5 economies in EU markets. Table 16 presents the share of Albania and other SEE-5 countries in EU imports over 1993-2002, together with annual changes in this share, and values of EU imports from Albania. The share in EU imports is neutral to exchange rate fluctuations. Changes in shares of SEE-5 countries offer a good insight into the dynamics of overall export performance in EU markets. Since the EU accounts for almost 90 percent of Albania's exports, these exporters provide an all-inclusive picture of Albania's total exports.

Not surprisingly, given the instabilities in the region, Albania outperformed its neighbors in 1993-96, with its share in total SEE-5 EU-oriented exports increasing from less than 4 percent in 1993 to almost 7 percent in 1996 (Table 16). The increase has been due to a combination of Albania's impressive performance and a very weak export growth, especially for Croatia and Bosnia and Herzegovina. In 1998-2003, Albania succeeded in maintaining and even slightly increasing its share. Except for Albania and Bosnia and Herzegovina, other SEE-5 countries have to date had a weaker export performance in EU markets than was the case in the 1990s. Macedonia's and Croatia's share in EU imports peaked in 1994, and Serbia and Montenegro's in 1997. It appears that the end of the embargo and the extension of autonomous trade measures (ATM) to Serbia and Montenegro and the prospects of deeper, policy-induced integration into the EU have so far failed to provide a boost to exports. The decade of instabilities and slow progress in second generation reforms in the region appears to have taken its toll on the supply capacities of former Yugoslav republics. It seems that there is not much potential left to tap in most SEE-6 countries, at least in the short run.

Albania's patterns of involvements in international production and

Textiles, clothing, footwear and leather products play an important role in Albania's EU-oriented exports, accounting for almost two-thirds of Albania's exports to the EU over the last seven years (Table 17). Clothing and, to a lesser extent, footwear have been the engines of

distribution networks confirm its strong potential in footwear and garment industries

growth for many of the CEEC-10 during the initial stages of transition. They have accounted for a significant share of value added and manufacturing employment, with consequential implications for poverty reduction. With labor costs going up, many outward processing operations in the clothing sector moved to other countries in Central and South East Europe through the 1990s. These products now dominate the exports of some SEE economies including Albania. Their aggregate value, including leather products, was US\$ 266 million dollars in 2003 up from US\$ 158 million in 1998. Their share peaked in 1999 at 65 percent and had been falling thereafter to 58 percent in 2002. But it increased to 64 percent following a strong increase in exports in 2003.

Producers from these sectors are firmly anchored within corresponding value chains organized in the EU. Except for the 1997 crisis, which dramatically affected production and exports, trade in both sectors has experienced strong and steady growth. This shows a considerable degree of stability of established commercial links between Albanian suppliers and EU firms. Despite some volatility, Albanian suppliers of both textile and clothing and footwear have kept pace with competition in EU markets. Since 200 exporters of footwear have succeeded in expanding their presence.

Table 17: Trade in Textiles/Clothing and Footwear, 1996-2003 (in thousand of US \$ and percent)

	1996	1997	1998	1999	2000	2001	2002	2003 e
Textiles and Clothing (SITC 65 and 84):								
Exports of Textiles & Clothing (million of US dollars)	75.2	68.7	86.8	87.4	94.1	120.4	91.9	127.3
Share of textiles in exports of textiles and clothing	3.8	3.1	3.2	1.3	1.3	0.7	0.6	0.7
Imports of Textiles (\$ '000)	42.8	25.3	35.5	38.4	35.0	48.3	53.0	72.1
Share of textiles in imports of textiles and clothing	52.6	47.1	43.0	41.9	38.3	42.6	40.3	39.1
Imports of textiles as % of exports of textiles and clothing	56.9	36.9	40.9	44.0	37.2	40.1	57.7	56.7
<i>Memo Items:</i>								
Share of textiles & clothing in Albania's exports (%)	29.9	30.6	35.0	35.5	35.2	36.4	27.3	30.4
Share of EU in total textiles & clothing exports (%)	97.2	97.7	98.5	99.0	98.5	98.9	98.8	98.9
Share of Albania in EU external imports of textiles and clothing	0.12	0.10	0.12	0.13	0.13	0.17	0.13	0.13
Footwear and parts (SITC 85 and 6123)								
Total Exports of Footwear and Parts (million of US\$)	76.8	57.9	71.6	71.5	69.5	88.7	103.7	138.8
Share of parts in total footwear exports	90.0	87.7	93.8	89.8	89.0	86.7	86.0	78.4
Imports of Footwear Parts (\$ '000)	50.3	13.1	35.9	31.4	26.6	35.0	33.7	61.2
Imports of parts as % of exports of footwear and parts	65.5	22.6	50.2	44.0	38.2	39.4	32.5	44.1
<i>Memo Items:</i>								
Share of footwear & parts in total exports (%)	30.6	25.8	28.9	29.1	26.0	26.8	30.8	33.2
Share of EU in Albania's exports of footwear and parts (%)	99.9	96.8	94.6	94.4	98.9	99.4	99.1	99.5
Share of Albania in EU external imports of footwear and parts	0.95	0.66	0.83	0.79	0.73	0.86	0.94	0.96

Note: The classifications of products are based on SITC Revision 2 as: Textiles (65+8998), Clothing (84), Footwear (85) and Footwear Parts (6123). Source: Own calculations based on UN COMTRADE Statistics as reported by EU. Note: The classifications of products are based on SITC Revision 2. Calculations based on UN COMTRADE Statistics as reported by EU.

Statistics on outward processing trade (OPT) also highlight the expansion in backward linkages, as domestic suppliers have provided for a larger share of input used in exports of garments and footwear.

The value of exports of processed imported goods as compared to the value of those imported for processing has been consistently significantly higher and the difference has been growing since 1998. In 2003 the value of exports of footwear was more than three times higher than the value of imports of footwear parts (Table 17). The difference was much less pronounced for clothing, and has been on the decline since 1997.

Despite the success in the footwear and textiles/clothing exporting industries, Albania has yet to become part of more sophisticated supply chains. Neither trade in the furniture network, for instance, nor trade in parts have really taken off, although the former shows signs of growth. Following Ng and Yeats (1999), we identify 60 SITC. Rev. 2 items capturing trade in parts. As can be seen from data reported in Table 17, exports of parts account for a very small portion of exports of manufactures excluding chemicals. More significantly, they have been highly volatile reaching a peak level of US\$ 12 million in 1999 and falling to US\$ 4 million in 2000 and then rebounding to US\$ 10 million in 2003. So has been the case with imports. They increased remarkably in 2001, doubling from US\$ 57 million in 2000 to US\$ 135 million in 2001, but contracted to US\$ 101 million in 2003.

Table 18: Trade in parts and share of EU (in 000 of US dollars and percent)

Parts and Component Product	1996	1997	1998	1999	2000	2001	2002	2003
Trade with the World:								
Exports of parts & Components (\$ '000)	2,131	1,799	6,420	11,872	4,198	4,831	7,279	10,430
Imports of parts & Components (\$ '000)	50,849	27,483	28,372	46,517	56,916	134,772	88,932	100,771
Exports of parts as % of imports (%)	4.2	6.5	22.6	25.5	7.4	3.6	8.2	10.4
Share of parts in manufactured exports (excluding chemicals, in %)	1.6	2.1	4.6	4.1	2.0	1.9	2.7	2.8
Share of the EU Markets:								
Exports of parts & Components (%)	86.4	97.1	98.4	90.6	95.2	81.8	80.5	92.2
Imports of parts & components (%)	71.8	85.7	86.9	85.9	74.9	86.2	75.4	75.7
Exports of parts as % of imports in EU (%)	5.0	7.4	25.6	26.9	9.4	3.4	8.7	12.6
Share of parts in EU-oriented manufactured exports (excluding chemicals, in %)	1.4	2.2	4.6	3.8	2.0	1.7	2.3	2.7

Note: Parts and components are based on 60 items which were classified in the SITC 7 and 8 (machinery and other manufacturing products in Revision 2. Source: UN COMTRADE Statistics as reported by Albania.

Albania has all the potential to become actively involved in the furniture network. In contrast to the automotive and electronic networks, the furniture network is less capital-intensive and much more labor-intensive. Albania is well endowed in labor. The furniture network operates mainly through marketing organizations that provide suppliers with precise specifications concerning the final product and the parts and components to be used. In consequence, only limited FDI inflows are needed to start operating in this network. Albania would seem to be well positioned to take advantage of opportunities in that network.

Notwithstanding the importance of

Foreign direct investment is crucial to increase the competitiveness of Albanian products in international markets, sustain strong economic

remittances and exports, foreign direct investment is crucial to growth in Albania

growth performance and increase competition and productivity in local markets. While domestic “start-ups” contribute directly to the increased competition, mainly due to their intimate knowledge of local conditions, the impact of FDI is multifaceted. It may bring stronger competitive pressures, but there are other more prevalent benefits. FDI brings higher technology, knowledge and management as well as contacts with foreign customers. It allows domestic economies to take advantage of their endowments in the skilled labor force, which Albania appears to have.

Albania’s legislation on FDI is open in terms of the right of establishment (Law on Foreign Investment). It observes the principle of national treatment, i.e., foreign firm are subject to basically the same procedures as domestic firms. Furthermore, there are no restrictions on entry into so-called sensitive sectors, such as transport and finance. But, as the SAP 2004 report notes, the weaknesses in implementation of this liberal approach adversely affect potential investment inflows (EU 2004a, p, 22). As the international experience shows, as long as personal contacts overshadow legal rules and procedures, investors, conscious of their reputation, tend to shun from investing.

Successful stabilization policies and structural reforms have helped Albania attract high volumes of foreign direct investment, although not at levels sufficient to mitigate the external vulnerabilities

Albania has not fared poorly in attracting FDI if one considers its level of economic development, the absence of attractive assets for privatization and two episodes of social unrest in 1997 and 1999 which contributed to the perception of the country among international investors as an unstable place in a highly volatile region. The total value of FDI over 1990-2003 of US\$ 352 per capita is higher than in Bosnia Herzegovina or FRY but significantly lower than in Bulgaria (US\$ 652), Croatia (US\$2057) or in Romania (US\$441). With the total inflows over 1993-2002 amounting to 26 percent of the 2001 GNI, Albania’s performance was similar to that of Romania and above Bosnia and Herzegovina and Serbia and Montenegro (Table 19). However, it should be noted that the sociopolitical disruptions triggered by the collapse of the pyramid scheme in 1997 had a major impact on Albania’s FDI performance. The price paid in terms of lost FDI inflows was significant, demonstrating vulnerability of FDI inflows to political stability. FDI fell almost 50 percent, from US\$ 90 million in 1996 to US\$ 48 million in 1997. It fell further to US\$ 45 million and US\$ 41 million in 1999. Taking the 1996 level as a benchmark, i.e., assuming that the FDI would be in 1998-99 at the 1996 level, the total loss was US\$ 136 million over three years, or almost 14 percent of total inflows over 1993-2002.

Table 19: FDI inflows. Total and Total per capita over 1990-023, Average Annual per Capita in 1993-96, 1997-2000 and Annual per Capita in 2000-03 (in US dollars)

	Average per capita		FDI inflows per capita				Total FDI 1990-03 per capita	Total 1990-03 (in mln.US\$)	Total 1993-02 in % of 2001 GNI
	1993-96	1997-00	2000	2001	2002	2003 (€)			
Albania	22	22	46	58	46	65	352	1,091	26.0%
Bosnia and Herzegovina	0	19	38	33	33	50	193	770	15.4%
Macedonia, FYR	5	45	95	222	41	225	687	1,373	39.2%
Serbia/Montenegro	0	22	5	18	47	66	217	2,302	23.3%
Bulgaria	12	85	119	108	77	65	652	5,477	41.5%
Croatia	49	235	279	436	260	225	2,057	8,227	41.3%
Romania	12	59	46	50	53	48	441	10,017	26.0%

Source: UN ECE Annual Survey, various issues, United Nations, New York and Geneva: IMF Balance of Payments statistics and WIIW 2004.

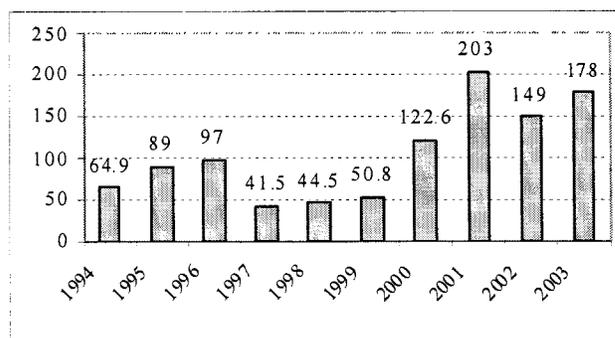
Foreign direct investment has picked up since 1998

FDI inflows reached US\$ 123 million in 2000, three times their 1999 level. In 2001, they reached US\$ 203 million (Figure 16). This one time increase was mainly the result of a successful privatization process. It reflects the privatization of AMC (Albanian Mobile Communication), Vodafone (Mobile Communication Company), and the concession taken by the Italian firm DARFO in Albkrom (Chrome-ore Albanian Industry). As the privatization of Telecom, the Savings Bank and INSIG were delayed, the 2002 FDI flow decreased to US\$ 149 million. According to the Bank of Albania, the upward trend resumed in 2003 with FDI reaching US\$ 178 million, 16.3 percent above the 2002 level.

Italy and Greece are the main countries investing in Albania

In contrast to other countries in Central and Eastern Europe, FDI in Albania comes mainly from neighboring countries such as Italy and Greece. Data from INSTAT indicate that the sources of FDI are as follows: 48 percent from Italy; 43 percent from Greece; 2.2 percent from Macedonia and Turkey, and less than 7 percent from other countries in Europe and from the United States (Figure 18).

Figure 16: Foreign Direct Investment in Albania, in millions of US\$



Source: Bank of Albania

Figure 17: FDI by Sector, 2001 (% of Total)

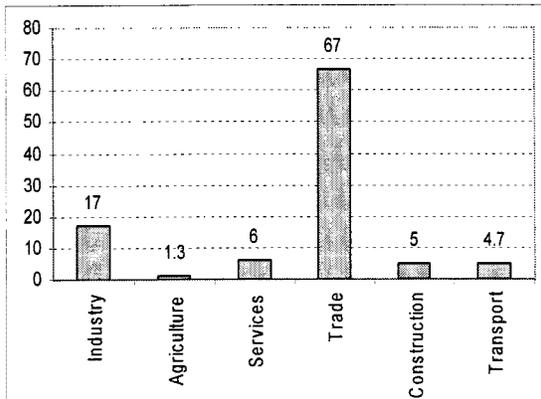
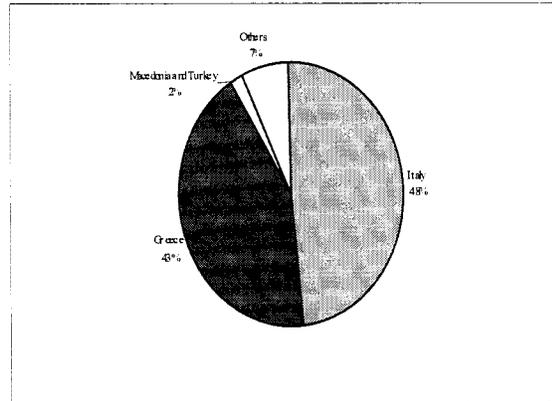


Figure 18: FDI by Country of Origin, 2001 (percent of total)



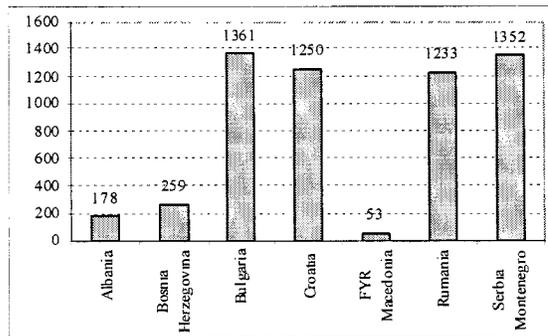
Foreign investors are mostly interested in Albania's low wage labor force

Italian investments are concentrated in the west of the country, close to the Adriatic Sea. Most Italian investments are small and medium-size enterprises, mainly involved in construction (35 percent), textile and footwear manufacturing (21 percent), trade and services (16 percent), and the agro-food industry (8 percent). Italian companies benefit from the competitive advantage of the low-wage labor force. Wages in Albania are about one-tenth of those in Italy. Greek investments are mainly concentrated in the south and southeast of the country, close to the border with Greece. Greek investors in Albania are mostly involved in trade, with less than 2 percent in other industries such as textiles, garments, the manufacturing of leather products and tobacco.

Albania's performance in attracting FDI in 2003 was poor when compared to other SEE countries

Despite an increase over recent years, Albania recorded a modest level of FDI in 2003 (Figure 19). Furthermore, foreign investment is concentrated in Tirana and Dures. These two cities alone attract approximately 67 percent of the companies with foreign participation. They are the largest cities in the country, with Dures having the largest port and Tirana being the capital. While such concentration is justified on economic grounds, it reinforces internal migration from the poorest rural regions of the country to the large cities.

Figure 19: FDI in SEE Countries, 2003 (in million of US\$)



But a closer look at the number indicates that Albania's performance in attracting FDI is consistent with its level of development

However, considering its level of economic development, the absence of attractive assets for privatization and two upheavals contribute to a prolonged perception of Albania among international investors as an unstable country in a highly volatile region, Albania has not fared poorly in attracting FDI inflows. FDI inflows do not strike one as particularly low, although only in the context of SEE-6 economies excluding Croatia. The total value of FDI over 1990-2003 of US\$ 352 per capita is higher than in other SEE-5 countries except FYR Macedonia, but significantly lower than in Bulgaria (US\$ 652) and Croatia (US\$ 2,057).

Differences in FDI per capita are a reflection of the variation in the level of GDP per capita. A relatively flat economic growth explains large FDI flows to Moldova relative to its Gross National Income (GNI). With the total inflows over 1993-03 amounting to 26 percent of the 2001 GNI, Albania's performance is comparable to Romania's (26 percent) and above that of Bosnia and Herzegovina and Serbia and Montenegro.

Albania's relatively good performance on FDI inflows per capita cannot be attributed solely to the wars in the former Yugoslav republics. First, the country also suffered from political and social instability in the 1990s. Social upheaval triggered by the collapse of the pyramid scheme in 1997 has negatively affected Albania's FDI performance. Second, Albania fared quite well in the post-Kosovo war environment in 2000-03. Except for FYR Macedonia, FDI inflows per capita to other SEE-5 were roughly at similar levels.

Table 20: Annual FDI Inflows in Million of US Dollars and in Percent of GDP, 1993-2003

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Net inflows (\$ million)	58	53	70	90	48	45	41	143	207	213	156
as percent of GDP	4.7	2.7	2.9	3.4	2.1	1.5	1.1	3.8	5.0	4.5	2.5

Source: World Bank World Development Indicators and IMF.

WTO membership, and preferential trading privileges granted by the EU combined with the progress in political stabilization in Albania as well as in the region following the Kosovo war all appear to have contributed to a more attractive investment environment. In 2000, FDI inflows surged to US\$ 143 million, exceeding by 40 percent the peak level reached before the 1997 crisis. The upward trend has continued into 2001-02, with a contraction in 2003. The IMF projects FDI inflows over 2004-12 at levels above US\$ 200 million per year.

2. Policies to Boost Trade Integration

The first pillar of Albania's medium-term strategy should be the implementation of policies to boost

Taking advantage of its geographic location, its historical past, and the prospects of stronger trade relations with its neighbors and the EU, Albania is currently engaged in negotiations to develop regional integration in SEE countries and closer cooperation with the EU, simultaneously with compliance with the country's WTO commitments.

trade

A quantitative assessment of the impact of changes in trade policies (i.e., identifying how the economy will adjust to such price changes and capture the positive impact of trade liberalization for growth) was carried out using a computable general equilibrium model (see Box 2). The objective of this exercise was to estimate both direct and indirect implications on government revenues, in addition to the impact on the economy's growth perspectives following resource reallocation of labor and capital as a result of competition in the domestic market. The study focuses on the welfare implications for the Albanian economy under three following scenarios for trade policy changes: (i) full implementation of the SAA with the EU;²⁸ (ii) full implementation of Albania's Free Trade Agreements with neighboring countries in South Eastern Europe; (iii) adoption of the Common European Tariff on industrial products; (iv) scenarios (i) and (ii) combined; (v) reduction of Albanian tariffs with respect to all trading partners – scenarios (i), (ii) and (iii) combined.

CGE modeling allows us to capture the underlying processes at work, and to formulate predictions about the impact of trade policy changes on production, trade, prices, factor rewards and welfare.²⁹ Reductions in barriers to trade decrease the prices of goods for consumers, as well as the prices of intermediates and capital goods for producers. The extent of these gains depends on the amount of trade between the trading partners and the trade creation and trade diversion effects. Liberalization of trade leads to increased efficiency of resource allocation, as demand shifts to regions with the lowest cost suppliers. However, the gains from trade also involve adjustment costs and may be associated with potentially painful restructuring in Albania and significant redistribution effects.

²⁸ With respect to the impact of the SAA (scenario 1) the proposed Albanian concessions under the 8th round of the negotiations form the basis for our simulations. The model does not take into account the impact of the phasing out of the MFA quotas in 2005. Given the high dependency of Albania on textile exports, it is possible that the estimated surge in textile exports following trade liberalization assumed in the model will be mitigated once the effect of the phasing out of the MFA quotas will take place.

²⁹ For each scenario, we present both short-run and long-run implications. In the long-run simulations, we allow for the adjustment of the capital stock. The calculation of steady state growth effects follows HRT (1996a). In the static or short-run scenarios, the cost of capital is allowed to vary within each country while the capital stock is held constant. In the steady state scenario, the capital stock in each country is allowed to adjust while the cost of capital in each country is held constant. This approach is in the spirit of the equilibrium concept in multi-sectoral planning models. It assumes the existence of an invariant capital stock equilibrium, which is defined as a set of prices, production and investment levels for which the economy is able to grow at a steady rate with constant relative prices.

While the implications of trade policy changes on Albania's terms of trade are difficult to predict a priori, the use of a CGE model incorporating demand and supply side effects is helpful for policy simulations.

Box 2: A CGE Model for Trade Simulations: Data Sources

In designing a framework for the analysis of the implications of these trade policy changes, we construct a computable general equilibrium (CGE) model, which allows for the evaluation of the likely impact of the trade agreements on trade, output, factor rewards, tariff revenue and welfare. Our simulations of several policy scenarios can provide some guidance as to the welfare implications of various dimensions of trade integration, the size of loss of tariff revenue and help the Albanian government formulate policies that would ease structural adjustments in sectors mostly affected by policy changes.

We use GTAP (Global Trade Analysis Project, www.gtap.org) database and multiregional trade model developed by Harrison, Rutherford and Tarr (HRT) implemented in their evaluation of the impact of trade liberalization under the Uruguay Round and other trade policy related experiments (HRT, 1996a and HRT, 1996b). The major source of data on Albania is the 24 sector input-output table for 2000 constructed by Mark Horridge (2002). Data on macro aggregates such as the level of GDP, trade flows and taxes originates from the Albanian Ministry of Finance. The Institute of Statistics provided the data on the distribution of value added across sectors, which incorporated the estimates of the size of informal or un-recorded economic activity. Horridge used shares in agricultural output from the IMF (2002) to split up agriculture between the 13 corresponding agriculture sectors in the original 57 sector input-output tables. The INSTAT 2000 Structural survey of economic enterprises provides suggestions for other splits of economic activity across sectors.

First, we consider each of the three scenarios alone:

Under the first scenario (liberalization of tariffs on imports from the EU) Albania will suffer a significant loss of tariff revenue, but will expand exports to all regions

*Despite the significant fall in tariff revenue, the welfare implications of liberalization of tariffs on imports from the EU are positive in the long run - 0.4 percent of GDP³⁰. Welfare implications represent changes on a recurring annual basis, so a 0.46 percent welfare gain should be interpreted as a 0.46 percent increase in real income each year in the future (Table 21). Albania's export to the EU could increase by 35.5 percent, *ceteris paribus*, relative to their 2000 level. Such an increase would be fueled by the surge in the production of textiles, clothing and footwear by 28.7 percent (see Table 23). This would not be surprising since they account for 56 percent of total exports, 98 percent of which is directed to the EU.*

Table 21: Implications of the SAA with the EU

(% CHANGE)	SHORT RUN	LONG RUN
Welfare (Equivalent Variation as a Share of GDP)	-0.72	0.46
Wage	1.14	2.46
Capital Rental	0.95	
Revenue from Taxes on Imported Goods*	-13.63	-12.93
(in million 2000 USD)	-53.72	-48.81
Capital Stock		2.5

* These include customs, excise and VAT. Source: model simulations.

³⁰ The welfare measure used in this exercise is the equivalent variation in national income expressed as a percentage of the benchmark income. It takes into account the purchasing parity of income. Therefore an increase in income is welfare improving as long as the prices of consumption goods do not rise faster than income.

Table 22: International Trade Implications Under Short-Run Scenarios (percentage change relative to 2000 performance)

	EU15	SEE	ROW
1. SAA with the EU			
Imports from	12.5	-19.4	-21.4
Exports to	35.5	25.2	25.6
2. FTA with SEE			
Imports from	-2.4	29.47	-2.12
Exports to	3.2	2.37	2.43
3. Adoption of the CET			
Imports from	-4.1	-5.2	11.9
Exports to	5.6	4.4	3.8
4. Combined 1+2			
Imports from	10.6	2.7	-22.5
Exports to	38.2	27.0	27.6
5. Combined 1+2+3			
Imports from	7.3	-1.1	-12.7
Exports to	40.6	29.0	28.9

Source: Model simulations

The lowering of domestic prices will also allow for the expansion of Albanian exports to other markets, although on a much smaller scale. The liberalization of tariffs on imports from the EU will lead to trade diversion, as imports from the EU15 increase significantly, while imports from other regions fall. Wages would rise slightly more rapidly than the return to capital (real cost of capital), as the implementation of the SAA leads mainly to the expansion of labor-intensive sectors in Albania.

The welfare implication of SAA are negative in the short run and very small in the long run because we are looking only at one policy change out of the range of changes following the implementation of the SAA, namely the reduction in tariffs on EU products. Tariff revenue accounts for a large share of government revenue and the model in its present state does not incorporate the introduction of alternative sources of revenue such as an increase in domestic tax rates or transfers from the EU. SAAs are more than free trade arrangements. They encompass also such issues as competition policy, environmental issues, standards, and investment conditions. They aim at the harmonization of legislation with that of the EU, and assistance in institution building in order to implement the relevant legislation. All these policies will improve the business environment and are expected to reduce the real costs of trade. These effects are not incorporated into our study, as we mainly focus on different options for trade liberalization.

Table 23: Output Changes under Short Run Scenarios (percentage change relative to 2000)

	SAA with the EU	FTA with SEE	CET on industrial products	Combined Scenario (Short Run)	Combined Scenario (Long Run)
	(1)	(2)	(3)	(4)	(5)
Grains	1.2		0.4	1.1	1
Vegetables, Fruits, Other Agricultural Products	-1.3	-0.1	-0.1	-1.3	-1.4
Livestock	-0.4	-0.1	0.1	-0.3	-0.4
Forestry	-0.6	-0.2	-0.1	-0.7	-1
Fishing	1	0.1	0.2	1.1	1.1
Energy, Mining	-2.6	-3.1	-3.7	-5.1	-8
Minerals nec	11.9	2.2	2.7	13.6	14.4
Food Products	-2.8	-0.1	0.1	-2.8	-2.9
Textiles, Clothing, Footwear	28.7	2.5	3.7	31	32.4
Wood, Paper products	-1.5	-0.3	-0.3	-1.6	-2.1
Petroleum, Coke Products	-5.1	-3.9	-5.4	-8.1	-12
Chemicals, Rubber, Plastic Products	2	0.6	0.4	2.4	2
Non-Metallic Mineral Products	-13.4	-1.7	-0.8	-14.1	-14.7
Metals and Metal Products	1.8	0.3	-2.4	2.2	0.4
Transport Equipment, Machinery and Equipment	10.6	1.3	3.2	11.5	13
Electricity, Gas, Water	1.3		0.4	1.3	1.3
Construction	0.2	-0.1	0.1	0.2	0.5
Transport	-0.2	0.1	0.1	-0.2	-0.1
Trade, Hotels	-0.6			-0.5	-0.5
Communications	-0.5	-0.1	-0.1	-0.5	-0.6
Financial Services	0.5		0.1	0.5	0.5
Real Estate Services	-1	-0.1	-0.2	-1	-1.1
Other Services	-1.6	-0.3	-0.3	-1.7	-1.9
Public Admin., Defense, Health, Education	1.1	0.1	0.1	1.2	1.2

Source: Model simulations.

The simulations indicate that Albania can benefit from further integration with its neighbors. However, the benefits from regional integration can only be realized if Albania gains better access for its exports on regional markets

Under the second scenario of the liberalization of tariffs on imports from neighboring countries (FTA), Albania would record a small welfare loss of 0.1 percent of GDP (Table 24). In some sectors, the abolition of tariffs on industrial goods would involve an absolute reduction of duty up to 10 percentage points. As a result of tariff reduction, the prices of goods from the SEE region would fall relatively to prices of domestically produced goods and imports from the EU15 and the rest of the world (ROW). Imports from SEE would then increase significantly, replacing to some extent domestic production in selected sectors. The reduction in domestic prices would be limited, as imports from SEE amount to only 8.3 percent of total imports. At the same time, the revenue from taxes imposed on imported goods (i.e., customs, excise and the VAT) would decline. It is unlikely that trade

creation would exceed trade diversion—a small increase in exports following a decrease of prices on the domestic market would not compensate for a surge in imports, and would not lead to an output expansion. However, when we also allow for the full access of Albanian products to SEE markets Albania records a small welfare gain (0.4 percent of GDP in the long run) and an increase in taxes on imported goods of 1.4 percent. Under this scenario exports to SEE would more than double.

Table 24: Implications of the Liberalization of Tariff on Imports from SEE

(% CHANGE)	Liberalization of Albanian tariffs under FTA with SEE		In addition free access to SEE markets	
	SHORT RUN	LONG RUN	SHORT RUN	LONG RUN
Welfare (Equivalent Variation as a Share of GDP)	-0.11	-0.06	0.05	0.39
Wage	0.2	0.22	0.21	0.62
Capital Rental	0.08		0.4	
Revenue from Taxes on Imported Goods*	0.76	0.86	1	1.36
(in million 2000 USD)	2.87	3.25	3.78	5.13
Capital Stock		0.14		0.82

* These include customs, excise and VAT. Source: model simulations.

Adoption of the CET leads to expansion of exports to all regions and a rise in tariff revenue and income in the long run

Under the third scenario alone—adoption of the Common European Tariff on industrial products—the welfare impact for Albania would be very small, as imports from the ROW accounts for only 26 percent of the country’s total imports (Table 25). The biggest tariff reductions are recorded in coke and petroleum products, metals and metal products and energy and mining. As goods from the ROW become relatively cheaper, imports from the ROW increase substantially and replace domestic production, especially in the above mentioned sectors (see Column 3, Table 23). In some other sectors such as textiles, clothing and footwear, transport equipment and machinery or other metals, cheaper intermediate inputs lower the prices of domestically produced goods. The overall effect would be an increased demand for Albanian products abroad and expansion of production and exports.

Table 25: Implications of the Adoption of the CET on Industrial Products

(% CHANGE)	SHORT RUN	LONG RUN
Welfare (Equivalent Variation as a Share of GDP)	-0.07	0.14
Wage	0.33	0.56
Capital Rental	0.24	
Revenue from Taxes on Imported Goods*	-0.06	0.2
(in million 2000 USD)	-0.23	0.72
Capital Stock		0.49

* These include customs, excise and VAT. Source: model simulations.

The simulations indicate that Albania has a lot to gain from further integration with its neighbors. However, the benefits

The results of these simulations are in line with the theoretical literature on regional integration (see World Bank, 2000). A regional integration arrangement between small low-income countries does not necessarily bring income gains to the countries involved. It might lead to the rationalization of production and the elimination of unnecessary duplication of plants, which will result in more efficient allocation of

from regional integration can only be realized if Albania gains better access for its exports on regional markets

resources and help attract FDI. However, these gains can only be realized if there are no other significant obstacles to trade. Furthermore, they depend on the extent to which the opening of markets increases competition in domestic markets. If the countries involved in the integration process trade little with each other, the impact on domestic prices and competition will be small. If external tariffs remain high, trade diversion is likely. Quite often a loss of tariff revenue, which is an important source of government income in many small countries, outweighs the welfare gains due to the more efficient allocation of resources. This seems to be the case with the liberalization of Albanian trade with its SEE neighbors or with the ROW, as the model projects significant trade diversion.³¹

Liberalization of trade with all trading partners could increase Albanian income by 1% per year and lead to expansion of exports and output in the majority of sectors. However the loss of tariff revenue would be substantial (-15%).

Albania would have much to gain under the final scenario—a combination of the three previous options. We look at the implication of two more trade policy options, namely, liberalization of tariffs under SAA and FTA with SEE neighbors and a combination of all of the scenarios discussed in the previous sections. We find that in both cases welfare implications are positive in the long run. This is mainly due to the fact that liberalization along all dimensions reduces the potential for trade diversion and allows for the full realization of efficiency gains. Under liberalization of trade with all trading partners Albania's GDP would increase permanently by 1 percent, and wages would increase by 3.4 percent compared to their 2000 levels (Table 26). Exports of Albanian products to the EU could increase by almost 40 percent, while exports to other regions would expand by 30 percent. Imports from the ROW and SEE neighbors would be replaced to some extent by imports from the EU. In our long run scenario, an increase in the return to capital encourages investment and results in an expansion of capital stock by 3.4 percent. This in turn allows for the growth of output in the majority of sectors. The highest increase would be recorded in textiles, clothing and footwear, transport equipment, machinery, electronic equipment, and minerals. Production of a few selected sectors such as non-metallic mineral products, and coal and petroleum products, energy and mining would be replaced by imports.

The most promising trade and growth opportunity for Albania clearly involves integration with the EU. Apart from political benefits of the SAA process, such as providing the policy lock-in mechanism to pursue further reforms and the incentive to create a stable business environment that would encourage foreign investment, the elimination of the remaining non-tariff barriers to trade such as differences in technical standards and regulations, delays at the border and others can lead to significant expansion of trade and income. However, trade liberalization should proceed along all dimensions, as the biggest gains are to be realized when Albania lowers its barriers to trade with respect to all trading partners. But in the short run the liberalization of trade

³¹ One caveat: as with any other CGE modeling exercise, the results here are very sensitive to the assumptions about elasticities of substitution between domestic and imported goods, and between imports from different sources.

with all trading partners leads to substantial loss of tariff revenue. This is likely to be mitigated by transfers from the EU. The introduction of reforms that would broaden the tax base and improvements in the effectiveness of tax collection are therefore necessary to avoid a huge drop in government revenue.

Table 26: Implications of Trade Liberalization with the EU, the SEE and the Rest of the World

(% CHANGE)	Liberalization of tariffs under SAA and FTA with SEE		In addition adoption of the CET on imports of industrial products	
	SHORT RUN	LONG RUN	SHORT RUN	LONG RUN
Welfare (Equivalent Variation as a Share of GDP)	-0.74	0.55	-0.62	0.97
Wage	1.28	5.08	1.6	3.4
Capital Rental	1.06		1.35	
Revenue from Taxes on Imported Goods* (in million 2000 USD)	-15.5	-14.1	-16.7	-15.1
Capital Stock		2.75		3.4

* These include customs, excise and VAT. The steady state scenario allows for higher capital stock. Source: model simulations.

Box 3: FIAS Recommendations for Removing Administrative Barriers to Investment

Customs

- Review import, export and transit procedures and adopt “risk management” approach, with a view to simplifying documentary requirements, speeding up processing, and reducing costs to the private sector.
- Establish clear rules and criteria for invoice valuation by following Article VII of GATT, with a view to minimizing discretion and arbitrariness in decision-making.
- Consider carefully the range of options for using international inspection assistance with valuation, and compare the associated costs and benefits.
- Improve the customs appeals system.
- Improve public relations and strengthen internal operation procedures.

Tax administration

- Institute measures to ensure that VAT refunds are funded by the Government and processed in a timely manner by the GDT.
- Develop and implement effective audit strategy for all market segments, including small business and individuals.
- The method for calculating installments of profits tax should be revised with a view to providing greater flexibility and with the aim of better reflecting the actual taxable profits of the business in the relevant period.
- Improve the compliance enforcement so that it is consistent, cannot be routinely and coercively used against taxpayers, and is appropriate in relation to the relative tax outstanding.
- Improve the internal appeal system for all first instances.
- Simplify and strengthen SBT registration. Administration of the SBT should be retained within the GDT.
- Strengthen taxpayer education and multi-party consultation to provide greater understanding, certainty and consistency on interpretations of the law.

Land and construction

- Halt uncontrolled construction Accelerate and complete the land restitution program; complete land registration with more emphasis on urban and commercially

attractive areas.

- Establish effective cooperation among the Restitution Commission, the National Privatization Agency, courts, land registry offices, and the municipal construction approval authorities
- Speed up the strategic territory planning to be followed by more detailed city planning, establish and implement modern building codes.
- Establish a “one-stop shop” information center for construction approval process in the municipalities.
- Establish a technical advisory committee at the municipality level to incorporate the inputs from the infrastructure/utility authorities and other key agencies when approving construction projects.
- Establish an effective appeal system that check and balance the power of site development approving authority.
- Explore the option of developing industrial and tourism parks.

“Non-Food Industry” License

- Abolish “non-food industry” license
- Review other sector licenses with a view to limiting licensing to the sectors justified by vital public interest; consider the “negative list” approach.

Administrative appeals system

- Conduct a cross-agency review, with a view to improving, on a consistent basis, the internal appeals processes within each agency.
- including the option of establishing specialized, independent tribunals in specific procedural areas.
- Establish a fully independent national administrative appeals tribunal.

To sum up, it appears that WTO membership and preferential trading privileges granted by the EU combined with progress in political stabilization as well as in the region following the Kosovo war have contributed to a more attractive investment environment in Albania. Yet much progress remains to be done as the country faces fiscal losses in the short and medium term and must continue improving its business environment to attract even higher levels of FDI and remittances.

CHAPTER 4: THE ROLE OF MIGRATION AND REMITTANCES

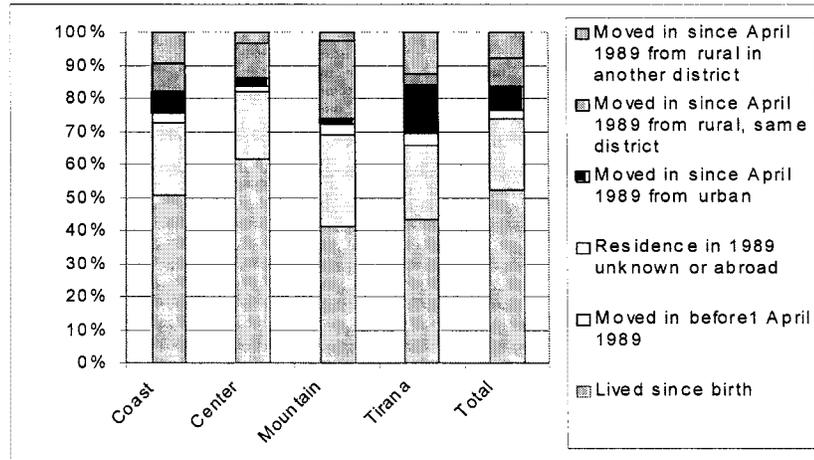
“Global links” have not been confined to capital inflows or trade in goods and services. By far one of the most important sources of financing imports has been revenue from “factor exports,” that is, labor. Together with Serbia and Montenegro, Albania was among the top 20 countries in the world ranked by remittances in terms of GDP in 2001 (World Bank 2003). Private transfers have been significant, amounting on average to almost one-third of the value of imports of goods and services since the collapse of central planning. Indeed, the social changes with the most significant impact on income generation have been the waves of internal and external migrations observed since the fall of the communist regime.

1. Patterns of Internal and External Migration

Internal migration resulted in significant reallocation of male populations from rural to urban areas between 1989 and 2001

Permanent internal migration is high in Albania and has contributed to creating income during the transition. Notwithstanding the social problems and the overload of urban infrastructure caused by migration, internal migration makes the Albanian labor market very flexible. On average, migrants perform better in the labor market than natives of the same age and education. Patterns of migration tend to adjust rather quickly to the changing situation in the labor market, as those who do not succeed move back or to other places.

Figure 20: Urban Adult Male Population by Migration History and Region, April 2001



Notes: Men aged 15 or older, excluding residents of institutional households. Category “Lived there since birth” includes persons born in the given city who were residing there in April 1989 and in April 2001. *Source:* Calculation based on 2001 PHC data.

As shown in Figure 20, more than 50 percent of the adult urban male³²

³² The analysis here is restricted to male population, which is the driving force of labor-related internal migration. Although in LSMS 2002 sample 60 percent of post-1989 inter-district migrants are women, a closer look reveals that just 4 percent of them are household heads, while almost all the rest either moved

population live permanently in the cities they were born in. This proportion is about 10 percentage points lower in Tirana (due to massive inflows from other cities, as well as from rural areas in other parts of the country) and cities in the Mountain zone (due to large inflows from nearby rural areas, but also to persistent outflows to other parts of the country; Tirana counts first as the destination of these outflows).

As shown in Table 27, the outflow of men from Mountain Albania to the Central zone during 1989-2001 was 1.5 times larger than each of the other two flows (to the Coast and Tirana city). Migration from the Mountain zone to Tirana has slowed down recently, while flows between Tirana and rural areas in the Central zone, as well as from Center and Coast to the Mountain zone, seem to intensify.

Table 27: Flows during 1989-2001 and 2000-2001 between the Coastal, Central, and Mountain Zones and Tirana City, (percentage of stocks in the beginning of the period). Men Aged 15+ and Living in Albania in April 2001 ^a

	Coast 2001	Center 2001	Mount. 2001	Tirana 2001	1989		Coast 2001	Center 2001	Mount. 2001	Tirana 2001	1989
Coast'89	97.3	0.6	0.1	2.1	28.3	Coast'00	99.7	0.10	0.03	0.20	30.5
Center'89	4.1	91.4	0.1	4.3	48.9	Center'00	0.40	98.7	0.06	0.82	46.7
Mount.'89	7.6	11.4	73.1	7.9	14.5	Mount.'00	0.74	1.0	97.7	0.54	10.8
Tirana'89	0.4	1.3	0.1	98.2	8.4	Tirana'00	0.12	2.3	0.05	97.5	12.0
2001	30.6	46.7	10.7	12.1	100.0	2001	30.6	46.6	10.6	12.2	100.0

Note: ^a The sample excludes those whose residence in 1989 and 2000 was unknown or abroad; hence the slight difference in 2001 distribution. *Source:* Calculation based on 2001 PHC data

About 25 percent of urban men moved to their current resident cities only after 1989. The proportion of recent immigrants in Tirana exceeds 30 percent and is at least 28 percent in the cities of the Mountain zone. While immigrants to urban areas in Mountain and Central Albania (excluding Tirana) come predominantly from rural areas in the same district, cities in the Coast receive inflows of comparable size from nearby rural areas, from rural areas in other districts, and from other cities.

Tirana and Durres are the primary destinations of internal migrants, followed by the districts of Lushnje, Lezhe, Fier (the latter has seen even larger emigration), and Vlore.³³ The majority of long-distance migrants move to the Central and Coastal parts of the country. The outflow from the economically backward North Eastern region (prefectures of Diber, Kukes, and Shkoder) has been in absolute figures almost twice as large as that from the South-East (prefectures Berat, Gjirokaster, Korce, and Vlore). There are also significant short-distance flows (predominantly rural-urban flows) within Central Albania and within the North East Mountains.

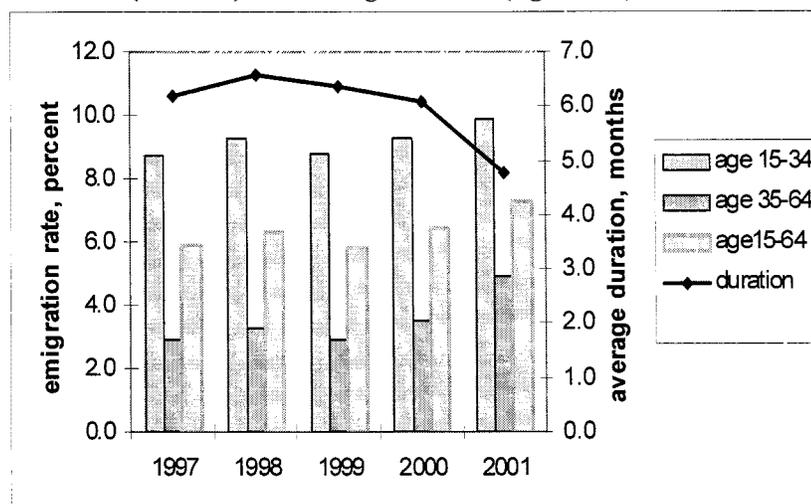
together with a male household head or indicated marriage or joining family as the main reason for migration. 90 percent of female migrants aged 18 and older are married.

³³ Galanxhi et al. (2003) and World Bank (2003) provide a detailed analysis of post-1989 migration between the 12 prefectures and between the 36 districts of the country.

Every year a significant and increasing proportion of Albanian men temporarily works abroad.

The geographical mobility of labor is one of the important adjustment mechanisms which helps to cope with poverty, structural unemployment and asymmetric shocks. According to LSMS 2002, during the period 1997 – 2001 each year 8 to 10 percent of Albanian men aged 15 to 34 were engaged in temporary employment-related emigration, mostly to Italy and Greece. For men aged 35 to 64 this proportion was about 3 percent until the year 2000 but jumped to almost 5 percent in 2001 (see Figure 21), resulting in a total temporary emigration rate of 7.3 percent of men³⁴ in the age group 15-64. The importance of short-term emigration as a strategy to cope with joblessness is confirmed by the fact that among men who were out of work in April 2002 but had worked in the past 12 months, 11 percent had their last job abroad; in Mountain Albania this proportion is two times higher than on average, while in Tirana it is two times lower.

Figure 21: Employment-related Temporary Emigration of Albanian Men: Rates (left scale) and Average Duration (right scale), 1997-2001.



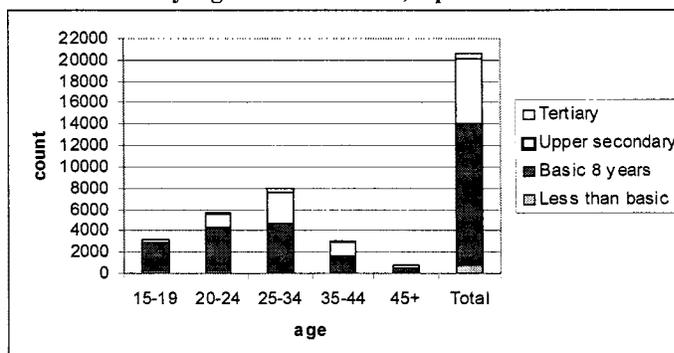
Note: The Figure is likely to underestimate the rate of temporary emigration in 2001 and its average duration. Source: Calculation based on LSMS 2002.

According to the 2001 Census, 2.6 percent of economically active Albanian men were working or seeking work abroad, although they were still considered members of the household at their permanent residence in Albania (this so-called “snapshot rate” is consistent with the above mentioned rate of 7 percent). The number of temporary emigrants is small if compared to the number of Albanians permanently working abroad, but it is not negligible, especially from the local labor market perspective. More than 80 percent of these temporary migrants are younger than 35. Slightly less than two-thirds have completed basic education (29 percent), or general or vocational secondary education, and just 2 percent have a university education (see Figure 22). Among the young economically active Albanians (below 35) with basic or

³⁴ For women similar rates are almost 10 times smaller, so the discussion here is restricted to male emigration.

secondary (general or vocational) education, the proportion of short-term labor migrants abroad was as high as 5 and 4 percent, respectively.

Figure 22: Albanian Men - Short-term Labor Emigrants by Age and Education, April 2001

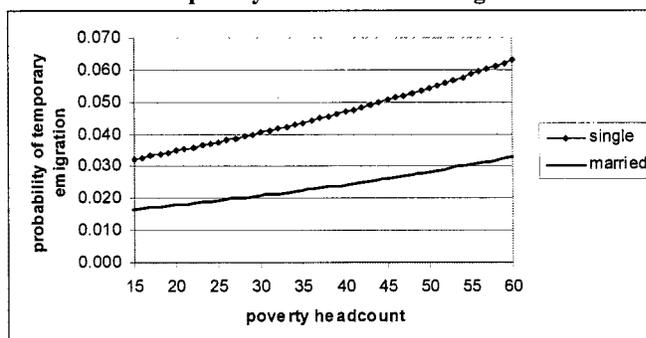


Source: Calculation based on 2001 Population Census data

Most of the temporary labor migrants go to Greece and Italy to work in agriculture, trade, and construction. Almost all (93 percent) of the employed temporary emigrants work in just five sectors: agriculture (43 percent), trade (20 percent), construction (14 percent), transport and communications (9 percent), hotels and restaurants (7 percent). The average weekly earnings of temporary emigrants in 2001-2002 were about three times higher than earnings in the last job of the men unemployed in April 2002, and 2.5 times higher than the current earnings of employed, men.

Emigration is an attempt to escape poverty—rather than unemployment. We have estimated a range of logit models to analyze effect of age, education, marital status and district of residence on the likelihood of temporary labor migration. Figure 23 confirms the fact that emigration helps in the escape from poverty: other things being equal, work-related emigration is more likely to be from districts with a high poverty headcount. Regional differences in emigration rates are striking: for the top 10 districts (with 25 percent of the labor force), the average predicted probability of short-term labor emigration is 10 times higher than for the 7 bottom districts (9 percent of the labor force). However, the average unemployment rate in these low emigration districts is higher than in the 10 high emigration ones. Logit models also confirm that local unemployment rates do not have a significant impact on temporary emigration. Tirana district, with 17 percent of the labor force, has the eight lowest emigration risk, and the risk ratio between the top and bottom quartiles of the labor force is 4.6. Single men are about two times more likely to emigrate than their married counterparts.

Figure 23: Effect of District Poverty Rate and Marital Status of Albanian Men on the Predicted Probability of Temporary Work-related Emigration

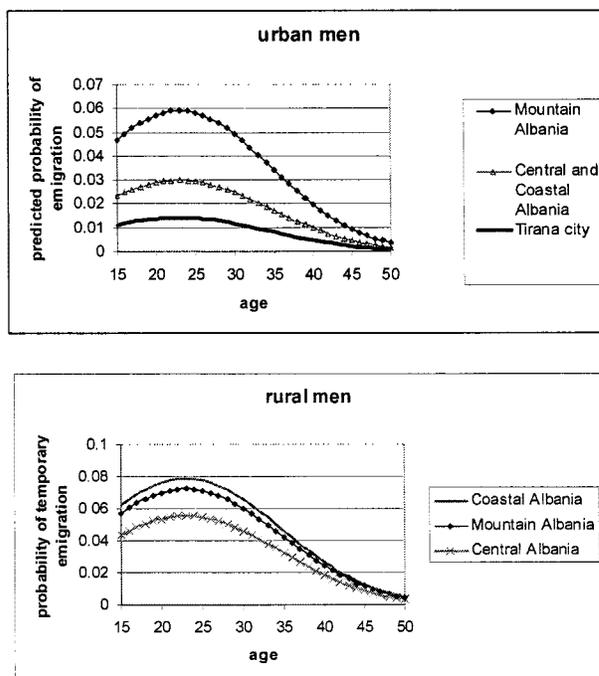


Source: Calculation based on 2001 Population Census data

Rural residents are significantly more likely to engage in temporary emigration—which helps create incomes in rural areas

The highest predicted emigration rates are recorded in rural areas, in the Coastal and Mountain zones, and in urban areas of the Mountain zone (excluding mountain districts on the Serbian border - Has, Kukes, and Tropoje). Living on the Serbian border reduces the probability of emigration by 1.7 percentage points, other things being equal. The probability of short-term emigration peaks at 23 years of age (when marital status is not controlled) (see Figure 24).

Figure 24: Effect of Place of Residence and Age on Predicted Probability of Temporary Work-related Emigration



Note: Excluding districts on the Serbian border. Source: Calculation based on 2001 Population Census data.

Willingness to move abroad is strong across genders

While 9.2 percent of men and 1.5 percent of women age 15 to 64 had been abroad for at least three months in a row during the 1997-2001 period, many of those who had not had considered moving abroad temporarily or permanently (see Table 28). Interestingly, the proportion of women who had considered moving but had not tried was the same as for men; however, men were much more likely to try and to succeed.

Table 28: Willingness to Move Abroad Temporarily or Permanently among Albanians Who Had Not Moved in 1997-2001 (April 2002, percent of population aged 15-64)

	Men	Women	Men and women
Have stayed abroad for 3 months or more at least once in 1997-2001	9.2	1.5	5.4
Have tried to move abroad but failed	20.0	6.3	12.7
Have considered moving but have not tried	15.5	15.2	15.3
Have not considered moving abroad	55.3	77.0	66.6
Total	100.0	100.0	100.0

Source: Calculation based on LSMS data.

There are gender differences in the determinants of migration

The econometric analysis reveals significant gender differences in the factors influencing willingness to move (for the persons who had not moved in 1997-2001). Men are significantly more inclined to move abroad when they live in a district with a high poverty rate, and when their household is subjectively perceived as poor. Women, in contrast, are much more likely to consider moving abroad when they are unemployed and/or live in a district with high unemployment, while a high district poverty rate negatively affects female willingness to move. Women with secondary and higher education, as well as those living in cities, are much more inclined to consider moving abroad than their male counterparts. Neither household per capita income nor subjective poverty assessment affects women's attitude towards moving. Having direct relatives abroad matters for women but not for men.

Three patterns, however, are similar for both genders. First, willingness to move abroad reaches its peak between 26 and 29 years of age. Second, unlike actual emigration patterns, the maximum willingness to go abroad is found in Central Albania, while men living in the Mountain, zone and residents of Tirana, are more often unlikely to move, other things being equal. Finally, Albanians with less than eight years of schooling are less likely to move abroad than those who completed basic education.

Table 29: Determinants of Willingness to Move Abroad among Albanians Who Had not Moved in 1997-2001 (direction of effect; 0 if not significant)

Factors	Men	Women
Household per capita income	-	0
Household subjective welfare ranking	-	0
District poverty rate	+	-
District average per capita consumption	-	+
District unemployment rate	0	+
Unemployed	0	+
Student	-	0
Education (vs. Basic 8 years)		
University or secondary education	0	+
Less than basic education	-	-
Residence (vs Central Albania and Rural)		
Coastal Albania	-	0
Mountain Albania	-	0
Tirana city	-	-
Urban	0	+
At least one of the female household members has a child permanently living abroad	0	+
Age when willingness is maximal	30	28

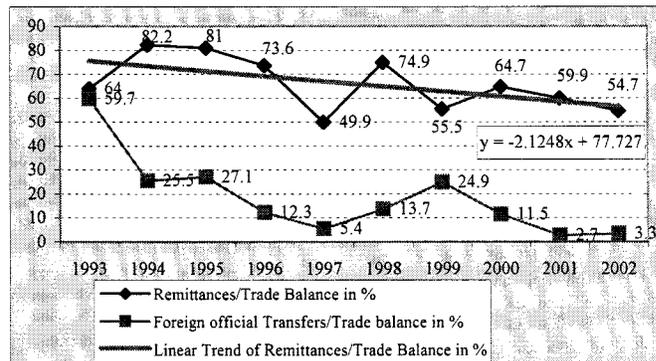
Source: Calculation based on LSMS data.

2. Macroeconomic Impact

Migration has also helped Albania contain its large current account deficit through high volumes of remittances

Remittances from Albanians living abroad have supported macroeconomic stability and stimulated economic growth. Throughout the past decade, remittances have played a crucial role in offsetting the lack of lending from the banking sector and have helped sustain consumption—and the country’s standards of living. While their general trend has been decreasing, they have represented on average more than 60 percent of the trade balance (in absolute terms—see Figure 25), compensating for low domestic savings, fuelling high levels of domestic demand, and fuelling small-scale private investment. The high volumes of remittances have contributed to the stabilization of the exchange rate and the fight against inflation.

Figure 25: Remittances and the Trade Balance, 1993-2002



Source: Bank of Albania, ACIT 2003

Remittances and external aid contribute to the

High volumes of remittances—most of which occur in cash, outside the banking system, large inflows of external financial assistance, and foreign direct investment most recently have fueled domestic

appreciation of the Lek

consumption and investment, contributing to the strengthening of the Lek. The Bank of Albania estimates that remittances amounted to \$600 million Lek in 2002, more than twice the volume recorded by the banking system (Figure 26). Indeed, Albania has the highest level of currency outside the banking system in SEE countries (Table 30). Statistics from the Ministry of Economy's Department of Monitoring and Evaluation indicate that Albania has received over the period 1991-2002 a total commitment of external assistance of around US \$3.9 billion (see Table 31). However, Government capacity to manage aid projects and programs, and issues of air coordination among donors have reduced the effectiveness of foreign assistance.

Figure 26: Remittances, in Millions of Leks, 1994-2002

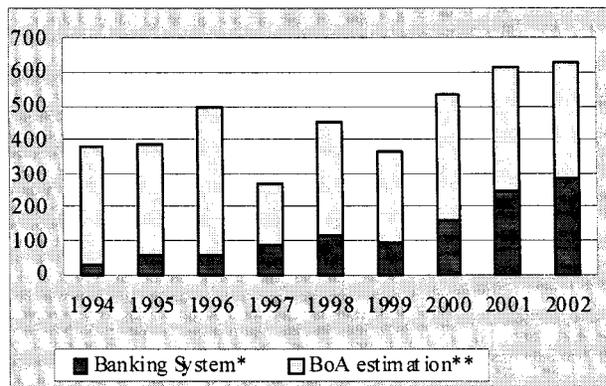


Table 30: Currency Outside the Banking System as a percentage of Ms, SEE

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
SEEurope (average)	23.8	18.0	22.0	22.6	20.4	25.3	20.7	20.3	20.1	20.1	
Albania	34.4	35.7	39.0	39.0	30.9	36.6	28.5	27.8	30.2	30.3	31.4
Bulgaria	12.0	10.8	9.5	10.9	10.2	23.7	28.2	28.3	26.7	25.5	-
Croatia	-	13.7	15.0	13.5	11.9	10.5	10.0	10.6	9.1	8.0	-
Macedonia	-	6.3	25.9	28.9	31.3	27.1	24.4	22.0	20.8	23.4	-
Romania	25.0	23.5	20.7	20.8	17.8	28.6	12.5	13.0	13.9	13.2	-

Source: IFC

Table 31: External Assistance to Albania, 1991-2002

	Pre-1998	1998	1999	2000	2001	2002	Total
Commitments, in thousand \$	2,230,687	276,149	478,197	397,526	252,409	261,618	3,896,586
In % of GDP		8.4	12.7	9.37	5.43	5.0	
In % of Budget Expenditure		25.3	37.5	30.3	17.6	15.9	
Disbursement, in thousand \$	1,977,773	207,376	286,139	215,069	263,275	192,752	2,242,384
In % of GDP		6.3	7.6	5.1	5.7	3.7	
In % of Budget Expenditure		19.0	22.5	16.4	18.4	11.7	
Cumulative Disbursement Rate	48.3%						57.5%

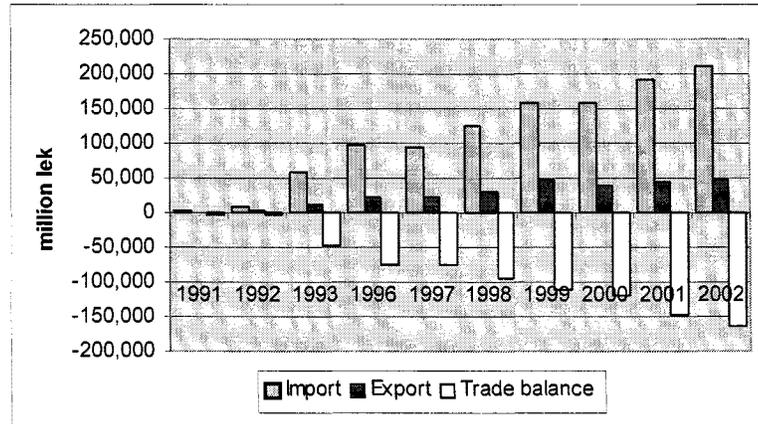
Source: Ministry of Economy, Department of Monitoring and Evaluation.

The appreciation of the Lek is a constraint to external competitiveness

The strengthening of Albania's currency has been associated with slower export growth and a larger trade deficit. While Albania's import needs are consistent with the levels observed in open economies at similar levels of development—about 30 percent of GDP on average between 1993 and 2003-- its exports remain low, at less than 10 percent of GDP. Thus, the trade deficit has remained high (Figure 27). The still

manageable current account deficit (7.5 percent of GDP in 2003) mostly reflects the large volumes of remittances flowing into the country. This is an indication that the appreciation of the Lek may be negatively affecting the country's external competitiveness.

Figure 27: Albania's Increasing Trade Deficit



Albania thus faces serious challenges in maintaining a sustainable external position. The current account deficit is still one of the highest in South East Europe at 7.5 percent of GDP in 2003, up from 2.4 percent in 1995, its lowest level during the transition. Given the country's structural trade deficit, the current account deficit would have been even higher, except for the continuous flow of private transfers (remittances).

Remittances are expected to decline over time

Consistent with economic theory and cross-country studies, the long-term trends in Albanian remittances are expected to decline. A recent study conducted by the Ministry of Labor and Social Affairs concludes that Albanian emigrants tend to stay for a shorter time in the host countries. Their savings are mostly placed in their respective host countries, and 66 percent express willingness to come back to their country. Those who are living in Greece, who represent the largest emigrant community, are the most willing to return (78.6 percent) in no more than 4.8 years. The average time of the stay abroad is estimated to be 13-14 years.

Migration is a double-edged sword, as it negatively affects the size and composition of the labor force

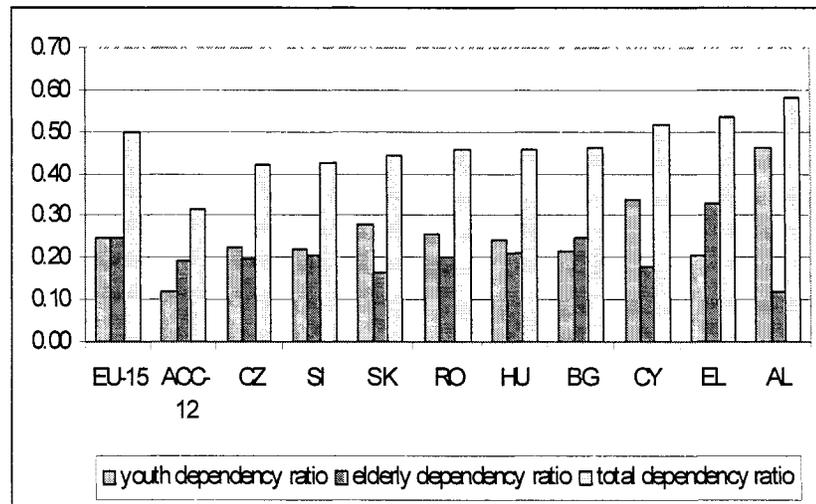
As Albania's market economy develops and matures and the structural reform agenda is completed (especially in the transport, energy, and telecommunications sectors), factor accumulation should again become an important engine of growth. While in the past migration out of rural areas was perceived as a potential solution to the problem of rural poverty in Albania, it is also increasingly seen as contributing to social dislocation, agricultural labor shortages and a rapid deterioration in the provision of social services in urban areas. Furthermore, the large-scale legal and illegal migration of Albanians to other parts of Europe constitutes an important political and social challenge to the

governments and citizens of the EU. It is also perceived as a source of informal labor and criminal activities. Stricter migration laws, increasing costs and associated risks also make migration less of a viable solution, particularly for the less-endowed households.

The Albanian population is younger than that of other European countries but its overall demographic burden is heavier

The massive emigration of the post-socialist era (see World Bank, PA) changed the structure of the population and has not been compensated by natural increase. The total population declined by only 3 percent between 1989 and 2001. However, the population aged 20 to 29 declined by 26 percent.³⁵ While the population remains relatively young if compared with other countries in South-Eastern Europe (Figure 28), the youth dependency ratio (the ratio of the population below 15 to the population aged 15 to 64) is significantly higher in Albania than in comparison countries, and the old age dependency ratio (the population above 64 to the population aged 15 to 64) is lower. The total dependency ratio in Albania is higher than in any of the comparison countries. Together with the low employment of the working age population, this stylized fact is one of the reasons for poverty. Other things being equal, Albania needs higher employment rates to support its children and elderly than, for example, Slovenia, Romania, Hungary and Bulgaria. Put differently, if employment rates and productivity were the same, per capita GDP would be lower by about 20 percent in Albania.

Figure 28: Demographic Dependency Ratios^a in Albania and Selected Countries^b, 2002



Notes: ^a The youth (respectively, elderly) dependency ratio is the ratio of the population below 15 (respectively, above 64) years of age to the population aged 15 to 64. The total dependency ratio is the sum of youth and elderly dependency ratios. ^b ACC-12 refers to average indicators for the ten new EU members, Bulgaria, and Romania. Country abbreviations: CZ – Czech R., SI – Slovenia, SK – Slovak R., RO – Romania, HU – Hungary, BG – Bulgaria, EL – Greece, AL – Albania. Albanian data refer to year 2001. *Source:* Calculation based on LFS data presented in Franco-Blondal (2003) and Franco-Jouhette (2003), and Albanian Population and Housing Census 2001 data.

³⁵ See Heleniak (2004).

Economic dependency is rising, putting strong pressure on the labor force. The net economic dependency ratio (number of non-employed per one employed individual) increased from 1.21 in 1989 to 1.95 in 2001,³⁶ well above the ratio of 1.31 for the ten new EU members, Bulgaria and Romania. As Table 32 shows, the economic dependency ratio in Albania is similar to that in Bulgaria but higher than in other Southern European countries. In fact, the difference is even larger because part-time and temporary employment is more widespread in Albania than in comparison countries (see below).

**Table 32: Net Economic Dependency Ratio^a
in the EU and Selected Countries, 2002**

EU-15	ACC-12 ^b	SI	CY	RO	HU	EL	BG	AL	AL
1.30	1.31	1.16	1.16	1.28	1.56	1.63	1.82	1.70 ^c	1.95 ^d

Notes: ^a Ratio of total non-employed to total employed population. ^b ACC-12 refers to average indicators for the ten new EU members, Bulgaria, and Romania. Country abbreviations: CZ – Czech R., SI – Slovenia, SK – Slovak R., RO – Romania, HU – Hungary, BG – Bulgaria, EL – Greece, AL – Albania. ^c Based on LSMS 2002 results (which may overestimate employment and hence underestimate the dependency ratio). ^d Based on the 2001 Population and Housing Census 2001 data, which may underestimate employment and underestimate the dependency ratio. *Source:* Calculation based on LFS data presented in Franco-Blondal (2003) and Franco-Jouhette (2003), Albanian Population and Housing Census 2001 data, and Albanian LSMS 2002 data.

Clearly, this geographical mobility of labor has been one of the important adjustment mechanisms for Albanians to cope with poverty, structural unemployment and asymmetric shocks. The analysis of short-term labor emigration from Albania, permanent internal migration, and commuting (using microdata from the 2001 Census and the 2002 LSMS) confirms the need to mobilize labor resources as a crucial factor of growth for the medium and long term.

³⁶ Muca et al., 2004, p. 20. Since 1989, the ratio has almost doubled in urban areas outside Tirana.

CHAPTER 5: MOBILIZING LABOR RESOURCES

The work on growth accounting in the previous chapter showed that growth in Albania during transition has been driven primarily by high rates of TFP growth (i.e., by the improved allocation of resources). In order for Albania to sustain high growth going forward, it must increase its rate of capital accumulation and also generate additional improvements in TFP through the improved allocation of resources. This can only be done through a better mobilization of labor resources, which is the focus of this chapter.

1. Profile of the labor market

Formal employment has yet to recover after the sharp decline at the beginning of the transition

A comparison of the results of the 1989 and 2001 Population and Housing Censuses (notwithstanding some methodological differences) shows that employment rates have declined dramatically during the past decade, especially for men aged 20-29 and women aged 20-39 (see Figure A.5 in Annex). As noted by a World Bank report, "Reduced employment rates of the nineties were a result of the falling public sector employment. The number of jobs in the public sector decreased dramatically from 850,000 in 1991 to 189,000 in 2001. This drop in the public sector employment was mostly due to mass privatization of state-owned enterprises. ...The industrial sector – extraction of minerals, metallurgy, equipment, chemicals, paper and textiles – were hit the most. Reduced revenues decreased the number of jobs in government structures as well."*

The 2001 Census results overestimate unemployment, while the 2002 LSMS statistics and the official labor statistics underestimate unemployment and labor force participation, especially for men

Box 4: Dealing with Inconsistencies in Labor Market Statistics

Measurement and Methodological Issues. There are three major sources of information on the Albanian labor market: (i) the official labor statistics (covering the years 1993-2002); (ii) the 2001 population census; and (iii) the most recent living standard and measurement survey (LSMS), dated 2002. The three sources give three very different pictures of Albania's labor market, even when we compare the results for the same age group, the so-called "official working age." According to official labor statistics, unemployment in 2001 and 2002 was around 14 percent for men and between 19 and 20 percent for women. Census results indicate that in 2001, unemployment rates were 19 percent for men and 29 percent for women. Yet the 2002 LSMS, under standard ILO definition, gives much lower rates, which are almost identical for men and women (10.5 percent and 10 percent, respectively). It appears that: (i) The Census results overestimate unemployment by including in its calculations some underemployed workers or those jobseekers that are not fully active. However, the analysis of the determinants of unemployment based on the Census data will give qualitatively correct results; (ii) The LSMS statistics and the official labor statistics underestimate unemployment and labor force participation, especially for men; and (iii) There are some problems in the design and representativeness of the labor module of the 2002 LSMS.

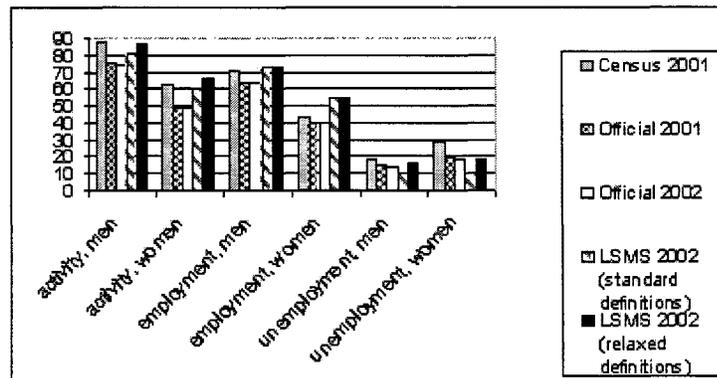
In addition to possible mistakes in calculation methods, one explanation of these inconsistencies could be the different methodological approaches by each source, and the fact that the Albanian labor market has several characteristics which make it difficult to analyze with the traditional methodological frameworks used for European countries: (i) a very high proportion of self-employed and contributing family workers among the employed population; (ii) a high incidence of subsistence farming; (iii) a

very high proportion of workers employed in agriculture; (iv) a very low proportion of full-time, full year employment and a high incidence of underemployment; and (v) possibly some informal restrictions on female activity (including job search) in the labor market.

Approach Used for the CEM. The CEM uses the so-called relaxed definitions of unemployment. Registered unemployed are required to show up just once in 12 weeks to be classified in the “Active job search” category. Yet more than 20 percent of them reported “no active job search in the last 4 weeks.” Also, many jobless persons declare themselves ready to start working in two weeks, but not are searching for employment, either because they are discouraged, or because they are waiting for opportunities during the busy season. Adding these two categories into the calculations of unemployment increases the male unemployment rate by 4 percentage points and the female unemployment rate by 6 percentage points. The decision to consider unemployed all jobless persons who reported no active search in the past 4 weeks for various reasons but would be ready to take up a job in two weeks, increases the Albanian unemployment rate by 1 more percentage point. Under this relaxed definition, a corrected LSMS-based male unemployment rate in 2002 is about 3 percentage points below the one derived from the 2001 Census and about 3 percentage points above the registered unemployment rate in 2002. After these adjustments, LSMS-based male labor force participation, unemployment and employment rates, as well as the female labor force participation rate are reasonably close to the Census estimates.

Labor force participation is formally high by international standards, but more than a half of the male labor force and about three-quarters of the female labor force is either jobless or engaged in low-productive agricultural self-employment (Figure 29). Employment is heavily concentrated in agriculture (especially for women), a sector whose contribution to GDP has been declining. Paid employment represents less than one-third of the total number of people who are employed. Even in the urban areas (except for Tirana) only 70 percent of all employed are in the paid employment sector. Almost half of all employed (and almost one-third of all employees) of both genders are working part-time. About one-third of all employed are working less than 40 weeks a year.

Figure 29: Activity, Employment and Unemployment Rates (percent). Men Aged 15-59 and Women Aged 15-54



Gender disparities are acute in the labor market

Labor market outcomes for women are significantly worse than for men along all dimensions. Women have significantly lower participation and employment rates, and they comprise a lower proportion of paid workers among employees and (somewhat unusually) a larger

proportion of those in non-permanent jobs (see Table 33).

Table 33: Labor Market Status of Albanian Population Aged 15-64, April 2002 (percent)

Status	Men	Women	Tirana	Other urban	Rural	Total
<i>Employees</i> not working in a family farm or business	27.5	11.5	36.7	29.5	10.9	19.0
<i>Employers</i>	0.5	0.1	0.9	0.4	0.1	0.3
<i>Paid workers</i> (farm or family business)	0.4	0.2	0.2	0.2	0.3	0.3
<i>Self-employed workers</i> or <i>unpaid worker</i> in a family business (<i>except agriculture</i>)	9.0	2.6	5.5	9.7	3.8	5.6
<i>Self-employed agricultural worker</i> or <i>unpaid worker</i> in a farm owned or rented by a household member	33.3	36.7	0.1	2.3	56.7	35.1
<i>Unemployed 1</i> (standard definition: actively looking for a job in the past 4 weeks, or have already found one, or waiting recall from employer; ready to start in two weeks once a job is available) ^a	8.5	5.7	11.4	14.6	2.7	7.0
<i>Unemployed 2</i> (relaxed definition: not employed, not looking for a job in the past 4 weeks but ready to start in two weeks once a job is available; includes discouraged workers, seasonal workers etc.) ^b	4.8	5.1	5.7	8.4	3.3	5.0
<i>Student</i> or <i>pupil</i> ^c	6.3	6.3	10.2	9.6	4.1	6.3
<i>Retired</i> or <i>handicapped</i> ^d	6.6	11.3	12.5	11.8	7.2	9.1
<i>Other currently inactive but have worked in the past 12 months</i> (or are waiting for recall/busy season) ^e	0.8	2.0	0.4	0.8	1.9	1.4
<i>Other inactive</i>	2.3	18.6	16.4	12.7	9.1	10.9
Total	100.0	100.0	100.0	100.0	100.0	100.0
Labor force participation rate 1 (Employed + Unemployed 1)	79.2	56.7	54.9	56.7	74.5	67.3
Labor force participation rate 2 (Employed + Unemployed 1 + Unemployed 2)	84.0	61.8	60.5	65.1	77.8	72.3
Employment rate	70.7	51.0	43.5	42.2	71.8	60.3
Unemployment rate 1: Unemployed 1/Labor force 1	10.8	10.0	20.8	25.7	3.7	10.4
Unemployment rate 2: Unemployed (1+2)/Labor force 2	15.9	17.5	28.2	35.2	7.7	16.6
Longterm unemployed/Total unemployed	54.6	62.4	55.3	58.2	59.9	58.3
Paid employment (percent of total employment)	39.4	22.7	84.8	70.6	15.7	32.0
Worked < 40 weeks in the past 12 months (percent of employed who keep current job for at least one year)	32.3	39.6	10.6	19.1	42.3	35.6
Results of the Population and Housing Census 2001 (not comparable due to different methodology ^f)						
Labor force participation rate	82.9	55.9	69.8	72.3	67.4	69.3
Employment rate	67.3	40.0	51.6	48.4	56.8	53.5
Unemployment rate	18.8	28.5	26.1	33.0	15.7	22.7
Paid employment (percent of total employment)	30.7	32.7	68.3	61.0	10.2	31.5
Part-time (less than 35 hrs per week)/Total employment	47.1	49.4	32.3	43.5	52.6	47.6

Notes: ^a 27.6 percent of members of this group of unemployed have worked in the past 12 months. ^b 16.8 percent of this group of unemployed have worked in the past 12 months. ^c 10.0 percent of students/pupils have worked in the past 12 months. ^d 8.8 percent of retired or handicapped persons have worked in the past 12 months. ^e 94.1 percent of members of this group have worked in the past 12 months. ^f If the adjustments are made to account for the under-representation of registered unemployed in the LSMS sample, unemployment rates increase well above the unemployment rate 2 levels. [†] See Annex 2. Source: Calculation based on Population and Housing Census 2001 and LSMS 2002 data.

Various government sources provides different unemployment rates

Unemployment is high, although it is difficult to measure precisely. According to official labor statistics, unemployment in 2001 and 2002 was around 14 percent for men and between 19 and 20 percent for women, while Population Census results indicate that in 2001 unemployment rates were 19 percent for men and 29 percent for women. On the other hand, the 2002 LSMS, under standard ILO definition, gives much lower rates, which are almost identical for men and women (10.5 percent and 10 percent, respectively) (see Table 34).

**Table 34: Unemployment Rates in Albania, 2001-2003:
Men Aged 15-59 and Women Aged 15-54 (Percent)**

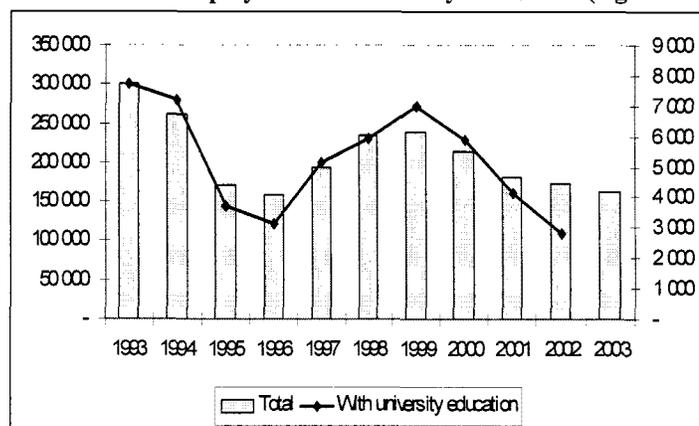
Source:	Official labor statistics (registered unemployment)	Population Census	LSMS	
			standard definition	relaxed definition
Men				
2001	14.2	19.0	n.a.	
2002	13.6	n.a.	10.5	16.4
Women				
2001	19.9	28.7	n.a.	
2002	19.1	n.a.	10.0	18.2
Total				
2001	16.4			n.a.
2002	15.8	n.a.	10.3	17.2
2003	15.0	n.a.		n.a.

Source: INSTAT and calculation based on Population census and LSMS 2002 data.

Long-term trends in unemployment are mixed

After a sharp increase in 1991-1992, the number of registered unemployed started to decrease gradually in 1993 when the law on Land Privatization was adopted. Figure 30 shows that after falling by almost 50 percent in 1993-96, registered unemployment rose in 1997-99, but has been declining since 2000. At the end of 2003 it was about two-thirds of its level of four years earlier. Given the inconsistencies between different data sources (see Box 4), it is difficult to evaluate to what extent this fall in registered unemployment reflects economic growth. However, the growth accounting carried out by Khan (2004) suggests that most of Albanian economic growth in 1993-2003 was driven by very substantial improvements in TFP, as Albania has reallocated resources to more productive activities; the contribution from employment growth was negligible, although it increased somewhat in 2002-03, which is consistent with the recent trends in unemployment.

Figure 30: Registered Unemployment in Albania, 1993-2003 (end of period): Total Number of Unemployed (left scale); Number of Unemployed with University Education (right scale)

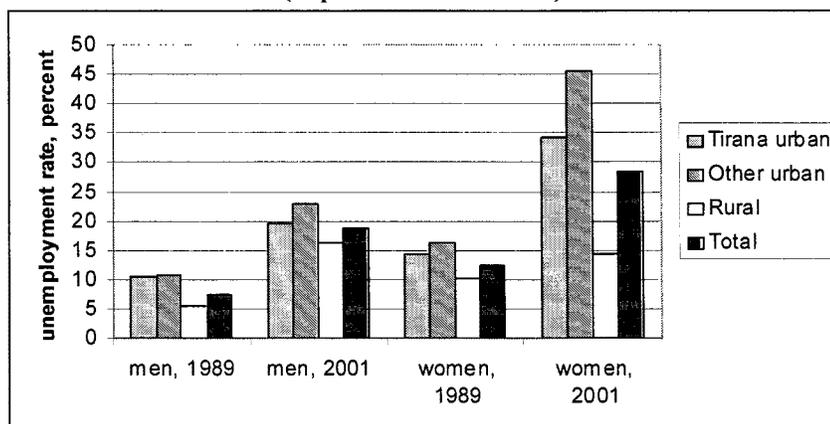


Source: Elaboration from INSTAT data.

There are strong regional and gender dimensions to unemployment

The unemployment rate measured by the Census has increased from 9.8 to 22.7 percent, but in some districts in the north and southeast it has more than tripled for both genders.³⁷ Comparison of the results of the 1989 and 2001 population Censuses (see Figure 31) shows that (self-defined) unemployment rates have more than doubled for urban men and women living in Tirana City, and tripled for rural men and women living in other urban areas. Applying the relaxed definition of unemployment to the LSMS 2002 data gives the results presented in Table 37. Both the unemployment rate and the incidence of long-term unemployment are higher among females. Average labor force participation rates and unemployment rates are similar in Coastal, Central (excluding Tirana city) and Mountain Albania, but the incidence of long-term unemployment is significantly lower on the Coast.

Figure 31: Unemployment Rates by Sex and Residence: 1989 and 2001 (Population Census data)



Source: Data from Table 3.8 in Muca et al., 2004.

Table 35: Employment, Unemployment and Labor Force Participation in Albania, April 2002 (population aged 15-64), in percent

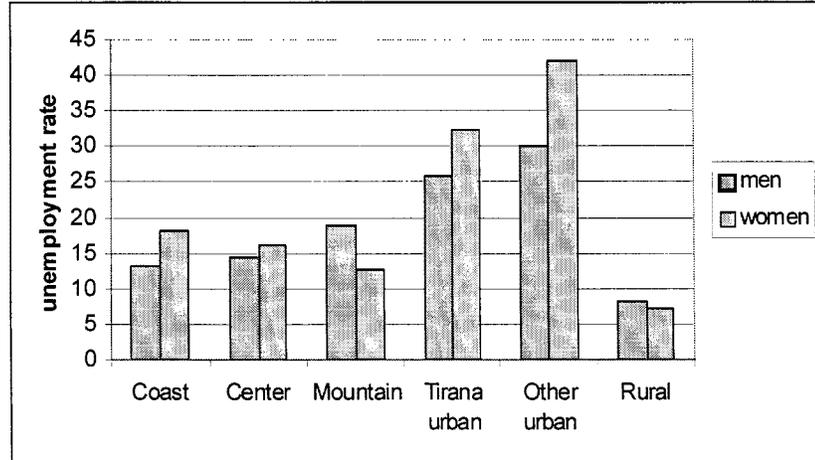
	Men	Women	Coast	Center	Mountain	Tirana urban	Other urban	Rural	Total
Employment rate	70.7	51.0	61.4	62.8	62.1	43.5	42.2	71.8	60.2
Unemployment rate (relaxed definition ^a)	15.9	17.5	15.5	15.2	16.0	28.2	35.2	7.7	16.6
Longterm unemployed (% of all unemployed)	54.6	62.4	47.7	64.5	64.5	55.3	58.2	59.9	58.3
Labor force participation rate (relaxed definition ^b)	84.0	61.8	72.7	74.1	74.0	60.5	65.1	77.8	72.2
Labor force participation rate (standard definition ^c)	79.2	56.7	67.5	69.7	68.2	54.8	56.7	74.4	67.2

Notes: ^a All persons who are not employed but are ready to start working in two weeks once a job is available, are counted as unemployed (and economically active) even if they have not reported an active job search. ^b All unemployed according to relaxed definition, as well as employed, are included in the labor force. ^c Only the unemployed according to standard definition, as well as the employed, are included in the labor force. **Source:** Calculation based on LSMS 2002.

³⁷ Muca et al, 2004, Table 3.8 and p. 43.

Regional disparities are gender-specific (Figure 32). Among the three zones (Coast, Center, and Mountain) the highest male unemployment rate is found in the Mountain zone and the lowest in the Coast. Female unemployment rates exceed male rates only in urban areas.

Figure 32: Unemployment rates by Residence and Gender, April 2002



Notes: All persons who are not employed but are ready to start working in two weeks once a job is available are counted as unemployed (and economically active) even if they have not reported an active job search. *Source:* Calculation based on LSMS 2002.

Unemployment is higher among the young

Other things being equal, the unemployment risk is highest for men aged 15 to 34 and women aged 15 to 24. This reflects the difficulty of finding the first job in Albania: almost all unemployed teenagers, one-third of unemployed women aged 20-24 and one-fifth of unemployed men aged 15-34 do not have work experience. The risk declines with age between 34 and 54 years. Beyond age 54, it stabilizes for women and increases slightly for men. These results are illustrated in Figure 33 which shows the net effects of age and residence on unemployment risk for economically active Albanians (the effects are estimated using the 2002 LSMS data and the relaxed definition of unemployment).

Figure 33a: Unemployment Risk for Economically Active Albanians by Age Group and Residence, April 2002—Men

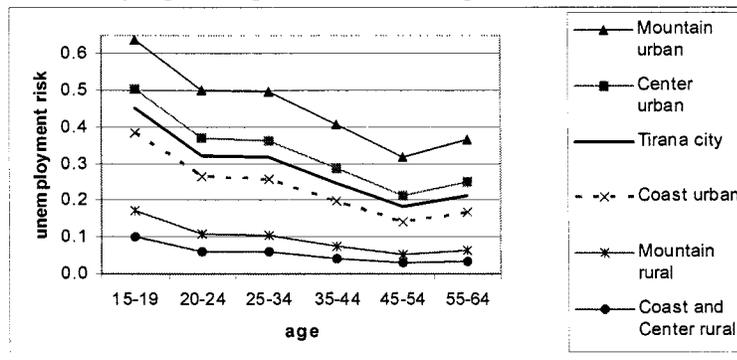
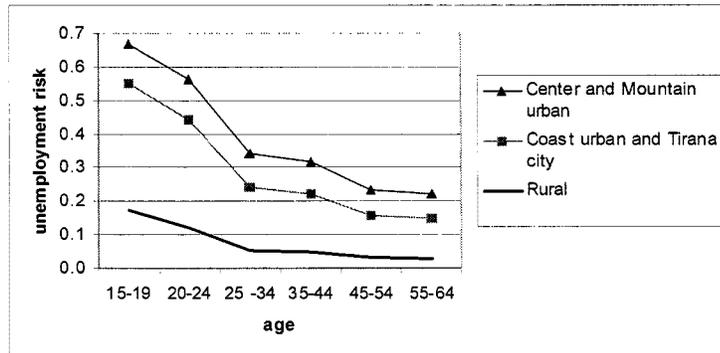


Figure 33b: Unemployment Risk for Economically Active Albanians by Age Group and Residence, April 2002—Women



Notes: A relaxed definition of unemployment has been applied: all jobless persons who are ready to start working in two weeks once a job is available are counted as unemployed. The profiles are based on a logit model with the following controls: age groups; marital status (for women also number of children below 7 years in the household); educational attainment (six categories); dummies for residence in urban areas, Coastal Albania, Mountain Albania and Tirana City; dummies for post-1989 immigrants from abroad, from other districts, from other communities in the same district, as well as for those who moved into the community before 1990; agricultural land ownership. Variables not shown in the graph are fixed at their mean values for men (respectively, women), so the differences between the profiles represent the net effects of the place of residence. *Source:* Calculation based on 2002 LSMS data.

Education does not always protect from unemployment

On average, neither basic nor secondary education seems to have a substantial effect on employability. The highest raw unemployment rates are found for labor force members with a secondary education, followed by those with a basic education. Compared to those with a secondary education, “Men with primary or basic education” are more often “discouraged unemployed” and less often “active jobseekers.” On the other hand, “Men with secondary education,” are on average more likely to be underemployed (and to declare themselves as unemployed) than their less educated counterparts-- other things being equal. However, urban men aged 25-34 face substantially lower unemployment risks if they have a secondary education compared to 8 years of basic schooling, other things being equal (Figure 34a).

Figure 34a: Unemployment Risk^a for Economically Active Albanians (students and pensioners excluded) by Years of Schooling and Residence, April 2001--a) Men, aged 25-34^b

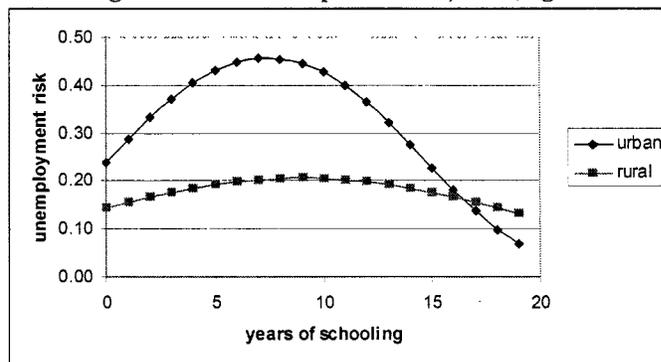
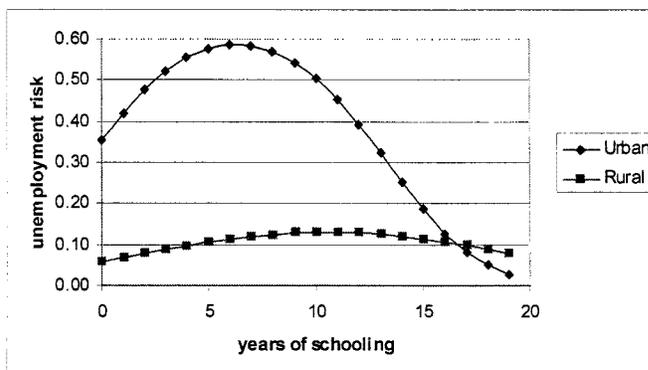


Figure 34b: Unemployment Risk^a for Economically Active Albanians (students and pensioners excluded) by Years of Schooling and Residence. April 2001--b)
Women, aged 15-64^c



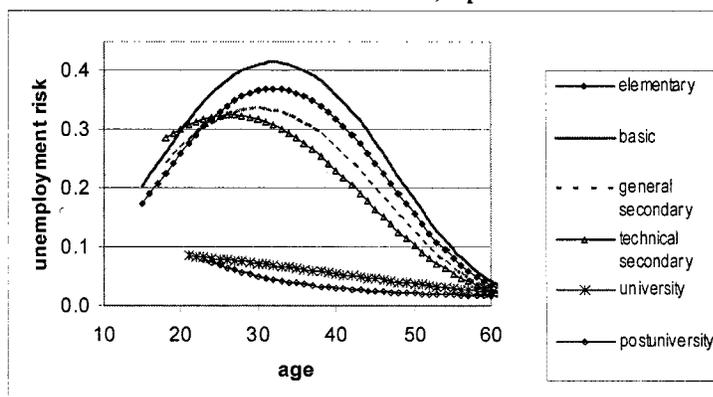
Notes: ^a Profiles are based on a logit model with the following controls: six age groups; marital status (for women also number of children and number of adult women in the household); [number of years of] schooling and schooling squared; dummies for residence in urban area, Coastal Albania, Mountain Albania and Tirana city, as well as their interactions with schooling and schooling squared; dummies for post-1989 immigrants from abroad and from other districts; dummy for having agricultural land located in the district of residence and belonging to a household member. ^b When constructing *Urban* (respectively, *Rural*) profile, variables representing region of residence, marital status, migration history and agricultural land ownership are fixed at their average values for *urban* (respectively, *rural*) men aged 25-34.

^c When constructing *Urban* (respectively, *Rural*) profile, variables representing region of residence, marital status and family situation, migration history and agricultural land ownership are fixed at their average values for *urban* (respectively, *rural*) women aged 15-64.

Source: Calculation based on 2001 Population Census data (796378 observations for men, 546257 observations for women; only respondents aged 15 to 64 included).

Figure 35: Unemployment Risk for Economically Active Albanian Women (students and pensioners excluded) by Age and Educational Attainment, April 2001

Tertiary education pays off

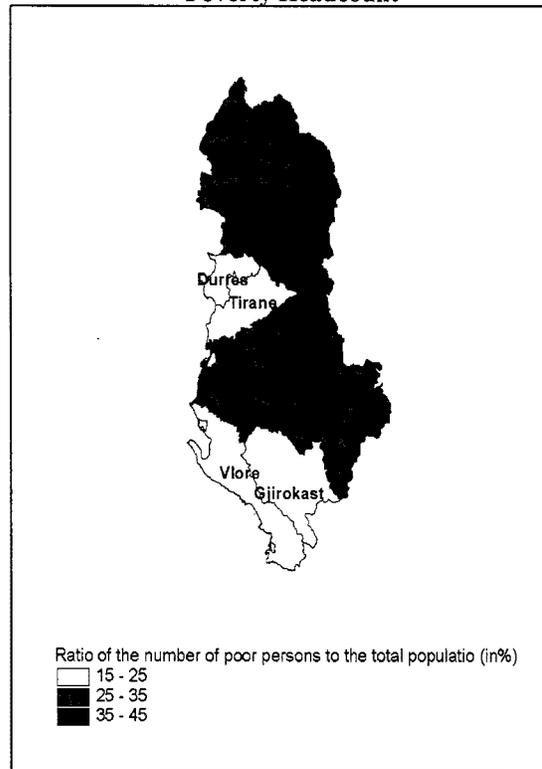


The positive effect of university education on employability is unambiguously strong for both genders, especially in cities. Other things being equal, the unemployment risk for college graduates is reduced by about half that for men with secondary education, and much more for women.

Poverty remains pervasive

In addition to these structural labor market issues, Albania also suffers from pervasive poverty. 25 percent of the Albanian population, or close to 780,000 individuals, falls below the poverty line. A large number of individuals are clustered around the poverty line. Increasing the poverty line by 10 percent increases the percentage of poor individuals by 25 to 50 percent, depending on the poverty line used.

Figure 36: Geographical Mapping of the Poverty Headcount



Source: World Bank Poverty Assessment.

Poverty in Albania has marked spatial and regional dimensions, with rural areas and the Mountain region being consistently poorer than the rest of the country

According to the 2003 World Bank Poverty Assessment, the poverty headcount in rural areas is 66 percent higher than in Tirana, and 50 percent higher than in other urban areas. Per capita consumption in rural areas, at 7,224 Leks, is about four-fifths of the consumption levels in urban areas. Households in the most remote districts in the Mountain region in the north and northeast of the country do not fare well in terms of poverty, and almost half of the residents of this area are poor, and more than a fifth live in extreme poverty. Also, the depth of poverty in this area is much more pronounced than in any of the other regions, with a poverty gap index of over 11 percent. Average consumption in the mountainous regions is two-thirds of the consumption levels in Tirana, and about 20-30 percent lower than in the rest of the country. Poverty rates and depth in all other regions are around or below the national averages.

2. Inadequate Supply and Low Demand for Human Capital

Low human capital and poor infrastructure are major structural constraints to growth

Prior to the transition, growth in Albania was driven by a mixture of factor accumulation and total factor accumulation growth. In other words, changes in the growth rate were driven by approximately proportional changes in the contributions of factor accumulation and TFP growth. During the transition years, the predominant engine of contraction and subsequent growth was TFP contraction/increase—as shown in Section II. As the recovery proceeds and matures and the structural reform agenda is completed, factor accumulation should again become an important engine of growth. Yet, poor governance, dysfunctional institutions (rules of the game) and weak capacities (both organizational and individual) are major underlying contributors to poor sectoral performance, including sector-specific corrupt practices. In addition, two types of structural constraints currently constitute major obstacles to Albania's growth prospects: (i) weak human capital—compounded by the current low demand for educated labor and low returns to secondary education; and (ii), the low quality of infrastructure, which impedes the country's competitiveness by maintaining input and factor costs high (see next chapter).

The adequacy of Albania's human capital for supporting a transition to investment-driven growth can be judged by evaluating, *relative to comparators*: net enrollment rates; expected years of education; the educational profile of Albania's working age population (25-64 year olds); the quality of the human capital produced by Albania's education system³⁸; and data from Albanian employers at the leading edge of Albania's economy on their assessments of their human capital needs relative to that supplied by the labor force.

Net enrollment rates are declining

Table 38 shows gross enrollment rates for 1989 and net rates for 2002. The data sources (Ministry data for 1989 versus LSMS data for 2002) and calculations of rates (gross versus net) differ. Using LSMS 2002 data to estimate gross versus net rates indicates that the latter are about 5-6 percentage points lower than the former. Even allowing for this difference, enrollment rates for all levels except tertiary education are declining. Enrollment rates for upper secondary schools have declined dramatically, partly because closures of 85 percent of Albania's secondary agricultural vocational schools caused vocational/technical enrollment rates to plummet from almost 70 percent of total upper secondary enrollments in 1989 to 16 percent in 2002. These schools, connected to the collective farms that were privatized early after the transition, were considered low quality. Attendance at them was probably negatively based—an imposition by an authoritarian regime, rather than reflecting families' demand for education. Thus, their closure was good policy. However, policies have not been put in place

³⁸ The quality of Albania's human capital (item 4) can only be judged by inference from measures of quality of Albania's regional neighbors. Survey data of Albanian employers (item 5) are not available, but need to be collected.

to create family demand, especially in the rural areas. The enrollments in secondary education in urban areas are almost 2.5 times higher than in rural areas, whether measured in gross or net terms.³⁹ In fact, access to education is low in many rural areas. This is due to the poor physical conditions of the schools, the poor road infrastructure, and the large number of children attending combined classes.

Table 36: Enrollment rates by level of education

Level of Education	1989 Gross Enrollment Rates	2002 Net Enrollment Rates (LSMS) ¹
Preschool (ages 3-5)	56.7	31.5
Basic (grades 1-8) (age 6-13)	103.2	93.3
Secondary (ages 14-17)	78.5	38.7
Tertiary (ages 18-22)	6.6	8.7

Sources: MOES; Albania LSMS 2002. ¹Note: Preschool data are for net attendance rather than net enrolment. In computing these results, non-reporting observations (27%) were omitted from the calculation. Tertiary includes students in university and postgraduate study.

Comparison with other countries reveals a large negative gap for Albania

Albania's net enrollment rates for basic education are below those for the OECD, including four regional comparators. Table 36 shows enrollment rates by ages, not levels of education, for five regional comparators and the mean for 30 OECD countries.⁴⁰ The 5-14 year old ages correspond roughly to Albania's basic education level; the 15-19 year old group includes its secondary level. The age groups of the 15-19 year olds and the 20-29 year olds include tertiary enrollments for both Albania and comparator countries. The 20-29 age range is much broader than that used for calculating tertiary enrollment rates for Albania (ages 18-22). Had a broader age range been used for Albania, its tertiary enrollment rates would be much lower than the 8.7 net rate in 2002 because the bulk of tertiary enrollments in both OECD countries and Albania are in the late teens and the first half of the twenties. Secondary enrollment rates are disastrously below all comparators. Their tertiary rates are very low, especially when the differences in the population age ranges used to calculate Albanian and comparator net rates are considered.

Albania performs poorly in terms of school expectancy

Albania's expected years of education are lower than average. In 1989 school expectancy⁴¹ in Albania was 11.6 years; by 1998 it had dropped to 9.5 years. Table 37 shows that school expectancy for the average five

³⁹ In urban areas gross enrollments are 73 percent versus 30 percent in rural areas; net enrollments are, respectively, 57 versus 23 percent.

⁴⁰ The first four regional comparators are OECD countries, and their rates enter into the calculation of the OECD mean.

⁴¹ Introduced by UNESCO, this now standard measure uses current enrollment rates for students at each level of education to estimate the number of years that a hypothetical five year old child in the country can expect to complete in his/her lifetime. This measure assumes that the probability of being enrolled in school at any particular age is equal to the current enrollment rates for that age for each level of education. It is calculated by adding the net enrollment rates for each single year of age from age five onwards and dividing by 100. Should there be a tendency to lengthen (or shorten) studies during the ensuing years, the actual duration of schooling for the cohort will be higher (lower). (OECD 2002, Annex A2, p.166.)

year old Albanian is about 3.5 years less than that which the average child from a country in the World Economic Indicator (WEI) program can expect to complete (these countries include Argentina, Brazil, Chile, China India, Indonesia, Jordan, Malaysia, the Philippines, the Russian Federation, and Thailand.). It is 7.4 years less than that which the average OECD child can expect to complete. As the table notes, the dates for these comparisons are not the same—the estimate for Albania being 1998; for the WEI countries, 2000; and for OECD, 2001. However, Albania’s enrollment rates were relatively stable during the 1998-2001 period. Even if school expectancy in Albania increased during this period by 0.5 years, there would still be a major difference between the expected average years of education being produced in Albania and that being produced by either the WEI or OECD countries.

Table 37: School Expectancy for WEI Countries (2000), OECD countries Including Regional Comparators (2001), and for Albania (1998) Country or Country Group
School Expectancy

Albania	9.5
WEI mean	13.0
OECD	16.9
Czech Republic	16.0
Hungary	16.4
Poland	16.7
Slovak Republic	14.9
Russian Federation	14.6

Source: Albania: Albania LSMS, 2002; WEI countries: OECD, 2002b, Annex A4, table 20, p.192; OECD countries: OECD, 2003a, Table C1.1, p.257. Notes: Expected years of education are calculated excluding children under five years of age. It is not clear whether in its school expectancy calculations the OECD included the enrollments of those five years old and older only if they were enrolled in primary school or if they were enrolled in any school (preschool or primary).

Educational attainment is low. Table 38 compares Albania's stock of human capital of its 25-64 year old population relative to that of this same age group for the EU15 and selected countries of Central and South-East Europe. Human capital is defined as years of education completed, or educational attainment. The last row shows the share of the population with upper secondary or tertiary attainment. Albania’s share is significantly below that of the other countries. To the extent that investment-driven growth in Albania depends on human capital accumulation, the share of Albania’s working age population with secondary and tertiary education will have to increase.

Table 38: Educational Attainment of 25-64 Year Old Population in Albania, the EU, and Selected Countries of Central and South-Eastern Europe, 2002 (percent distribution)

Education Level	Country								
	EU-15	ACC-12	SI	BG	HU	RO	CY	EL	AL
Basic or less	35.4	19.3	23.2	28.5	28.6	28.9	33.5	47.3	65.3
Upper secondary	42.9	66.2	62.1	50.4	57.3	61.1	37.4	35.1	28.5
Tertiary	21.8	14.5	14.8	21.1	14.1	10.0	29.1	17.6	6.3
Total upper secondary + tertiary	64.7	80.7	76.9	71.5	71.4	71.1	66.5	52.7	34.8

Source: Based on calculations of LFS data in Franco-Blondal (2003) and Franco-Jouhette (2003), Albanian Population and Housing Census 2001 data, and Albanian LSMS 2002 data. *Notes:* ACC-12 refers to average indicators for the ten new EU members, Bulgaria, and Romania. Country abbreviations: CZ: Czech Republic; SI: Slovenia; SK: Slovak Republic; RO: Romania; HU: Hungary; BG: Bulgaria; EL: Greece; AL: Albania.. Albanian data refer to the 2001 distribution and the 2002 enrollment figures.

Studies focusing on Albania’s curriculum concludes that it is inadequate and does not meet the requirements of an innovation-driven economy

A recent analysis of Albania’s pre-tertiary curriculum found several problems (Crisan, 2004). Since the transition, revisions of the curricula have been ad hoc and random without a clear frame of reference at the level of policy and strategy. Taken as a whole, they constitute a collection of different subject-based programs more than a coherent system that meets international standards for a national curriculum. The major problems are:

- Outdated curricula. The curricula have not been significantly revised since the transition;
- Overcrowded curricula at the primary and secondary levels;
- A lack of integration between subjects, within subjects, or across grades;
- Limited curriculum choice and flexibility in course selection.
- An excessive focus on content and facts.

The focus on content and facts is particularly disturbing. It encourages a teacher-centered model—the “frontal” and “directive” *ex cathedra* approach to instruction. Lecturing seems to dominate. Students are not encouraged to express their opinions. Debate, discovery, problem solving, classroom interaction, group work, project-based activities, “adventure learning,” field work, cooperative/active learning, critical thinking-based methods are rare—if not entirely unknown. Many teachers see their work as to “teach,” not to facilitate students’ learning processes. As a result, students do not develop initiative, the executive thinking skills (“knowing how to learn” skills), problem-solving skills, and the critical thinking skills key to modern economies. Opportunities to engage and interest them in learning are lost.

The quality of human capital is difficult to measure, though inference from neighboring countries are not encouraging. The Ministry of Education now conducts national assessments of learning, but there is no information on how students perform relative to international standards. Unlike many of its neighbors in the region, Albania has not participated in any of the several international assessments of learning: the Third International Mathematics and Science Study (TIMSS),

OECD's PISA⁴², or OECD's International Adult Literacy Survey (IALS).⁴³ The government plans to participate in the 2006 round of OECD's Program for International Student Assessment (PISA).

In the absence of international comparative data for Albania, the performances of neighboring countries in the Europe and Central Asia (ECA) region⁴⁴ that have participated in PISA, IALS, or both, have to be used to draw inferences on how Albanian students might perform on these assessments. Both mean scores and variance in scores on IALS and PISA are important. As the Albanian economy increasingly rewards skills and knowledge, high variances in its students' scores can translate into significant income inequalities. Scores on IALS were found to correlate strongly with the probabilities of unemployment, wages, and per capita GDP. The amount of variance in literacy scores within a country correlated with the extent of income inequality in that country.

Except for the Czech Republic, neighboring countries performed poorly on IALS. Three of the four participating ECA countries (Slovenia, Poland, and Hungary) had about 75 percent of 16–65 year old workers who tested at levels 1 and 2 on all three scales.⁴⁵ Levels 1 and 2 predict that the individual will have difficulty functioning in a modern workplace (OECD, 2000).

Albania's regional neighbors also did not perform well on PISA—again except for the Czech Republic (OECD, 2001). On the basis of the PISA and IALS results for Albania's regional neighbors, it seems reasonable to predict that, *had* Albania participated in these two assessments, their youth and adult populations would have had relatively low mean scores and high inter-school variances. Therefore, Albania's future economic growth will depend partly on an increase, not only in the amount of

⁴² Thirty two countries participated in the first round of PISA: Australia, Austria, Belgium, Brazil, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Latvia, Liechtenstein, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Russian Federation, United Kingdom, and United States. PISA results were only reported for 31 countries, excluding the Netherlands that had not met the sampling requirements for the assessment.

⁴³ Four ECA countries participated in the original or subsequent rounds of IALS: Poland, Hungary, Czech Republic, and Slovenia. The other participating countries included Australia, Belgium (Flemish speaking), Canada, Chili, Denmark, France, Germany, Great Britain, Ireland, New Zealand, the Netherlands, Norway, Sweden, Switzerland, and the United States.

⁴⁴ ECA (Europe and Central Asia) is one of the World Bank's six lending regions. The countries included are defined under acronyms.

⁴⁵ *Level 1* indicates individuals with very poor skills. For example, the person may be unable to determine the correct amount of medicine to give a child from information printed on the package. *Level 2* respondents can deal only with material that is simple, clearly laid out, and in which the tasks involved are not too complex. It denotes a weak level of skill, but more hidden than level 1. Individuals may have developed coping skills to manage everyday literacy demands, but their low proficiency makes it difficult for them to face novel demands, such as learning new job skills. *Level 3* is considered a suitable minimum for coping with the demands of everyday life and work in a complex, advanced society. It denotes roughly the skill level required for successful secondary school completion and college entry. It requires the ability to integrate several sources of information and solve more complex problems. *Levels 4 and 5* describe respondents who demonstrate command of higher-order information processing skills.

education that individuals obtain, but also in the quality of learning associated with these years.

The demand for educated labor is low and returns to secondary education are not very high, yet Albania's economy consists primarily of relatively low value-added, factor-driven activities

The econometric analysis of returns to education shows some demand for modestly skilled labor (secondary completers) and greater demand for more highly skilled labor (tertiary completers)—(see Tables 39 and 40). Calculations using LSMS 2002 data on monthly wages in leks by type of employer, level of education, and gender indicate that:

- Relative to basic or less education, completing secondary education carries a modest wage premium, especially for men in the private sector and women in the public sector.
- Relative to secondary education (vocational and general), completing tertiary education carries a significant wage premium, especially for women in the private sector.
- Although university completion carries a wage advantage relative to both types of secondary education, the private sector rewards both male and female graduates of general secondary education more than vocational secondary graduates.

Controlling for age, gender, broad type of residential area (urban or rural; Coastal, Central, Mountain Albania and Tirana city), sector of economic activity, ownership sector, and tenure (number of years with the given employer) for wage-earners, *the analysis shows that on average an individual with higher education earns 71 percent more than an individual with basic education.* This return to tertiary education is in the range for the OECD countries (OECD, 2003a, table A14.1, p.165). As in many other countries, returns are significantly larger for females than for males (86 versus 64 percent) and for the private versus the public sector (87 versus 68 percent).

Table 39: Average Earnings^a by Ownership Sector, Employee Gender and Education, 2002

Education	Monthly earnings, thousand leks						Private-public differential, %	
	men			Women			men	women
	Private sector	Public sector	National average	Private sector	Public Sector	National average		
University	41.3	25.5	28.9	38.6	20.1	22.9	61.8	92.1
Secondary vocational	25.8	16.6	21.2	15.0	14.0	14.1	55.1	7.4
Secondary general	23.9	17.0	20.3	13.1	13.4	13.2	40.3	-2.5
Basic or less	19.7	15.1	18.7	12.3	9.5	11.4	30.2	30.4
National average	22.8	19.1	21.2	15.4	15.5	15.4	19.8	-0.4

Source : Calculations based on Albania LSMS 2002 data. ^aBonus and fringe benefits included.

Table 40: Wage Ratio by Education, Ownership Sector, and Gender, 2002

Education	Wage ratio by education					
	Men			Women		
	Private Sector	Public sector	National average	Private sector	Public Sector	National average
Secondary/Basic	1.21	1.13	1.09	1.07	1.41	1.16
University/secondary vocational	1.60	1.54	1.36	2.57	1.44	1.62
University/secondary general	1.73	1.50	1.42	2.95	1.50	1.73

Wage earning university graduates are the only beneficiaries of high return to education

Although there are significant returns to a university education, the results on returns to education are high for wage-earning employees only, not for all those who consider themselves employed. Furthermore, most of the university graduates work either for the public sector or for the non-farm private sector. Yet these two sectors employ less than one-third of the working labor force.

Table 41 shows the educational distribution of employment in 2002. Those with a university education constitute 6.9 percent of all those employed, but 18.9 percent of total employees. About a quarter of women employees have a university degree. In sum, there are very good returns to a university education. While those with this level of education constitute a significant share of employees, they represent a small percent of all of those who are employed.

Table 41: Educational Distribution of Total Employment and of Employees, 2002

	Employed			Employees		
	men	women	Total	men	women	Total
None	1.4	1.5	1.5	0.5	0.7	0.5
Primary	9.8	9.3	9.6	4.1	1.2	3.2
Basic 8 years	49.8	58.7	53.8	37.9	23.8	33.4
Secondary, general	15.3	13.1	14.3	20.3	25.0	21.8
Vocational 2 years	2.2	1.0	1.7	3.7	2.9	3.5
Vocational 4/5 years	13.8	9.9	12.0	16.9	20.1	17.9
University	7.3	6.4	6.9	15.8	25.8	18.9
Post-University	0.4	0.2	0.3	0.9	0.6	0.8
Total	100	100	100	100	100	100

Source: Calculations using 2002 LSMS. *Note:* “Employees” are only those who receive paid wages, while “Employed” also include employers, own account workers, farmers, unpaid family workers, students who are employed.

Albanians with less than a secondary education have a lower probability of being employed than those with a secondary or tertiary education, a higher probability of being employed only part-time, and a higher probability of being out of the labor force (Table 42). However, this group has a lower risk of unemployment than those with a secondary education. Tertiary education offers a higher probability of being employed and lower probabilities of being employed only part-time, of being unemployed, or of being out of the labor force. Econometric analyses show that the same findings hold true when factors other than

education are kept constant.

Table 42: Labor Force Participation by Gender and Education (Population Aged 15-64)

Employment status	Men, by education			Women, by education		
	Basic or less	Secondary	University	Basic or less	Secondary	University
Employed	67.7	74.3	82.9	50.0	49.5	76.3
<i>Paid employment, percent of total</i>	27.6	51.6	83.9	8.7	45.2	89.9
<i>Part-time^b, percent of total</i>	55.8	40.2	25.2	56.9	38.5	35.3
<i>Worked < 40 weeks in the past 12 months^a</i>	38.3	25.9	11.5	44.8	28.9	18.9
Unemployed 1 ^c	8.0	10.5	4.4	4.0	10.8	3.9
Unemployed 2 ^d	5.2	4.4	2.3	5.0	5.6	4.1
Labor force participation rate 1 ^e	75.7	84.8	87.3	54.0	60.2	80.2
Labor force participation rate 2 ^f	81.0	89.2	89.6	59.0	65.9	84.4
Unemployment rate 1: Unemployed 1/Labor force 1	10.6	12.4	5.0	7.5	17.9	4.9
Unemployment rate 2: Unemployed (1+2)/Labor force 2	16.3	16.8	7.4	15.3	24.9	9.6

Source: Calculation based on LSMS 2002 data, except for part-time employment which is based on Population and Housing census 2001. Notes: ^a Percent of employed who keep current job for at least one year. ^b <35 hrs per week. ^c Standard definition (see Table 30). ^d Relaxed definition: includes persons not looking for a job in the past 4 weeks but ready to start in two weeks once a job is available (e. g. discouraged workers, seasonal workers etc.). ^e Employed + Unemployed 1. ^f Employed + Unemployed 2.

To support a transition to investment-driven growth, Albania has to increase the quantity and almost certainly the quality of human capital.

In order to sustain growth, Albania will have to shift its economic activities increasingly toward investment-driven growth—and ultimately toward innovation-driven growth. Both types of growth, especially innovation-driven growth, will ultimately require more human capital than the average Albanian is now obtaining. It will probably require human capital that is different from that which Albania's schools are now producing, but this conclusion can only be drawn by inference from data for regional neighbors, as there are no reliable data on this issue for Albania itself.

Table 43 lays out one schematic framework for thinking about stages of economic development and the educational implications of the types of labor markets generally associated with the different stages. The stages are points on a continuum that moves toward increasingly value-added products and services.

Table 43: Stages of Economic Development

Development Stage	Key Economic Challenges	Focus of Economic Production	Education Requirements for Labor Markets Associated with Different Stages of Economic Development
Factor-Driven Growth	Get factor markets working properly in order to mobilize land, labor, and capital	Natural resource extraction, assembly, labor-intensive manufacturing. Primary sector is dominant.	Employment concentrated in agriculture, extractive industries, and small enterprises. Education requirements: basic education, low-level skills, disciplined work habits.
Investment-Driven Growth	Attract foreign direct investment and imported technology to exploit land, labor, and capital and begin to link the national economy with the global economy	Manufacturing and outsourced service exports. Secondary sector is dominant.	Increasing share of employment in manufacturing, services, and medium size industries. Education requirements: an increasing share of new labor market entrants with upper secondary and tertiary education.
Innovation-Driven Growth	Generate high rate of innovation, and adaptation and commercialization of new technologies	Innovative products and services at the global technology frontier. Tertiary sector is dominant.	Employment increasingly concentrated in high value added goods and services and in firms with rapid technological change. Education and knowledge requirements: almost universal secondary education, modernized secondary vocational/technical education, continuous learning to retool and update skills, flexible labor markets (easy entry, easy exit), increasing enrollment rates in higher education, especially in science and engineering specializations, dynamic R&D sector linking higher education programs and innovating firms.

Source: Adapted by Berryman and Mertaugh from *The Global Competitiveness Report, 2001/2001*, Klaus Schwab, Michael Porter, and Jeffrey Sachs, editors. The World Economic Forum, Geneva, 2001.

Increasing the Quantity of Human Capital. The Government has already changed the length of compulsory education, and grade 9 will become compulsory for the school year 2004-05. However, the fundamental problem of low demand for education will remain, especially among poor families and rural families. Therefore, additional policy measures must be considered to stimulate the demand for education.

Increasing the Quality of Human Capital. Increasing the quantity and quality of human capital are interrelated issues. The international literature and findings from LSMS data clearly indicate that improving quality increases the demand for education. In the short to medium term, two policy actions are particularly important for improving quality. One is for the Government to participate routinely in international assessments of learning and to publish the results. These assessments let countries benchmark themselves against standards that frame the kind of human capital that their economies will ultimately need. They also measure one key outcome of the public education system for all stakeholders: learning performance.

The second policy option is a thorough and systematic revision of the curriculum, as the curriculum defines what gets taught and learned and

how. In some of Albania's regional neighbors, such as Croatia, employers have defined the curriculum as the major barrier to developing the human capital needed to support growth. A significant revision of a curriculum in and of itself is not particularly costly. However, major curricular changes would be ineffective unless complemented by corresponding changes in: (i) all textbooks, teacher guides, and learning materials; (ii) teachers' classroom practices; and (iii) measures of learning outcomes. It should be noted that new textbooks and changes in teachers' classroom practices will be significantly expensive. Exactly how costly will depend on policy decisions, for example, about whether to have single or alternative textbooks for each subject and grade.

Many of the policy options for increasing the demand for education, such as building schools to reduce distance or providing subsidies for the poorest families, are expensive. To target scarce resources effectively, demand analyses that identify the most important demand factors for different subgroups should be conducted. Using community planning exercises to let families allocate a hypothetical budget to factors that are most important to them can help Government customize and thereby increase the effectiveness of policy interventions.

To conclude, Albania should start participating routinely in international assessments of learning, such as PISA, and publicly release the results. It should also systematically revise the curricula to create coherence across subjects within a grade and between grades and to facilitate the development of students' critical thinking and problem solving skills. In parallel, it should initiate the writing of new textbooks and teaching guides and the establishment of professional learning networks for teachers to help them alter their practices.

CHAPTER 6: REMOVING PUBLIC INFRASTRUCTURE BOTTELNECKS

In addition to the inadequate quantity and quality of human capital, the Albanian economy suffers from poor infrastructure in key sectors: transports, electricity, and water. This chapter reviews the issues and outlines a policy agenda for improving infrastructure.

1. Poor Quality of Infrastructure

Lack of quality infrastructure is a major constraint to growth and poverty reduction

The World Bank's survey of poverty notes that, after employment and income, many Albanians feel that infrastructure problems are the main cause of their difficulties and low standard of living.⁴⁶ Respondents listed water and sewage treatment, electricity and roads as their most urgent priorities. Albania inherited a poor road system from the communist period. Initial investments correctly concentrated on the main road network which carried the most traffic. However, the secondary and tertiary roads connecting rural villages to the main road network are still largely inadequate. Rural inhabitants and leaders agree that an inadequate road system retards economic growth. Farmers have difficulty accessing local markets which either precludes the sale of their produce and livestock or makes it more expensive. The lack of roads and other rural infrastructure also contributes to rural-urban migration and adversely affects the delivery of education and healthcare services.

Albania's transport system is adequate in extent but in poor condition and cannot support the demand for transportation services required by the development of trade.

Transport demand in Albania has changed dramatically since the fall of communism, more so than in neighboring countries. The current transport system includes an 18,000 km road network; 667 km of single-track non-electrified rail line; the main commercial port of Durres and the secondary ports of Vlora, Shengen and Saranda; and Rinas international airport plus secondary airports. Prior to 1991, the Government administered all transport modes, set transport tariffs and directly allocated traffic, primarily to the railways. Private vehicles were prohibited and trucks and buses were not allowed to serve routes that competed with the railway. Since then, the road vehicle fleet has grown from almost zero to 233,954 in 2002 and 263,901 in 2003; the number of passengers at Rinas Airport increased from a low level to an estimated 510,000 in 2002; and traffic at Durres Port initially declined, but then more than doubled after 1993 to 2.18 million tons in 2002 (92 percent imports). On the other hand, both rail freight and passenger transports have fallen to around 5 percent of their previous levels (349,000 tons and 2.3 million passengers in 2003). Railways now transport an inconsequential 1 percent of freight and 1 percent of passenger traffic in Albania.

Traffic is expected to grow more rapidly in

The shift in transport demand results from structural changes in the economy which are not expected to be reversed. They include the

⁴⁶ *Poverty in Albania: A Qualitative Assessment*, Hermine de Soto et al., 2002.

Albania than in neighboring countries because it is starting from a lower base

closure of uneconomic heavy industries and mines, the liberalization of private transport, and the reorientation of trade toward the West. A reversible factor are the recent regional conflicts, including the economic blockade of FYR Serbia and Macedonia, which have now stopped. The main international transport movements at present are: (i) the importation of commodities through Durres Port, primarily from Italy, but to a lesser extent from Germany and elsewhere in Europe; (ii) the movement of workers to/from Greece, Italy and elsewhere; and (iii) a modest but growing volume of transit traffic along the so-called Corridor 8.

Despite the formal opening of Albania's trade regime, only 17 percent of GDP is generated by the export of goods and services, the lowest percent in the region.⁴⁷ However, recent work by EU Consultants REBIS forecasts a continuation of the rapid growth of road and air traffic, and a modest growth in rail traffic in Albania (Table 44).⁴⁸

Table 44: Forecast Traffic Growth Rates, 2001-2006 (in percent)

	Road (aadt)		Rail		Air
	Cars	Trucks/Buses	Freight (tons)	Passengers	Passengers
Albania	63	46	17	20	59
Bosnia & Herz.	30	29	11	13	37
Croatia	25	29	11	14	37
Macedonia	25	25	10	11	32
Serb./Mont.	30	30	12	13	38

High transport costs are hurting domestic competitiveness and may also preclude wage growth in labor intensive industries

The condition of Albania's road network is worse than in neighboring countries (Table 45). The road network totals about 16,000 km. Of these, 3,221 km are primary roads under the responsibility of the General Roads Directorate (GRD), 12,000 km are secondary and tertiary roads under the Ministry of Local Government and Decentralization (MLGD), and about 1,000 km are urban streets. Primary roads are generally in a poor but stable condition, design standards are outdated, construction practices are poor, and the roads have not been well maintained. The secondary and tertiary networks have been almost totally neglected for a number of years. The basic structures of these roads are modest but usable, and drainage is mostly non-existent or in very bad condition.

Table 45: Condition of the Road Network, 2003

Type of Road	Good (%)	Fair (%)	Poor (%)
National Road Network	15	22	63
Urban Roads	50	25	25
Rural Roads	20	30	50
Other (agricultural, mining, forest)	0	0	100
Overall	10	12	78

⁴⁷ Source: WDI, 2003.

⁴⁸ Source: Rebis, *Regional Balkans Infrastructure Study*, 2003. The consultants note that the forecast of rail traffic in particular should be treated with caution because it was not developed on a commodity basis.

Rural roads are an important tool for addressing poverty yet they lack funding

Local and Urban Roads are insufficiently funded. Road which are not under the responsibility of the GRD are managed by the 34 local elected legislative bodies called district councils, with the possibility to delegate responsibility to a commune or *baskia* (town) council. Although the legal responsibility is clear, neither the districts nor the communes have sufficient budgetary resources or technical expertise to carry out their responsibility. In 1999, MLGD was provided with some 1,800 of the staff and about 40 percent of the budgetary resources formerly belonging to GRD, but this is insufficient to maintain the 4,200 km of rural and 1,000 km of urban roads for which MLGD is directly responsible, nor the 7,800 additional km of mostly tertiary local roads.

Albania's transport investment needs are large because much infrastructure and equipment are in poor condition, road and air traffic are growing dramatically, the railway generates no funds for investment, and the agenda of sector reforms is not complete. Albania has made a number of important investments since 1991, financed primarily by multi-lateral and bilateral donors on a concessional basis. Government spending on transport increased to 2.5-2.7 percent during 1999-2001 (Table 46) but has since declined to 1.8-2.0 percent of GDP (40 percent foreign financed).⁴⁹

Table 46: Public Transport Expenditures (US\$ millions)

	1997	1998	1999	2000	2001	2002	2003	2004 budget
Roads	15.5	38.7	88.9	85.7	100.5	69.3	87.5	110.1
National (GRD)	11.9	32.0	80.4	74.0	82.9	57.8	73.6	98.8
Rural (MLGDD)	n.a.	4.4	2.3	9.1	5.5	4.9	7.7	6.6
Urban (municipal)	n.a.	2.3	6.1	2.6	12.1	6.7	6.1	4.7
Rail	5.2	2.1	3.4	4.4	1.6	3.2	n.a.	n.a.
Ports and Maritime Transport	-	-	4.4	1.0	6.4	3.3	n.a.	n.a.
Aviation	8.4	8.1	0.4	1.1	1.4	1.4	n.a.	13.5
Other	0.1	0.7	0.6	0.9	n.a.	n.a.	n.a.	n.a.
Total	29.2	49.6	97.7	93.1	109.2	90.9	105.8	145.6
(% foreign funded)	38	38	50	48	43	40	40	40
(% of GDP)	1.3	1.6	2.7	2.5	2.6	2.0	1.8	1.9

Source: various ministries.

Some of the major investment projects in the transport sectors have been initiated without a clear economic rationale. Upgrading the infrastructure is clearly a priority in Albania. However, the government has often adopted large investment projects before their financial and economic viability was independently assessed. A recent case in point is the modernization of the railway line between Tirana and Dures, and the construction of a railway connection to Rinas Airport. The projects were not put forward by the Albanian representatives in the framework of the Regional Balkans Infrastructure Study (REBIS), neither were they included in the Medium Term Expenditure framework (MTEF). They could put fiscal sustainability at risk and crowd out spending for the education and health sectors. The authorities only launched a

⁴⁹ This does not include non-MLGD rural roads nor public urban transport.

comprehensive and professional feasibility study after the donor community expressed concerns about its impact on the budget.

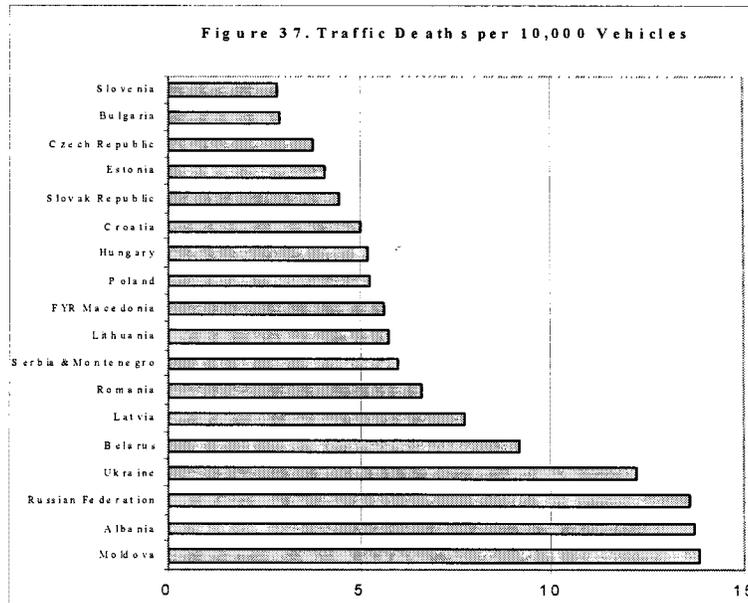
Road safety remains a serious problem

The number of road fatalities is still among the highest in Europe. There were 11.0 deaths per 10,000 vehicles in 2002 in Albania compared to 24.1 in 1996.⁵⁰ Road accidents were initially high because of Albanians' lack of driving experience and the poor condition of both vehicles and roads (see Table 47 and Figure 34).

Table 47: Comparison of International Road Fatality Rates, 2002

Central and Eastern European countries	Number of deaths in 2002	Population	Number of deaths per 10,000 population in 2002	Vehicles	Number of deaths per 10,000 vehicles in 2002
1 Moldova	412	4,282	9.62	298	13.83
2 Albania	250	3,401	7.35	182	13.74
3 Russian Federation	33,243	145,555	22.84	24520	13.56
4 Ukraine	5,982	49,291	12.14	4886	12.24
5 Belarus	1,728	10,020	17.25	1886	9.16
6 Latvia	518	2,368	21.88	665	7.79
7 Romania	2,398	22,435	10.69	3626	6.61
8 Serbia & Montenegro	847	7,688	11.02	1408	6.02
9 Lithuania	697	3,692	18.88	1206	5.78
10 FYR Macedonia	176	2,031	8.67	314	5.61
11 Poland	5,827	38,646	15.08	10966	5.31
12 Hungary	1,429	10,024	14.26	2749	5.20
13 Croatia	627	4,380	14.32	1246	5.03
14 Slovak Republic	626	5,402	11.59	1399	4.47
15 Estonia	224	1,434	15.62	552	4.06
16 Czech Republic	1,431	10,267	13.94	3826	3.74
17 Bulgaria	959	8,150	11.77	3262	2.94
18 Slovenia	269	1,990	13.52	931	2.89

Figure 37. Traffic Deaths per 10,000 Vehicles



Transport Taxes and Pricing policies are

Road user taxes and charges do not cover road costs in Albania, although they have been increased in recent years. Excise taxes on

⁵⁰ Road fatalities are believed to be under-reported by 15-25 percent in Albania because Government statistics refer to death at crash site rather than death within 30 days (international convention).

inadequate

unleaded fuel are on a par with neighboring countries although taxes on diesel fuel are lower (Table 48). In a market economy, the prices for public infrastructure services should be set to ensure full cost recovery including external costs; equity between transport modes; and adequate protection of the environment. Since transport is a productive sector, it should also be a net contributor to the Government, i.e. it should finance its share of social services (education, health, security, etc.).

Table 48: Excise Taxes on Petroleum Products, 2003 (US\$/l)

	Unleaded Petrol	Diesel
Albania	0.24	0.11
Bosnia and Herzegovina	0.25	0.16
Republika Srpska	0.19	0.12
Croatia	0.20	0.20
FYRO Macedonia	0.21	0.15
Serbia and Montenegro	0.24	0.17

Source: National authorities as reported in REBIS. There is a proposal to increase the excise tax on unleaded petrol in Albania to 30 lek/l (US\$ 0.25/l).

Road user revenues are too low

It is estimated that road user revenues fail to cover road expenditures by about US\$31 million per annum (see Table 49). Albania charges vehicle registration fees, as do most countries. Albania is unique in the region in also charging an axle load fee in order to increase the taxes on heavy vehicles. While the objective is commendable, the axle load fee may have the unintended consequence of encouraging the purchase of trucks with the lowest number of axles which tend to cause more road damage. Total taxes on heavy trucks are similar to most other countries in the region.

Table 49: Estimated Road Expenditures and Revenues, 2001 (US\$ millions)

	Expenditures				Revenues	Difference
	Construction	Maintenance	Urban/Local/Other	Total		
Albania	98.8	9.9	10.5	119.1	87.5	-31.6
Macedonia	35.9	31.4	5.9	82.3	82.4	0.1
Serbia/Mont.	23.6	94.1	0.0	117.8	405.5	287.8

Source: Consultants NEI and REBIS.

Foreign transit traffic is currently unprofitable

About 20,000 vehicles arrive or depart by ferry at Durres Port each year, and some of these are heavy trucks transiting to Macedonia and beyond via Corridor 8. Albania presently charges foreign trucks US\$0.025/km to transit Albania. However, consultants NEI estimate a domestic 20-ton truck pays about US\$ 0.075/km in taxes, and as noted above domestic vehicles do not cover their road costs. It is, therefore, unlikely that a foreign truck is covering its road cost at present, even allowing for a possible fuel purchase in Albania.

The performance of the railways system is poor and new investments would not be profitable

Albanian Railways is essentially a domestic railway. The only international connection via Montenegro, which is circuitous, was closed from 1996 to 2003 by the Balkan conflict and carried little traffic before then. The main East-West line (Corridor 8) is not connected to the Macedonian rail network. Consultants REBIS estimate the cost of

constructing the missing 68 km Kicevo – Albania border section in Macedonia to be US\$198 million. This is highly unlikely to be an economically justified investment due to the low volume of prospective traffic. Albanian Railways carried only 349,000 tons of freight and 2.3 million passengers in 2003, or about 1 percent of total freight and 1 percent of total passenger traffic in Albania. A generally accepted rule of thumb is that a railway needs to carry one million tons of freight in order to be commercially viable. Average lengths of haul were 73 km for freight and 65 km for passengers in 2002. Such short travel distances are more economically performed by road transport unless bulk traffic is being carried by trainload.

The true cost of operating the railways system is underestimated

Most railway infrastructure and rolling stock are in poor condition. There are numerous speed restrictions, with freight trains averaging 25 km/h and passenger trains 40 km/h in 2002. Around 45 percent of sleepers are reported to be damaged. Albanian Railways financial performance continues to be extremely weak due to the low volume of traffic and revenues. Total revenues in 2001 were US\$8.3 million which included a US\$3.2 million Government subsidy. Expenses were US\$9.4 million, leaving a loss of US\$1.1 million. However, these results significantly understate the true cost of operating the railway because maintenance and investments have been deferred for many years. Consultants REBIS estimate it would cost US\$ 996 million to modernize Albanian Railway's core infrastructure.⁵¹ Considering the need for new rolling stock and other infrastructure rehabilitation, the total cost of rehabilitating and modernizing Albanian Railways is likely to be of the order of US\$ 1.25 billion (26 percent of 2002 GDP). If railway modernization was financed with a 25 year loan at 7 percent interest, the Government would need to budget US\$108 million each year to service the debt (in addition to providing an operating subsidy--US\$ 3.2 million in 2002). It is highly unlikely that this expenditure is economically justified. It should be noted that Albania has sufficient road and road vehicle capacity to carry this traffic. For example, it would require about 63 trucks and 192 buses to handle the volume of traffic which Albanian Railways carried in 2003, an insignificant increase in the road vehicle fleet.⁵²

Price controls are still in place for railways

Albania Railways is not free to set freight or passenger tariffs without approval by the Government, similar to the practice in neighboring countries. Average revenues per traffic unit (pkm + tkm) are lower in Albania than in neighboring countries (excepting Serbia and Montenegro which was affected by the war and high inflation) (see Table 50).

⁵¹ Including Vopre-Kufi, Durres-Tirana, Rrogzhine-Vlore, and Shkozet-Lime-Kufi sections. Does not include the new Lime Greek border rail line.

⁵² This assumes that 347,000 tons carried an average 73 km in 20 ton trucks which travel 40,000km/year at a 50 percent load factor. It assumes that 2.3 million passengers carried an average 65 km in 40 passenger buses which travel 30,000 km/year at a 65 percent load factor.

Table 50: Average Railway Revenues per Traffic Unit (US\$)

	Average Revenue per Traffic Unit excluding subsidies, 2001
Albania	0.033
Bosnia & Herzegovina	0.046
Croatia	0.065
Macedonia	0.073
Kosovo	0.078
Serbia and Montenegro	0.024

Source: REBIS

There is no economic rationale for subsidizing railway traffic

Albanian rail passenger tariffs are quite low by European standards and are also only about 40-50 percent of the level of competing bus services. For example, the passenger fare from Tirana to Pogradec (140 km) is US\$2.19 by rail and US\$5.38 by minibus. There is no economic reason for the Government to subsidize interurban passenger transport. It is recommended that rail passenger fares be increased to the level of competing bus services and that Albanian Railways be permitted to set its own freight tariffs. Urban bus fares in Tirana are also quite low, amounting to only 15 Lek (US\$0.09) for regular buses for trips up to 9 km; mini-bus fares are 20 lek (US\$0.15). Urban public transport fares need to be increased to improve service as discussed below. Maintaining low urban bus fares is not an efficient way to subsidize the urban poor.

Despite improvements in recent years—including transfer of responsibility to the private sector—the port system is still inefficient

Maritime transport does not yet support the country's trade potential. While the most urgent needs have been addressed under various donor-financed projects, many facilities at Durres Port are still in poor condition, outdated and under-equipped, and port areas and basins are restricted, often encumbered by remains of old activities. The ports were formerly centrally managed public enterprises which exercised all regulatory as well as operational functions. International trade was restricted, procedures were outdated and port operations were performed poorly. The former monopoly granted to the national flag carrier and the old age of ships calling at Albanian ports explain why outmoded practices such as direct delivery, the use of nets, etc., are still in use, and also explain the low level of unionization. The situation has improved, but most port regulations and management activities are still not well adapted to modern commercial practices.

High turnover of government officials has impeded privatization in the transport sector

While good progress was made in deregulating transport operations (privatization of the Urban Transport Enterprise, transformation of the Durres Port into a quasi-Landlord Port, opening of civil aviation to the private sector), much still remains to be done to complete and implement market-based legislation, and to complete privatization. One important underlying issue is that the Government is subject to frequent political change. For example, there have been five Ministers of Transport, nine Directors of GRD and three Directors of Durres Port during the last five years. New administrators frequently replace their assistants and hire additional staff in a revolving system of patronage.

Albania is too small to have a large cadre of transport professionals. The benefits of training and experience are lost when senior staff leave, staff reduction programs are compromised, and decisions taken by predecessors are not always maintained.

A second major obstacle to competitiveness and growth is the crisis in the power sector since 1999

The crisis in the power sector has slowed down productivity growth in Albania over recent years. It also has had an important indirect effect in that it has served as a significant disincentive for new investment in industry and other productive activities. Four main factors explain the crisis and its impact on the performance of the business sector: poor hydrological conditions, load shedding, widespread purchase and use of costly back-up generators, and damage to electricity-using equipment caused by voltage fluctuations.

Poor hydrological conditions may have cost 0.5-0.7 percent of GDP in 2002

The first cause is a large reduction in hydropower production in the years 2001 and 2002 as a result of poor hydrological conditions. Hydropower production was 5,271 GWh in 1999, 4,586 GWh in 2000, 3,542 GWh in 2001, 3,055 GWh in 2002, and 4,806 GWh in 2003. Production in a normal hydrological year is estimated to be 4,200 GWh. The impact of the reductions in 2001 and 2002 below the normal level can be approximately estimated as the fall in hydropower production in GWh, valued at the average retail price of electricity, which is adjusted downwards to reflect technical losses in transmission and distribution. The resulting impact has been a fall in GDP of 0.5 percent in 2001 and 0.7 percent in 2002.

The second cause is load shedding. Instead of meeting all peaks in demand through imports of electricity, Albania resorted to partial load shedding, partly due to transmission constraints (these have now been largely removed) and partly due to financial constraints. Load shedding is estimated to have been 450 GWh in 2000, 820 GWh in 2001, 850 GWh in 2002 and 660 GWh in 2003. These estimates are uncertain and may be too low. Over 50 percent of these amounts would have been cuts in electricity supply to households.

It is estimated that the negative impact of load shedding on GDP was about 1.4 percent in 2001

The Albania Energy Sector Study (World Bank, 2003) estimated that auto-generated energy by small industry and commerce was 192 GWh in 2001. The Study indicated no significant auto generation by large industry. Assuming that 58 percent of the load shedding in 2001 was for households based on their proportion of total demand, load shedding for other consumers would have been 344 GWh, of which 192 GWh would have been offset by auto generation, leaving 152 GWh. Definitive estimates of the cost imposed by “unserved energy” have not been made for Albania. Estimates for other countries vary widely and go as high as US\$ 2.00 per kWh or more. An approximation can be made for Albania by taking industrial GDP per kWh of electricity demand by industry. This figure is estimated, on the basis of data from the Energy Sector Study, to be Lek 54 for 2000. Using this figure gives an estimate of the adverse impact of load shedding of 1.4 percent of year 2001 GDP. To the extent that industries were able to work around load shedding periods, the actual impact may have been less and more investigation is

needed in order to get a more accurate measure of the cost imposed on industry and commerce by load shedding.

The purchase of costly back-up generators has also burdened input and factor costs, and increased the loss in GDP

The purchase and use of back-up power generators also imposes a heavy cost on existing commercial and industrial enterprises. A recent consumer survey in Albania (2003) found that two-thirds of industrial and commercial enterprises have back-up generators. Assuming that the back-up generating capacity would be sufficient to cover two-thirds of the peak demand of small industry and commercial enterprises estimated by the Energy Sector Study for the year 2002, the amount of back-up generating capacity would have been 248 MW in 2002. The capital cost ranges from US\$ 500 to US\$ 1000 per kW, with the higher-cost equipment having higher fuel efficiency. The total capital cost would range from US\$ 124 million to US\$ 248 million. These estimates correspond to 2.7 percent to 5.4 percent of year 2002 GDP. However, they are for one-time investments, only a portion of which would have been incurred in 2002. Most of the rest is likely to have been incurred between 1999 and 2001. The fuel and other operating costs would range from about US\$ 0.084 to US\$ 0.10/kWh, including import duty and excise tax, and US\$ 0.056 to US\$ 0.067/kWh without tax. The tax-exclusive costs are the relevant ones for purposes of measuring the impact on the economy. Since these are only moderately above the retail price of network electricity (US\$ 0.043/kWh in 2002, which is roughly equal to the cost of network supply), the impact on GDP is small and it may be concluded that the dominant cost of using back-up generators is the capital cost. Adding up the above costs gives a sum for 2001 of 1.9 percent of GDP plus that portion of the cost of back-up generators corresponding to those purchased in 2001, for a total of nearly 3 percent of GDP. The impact in 2002 would have been about the same.

The prospect of load shedding also acts as a deterrent for new industrial and commercial enterprises. Those that could protect themselves by using back-up generators would have to pay a levelized cost of about US\$ 0.15/kWh (including capital cost and tax) from back-up generators for 10-15 percent of their electricity needs, compared to the average retail price of less than US\$ 0.043/kWh in 2002. The large industries face the prospect of frequent cuts in production.

The poor condition of the water infrastructure is another major constraint on competitiveness and growth—especially in the agriculture and tourism sectors

The country has abundant water resources. However, water supply in almost all urban areas is intermittent because of the bad condition of the infrastructure. The water quality is poor due to the absence of wastewater treatment facilities. Deteriorated networks allow sewage to enter the drinking water system and insufficient operation and maintenance (e.g., inadequate chlorination) affect the water quality. Rivers and coastal areas are polluted because raw sewage is discharged untreated into rivers and the sea.

As a result of the bad water quality,

In 1998, the Government approved water quality standards which are similar to WHO standards. Yet the implementation of these standards is

waterborne diseases have a negative impact on the productivity and efficiency

difficult because there is almost no wastewater treatment and the distribution networks are old and are lacking in maintenance. Illegal tapping also compromises water safety. There were repeated cases of waterborne diseases -- for example, the 1994 outbreak of cholera with 626 cases and 25 deaths caused by *Vibrio Cholerae* El Tor. The waterborne spread of the disease was confirmed by national and international health institutions. There is a high incidence of gastroenteritis in Albania.

Insufficient and unreliable water availability cause economic costs for individuals and businesses

In rural areas people devote time to fetching water which could be used for income generating activities. A study conducted by Plan International at the end of 2000 showed that the average distance to the nearest water source within the survey areas was 410 meters with an average of 4.4 trips per day. *On average, women spent approximately 3.5 hours per day fetching water.* In urban areas additional costs accrue for individuals and businesses from buying water tanks and water from water trucks. In Durres, for example, the water tariff charged by the water utility for private businesses in 2003 was 80 Lek/m³; private vendors who sell water from water trucks demand 200 lek/m³ from private businesses. The Baseline Survey⁵³ for the PSIA Water Sector Reform [4] showed that 43 percent of the respondents to the survey obtain water from indoor/outdoor tanks, 28 percent through purchase from private vendors, and 24 percent from neighbors, and the rest use wells or pumps in their yards. The survey also showed that 38 percent of households in Durres use bottled water, in Saranda it is 33 percent. The price for bottled water is around 50 – 60 Lek for 1.5 liters, whereas the domestic water tariff for families charged by the water utilities in 2003 in Durres was 0.06 Lek for 1.5 liters and in Saranda it was 0.045 Lek for 1.5 liters.

⁵³ For this, 174 household interviews were conducted in Durres (and villages around Durres), Saranda, Gjiorkastra, and Vlora. The household survey is based on a purposive sample of about 40 households in each of the four cities and in 12 Durres rural areas.

Table 51: Financial and Operational Indicators in the Water Sector, 2001

Indicator/City	European Standards	Durres	Lezha	Fier	Saranda
Working ratio	0.75	4.6	6.9	4.9	6.1
Current ratio	>1.3	0.3	0.6	0.9	0.6
Collection Rate (%)	>95	34	33	33	33
Staff/1000 water connection	1	11.19	28.87	7.6	12.75
Staff/1000 water & sanitation connections	2		13.18	4.9	
Non revenue water (%)	<12	73	61	59	63
Hours of Supply	24	2.1	20	6.2	1.76
Customers receiving minimum of 2 hours/day (%)	100	38	95	88	45.6
Samples complying with residual chlorine standard (%)	99	56.4	5.8	28.8	21
Current domestic Tariff USD/m3	0.44 - 4.44 (av. 2.53)	0.15	0.11	0.14	0.11

Source: Albania – National Water Supply Strategy, WB 2003.

Insufficient revenues and over consumption due to subsidies are at the root of the problems in the water sector. For political reasons, water tariffs are kept low, yet they are far below the cost recovery level. The use of flat rates instead of metered consumption has resulted in over-consumption. Additionally, high migration to urban centers with illegal tapping has a negative impact on the water sector.

Most of the water utilities are in a negative cash flow situation and they rely on subsidies from the government

There are direct and indirect subsidies provided to the water sector. Direct subsidies cover some of the operating costs: salary, social security, and chemicals. From 2002 on, the Government subsidized all the electric bills directly, current and arrears, owing to an agreement between the Ministry of Finance and the IMF. Yet the subsidies provided by the Government were not sufficient to cover the gap between operating costs and operating revenues. Indirect subsidies to the electricity company KESH include deferred payments of social security contributions and the VAT. Despite these subsidies, most of the water utilities are not carrying out adequate operations and maintenance works. For the year 2004 the Government has foreseen Lek 800 million in the central budget as direct operational subsidies for the water sector. The trend of the subsidy, as can be seen in Table 54, from 1993 until 2004 is not linear. It has fluctuated based on needs and emergency intervention to maintain a minimum level of public service provision. In the last two years the amount of the subsidy reached its peak.

Table 52: Direct Operational Subsidies to the Water Sector, 1993-2004 (million Leks)

Years	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 (Planned)
Subsidies	70	147	142	30	45	134	225	70	60	762	2,222 (*)	800

Source: Albania – National Water Supply Strategy, WB 2003 and Albania – Ministry of Territory Adjustment and Tourism, 2004.

*The amount for the year 2003 comprises the subsidy for electricity, social insurance, chlorine and salaries of 720 million Lek allocated and disbursed from the Ministry of Territory Adjustment and Tourism and in addition with a separate decision by the Council of Ministers an amount of 1,500 million Lek to pay arrears to the electricity company KESH.

Problems in the water sector are major constraints for the

Insufficient and unreliable water supply are major obstacles for tourism development. In the coastal city of Durres, which is the second biggest city in Albania with the largest accommodation capacity for tourists in

development of tourism

the country, water is only available once every two days for not more than two hours. In other cities with a big tourism potential such as Saranda, Vlora, or Pogradec, the situation is similar. Hotels and restaurants must incur additional costs to fill the gap and to have water delivered by tanks and water trucks. Another major obstacle for tourism development is the pollution of beaches due to the lack of wastewater treatment.

2. Public Infrastructure Priorities

The implementation of the ambitious infrastructure agenda is another pre-requisite for sustained growth

Besides policies to build human capital, Albania should also implement a multi-sectoral strategy to develop infrastructure in the context of regional trade. In the electricity sector, action must be taken to avoid load shedding when possible, for example through provision of additional domestic generation and by importing additional electricity. The subsidy provided by the Government to help the national electricity company KESH pay for imports has served an important role by limiting the load shedding to the levels experienced to date. As this is to be terminated by the end of 2004, it is critical that KESH's financial performance is improved significantly so that load shedding can be minimized/eliminated.

Reforms in the water sector would stimulate growth

The implementation of the National and a Rural water sector strategies to overcome the obstacles to growth arising from the water sector should continue. Both documents adopt appropriately a two-tier approach focusing in the short term on urgent rehabilitation of the systems, and in the medium term on a program to support sector reforms. The Government's long term objective for the water supply and sanitation sector is to achieve sustainable water supply and sanitation services at the EU Standards in urban and rural areas. The Government should accelerate the implementation of the Action Plan derived from these documents and should also undertake the following:

- Complete the rehabilitation of the obsolete water supply and sewerage networks
- Extend services to the poor and under-served
- Transform the water utilities to self-financing entities
- Increase private sector participation in the water sector
- Enable local governments to provide safe and sustainable water and sanitation services
- Introduce adequate collection and treatment of wastewater.

The transport sector is at the center of trade and regional development

In the transport sector, the Government's transport investment objectives stated in the 2003-2005 Medium-Term Expenditure Framework (MTEF) are generally reasonable. The first objective is to concentrate on the rehabilitation of the existing transport network. Specific measures include the following:

- Completing the first stage of the reconstruction of road transport corridors

- Reorganizing road maintenance services and increase financing
- Completing detailed feasibility studies for: (i) tourism roads; (ii) the Durres-Kukes-Morine road (completed in 2003); and (iii) the Tirana-Klos-Peshkope-Bllate road
- Completing ongoing projects at the primary ports of Durres and Vlore and the secondary ports of Shengjin and Sarande.
- Implementing the ongoing railway rehabilitation projects for Durres-Tirana, Durres-Rrogozhien, Skoder-Han i Hotit
- Carrying out a feasibility study for a rail connection to Macedonia.

The second objective is to complete the commercialization of transport services and the privatization of state-owned services. Specific policy measures should include the following:

- Establishing the Albanian Maritime Authority to manage port infrastructure
- Improving information and management systems
- Modernizing rail passenger carriages
- Implementing the air traffic control master plan and improving the regulatory and institutional framework
- Carrying out the feasibility study for the development of air transport
- Offering for concession the construction of a new passenger terminal at Rinas Airport and additional apron areas.

Investment decisions in the transport sector should be driven by economic criteria

In selecting investments, discounted benefits should exceed costs by a sufficient margin to cover the risks associated with the investment. In the case of publicly owned infrastructure (roads, ports, railways), these investment decisions should be made by the State. Other investment decisions, mainly for transport vehicles and equipment (locomotives, aircraft, ships, trucks), should be driven by the commercial perspective of business managers operating in a competitive environment. It is recommended that the Government subject all proposed public investments to rigorous cost/benefit assessments and base their decisions on the results. Albania is developing a pool of professionals who know how to carry out these studies, who can be supported by outside consultants when needed. Public investments should only be undertaken following the demonstration of a satisfactory economic rate of return, the preparation of a realistic financing plan, and the judgment that the investment cannot be undertaken by the private sector, or as part of an agreed public service obligation (PSO) for a specific social service which the Government agrees to subsidize. The Government's recent decision to undertake a full feasibility study for upgrading the Tirana-Durres rail line and constructing a new rail line to Rinas Airport is an example of how this should be done.

Albania should strive to meet the requirements of the SAP in the transport sector as quickly as

As part of the SAP process, the EU consultants REBIS have recommended investing in the Pan European Corridors 8 and 10 in Albania. In particular, they recommend that Albania spend US\$ 868 million on these corridors in 2004-2009, or 1.4 percent of forecast GDP,

possible

a higher level of investment than is proposed for neighboring pre-accession countries. Most of these funds would be spent on road improvements. However, given that the MTEF plans to increase transport expenditures to 2.4 percent of GDP by 2005, only 1 percent of GDP would be left for non-Corridor expenditures, which is not sufficient. Taking into account that Albania has already made significant investments in Corridors 8 and 10, it is recommended that further Corridor investments be prioritized in competition with other proposed transport investments using the tools of benefit/cost analysis.

Table 53: Proposed Investment Expenditures in Pan-European Corridors (US\$ millions)

Country	Road	Rail	Airport	Sea-port	Inland Water	Multi-modal	Border Crossing	Total	Forecast 2004-09 % of GDI
Albania	600	0	84	10	0	0	0	694	1.4
BiH	501	143	5	0	0	0	15	664	1.1
Croatia	344	650	45	183	0	1	5	1,226	0.5
Kosovo	88	13	26	0	0	0	5	131	0.7
Macedonia	508	65	26	0	0	0	4	603	1.2
Serbia-Mont.	666	581	158	10	8	0	34	1,456	1.1
Total	2,706	1,450	344	203	8	1	63	4,773	

Source: REBIS. All REBIS estimates in EUR are converted at 1 EUR=US\$1.25.

Selectivity should be at the heart of the transport plan

As part of the SAP, the EU has recommended that Albania prepare a comprehensive transport plan. Prior to reaching important decisions on such a plan, the Government should seek input from internationally known experts on difficult issues—e.g., determining the future role of the railway, rationalizing secondary ports, or deciding how best to further improve the road network. It is important that the study not be used to prepare an unrealistic list of large transport investments for non-concessionary financing with little economic rationale.

Transport taxes and pricing policies should be revised so that road user revenues cover road expenditures. It is recommended that:

- Road user charges be increased.
- The Government raise the tax on diesel fuel to the same level as petrol to: (i) charge heavy trucks (which cause most road damage) for their full road costs and assure fair competition with the railway, and (ii) discourage the use of diesel automobiles which are highly polluting .
- The Government permit the Port of Durres Authority (PDA) to retain port dues (the practice in most countries) while at the same time making the port responsible for its own investments and debt service. The Government could then offset the loss of port dues by collecting a tax on port profits. This will have the important advantage of giving PDA the incentive to undertake only those investments that are profitable, avoiding the tendency to invest prematurely, which occurred during the communist period. PDA should then be required to concession all remaining port operations.

The government

There is an urgent need to improve Albania's ability to maintain its

should step up its efforts on road maintenance and road safety

road network. Large amounts are being spent to rehabilitate sections of the main road network. However, rehabilitated roads will deteriorate unless an effective road maintenance program is put in place. The Government has agreed with the World Bank on a strategy for improving road maintenance which is being supported under the IDA-financed Road Maintenance Project (RMP). The strategy includes measures in four areas:

Organizational Structure: As many maintenance functions as possible would be carried out by competitive contract. Contracting out of periodic maintenance has been widely adopted throughout the Western world, and now an increasing number of road administrations are contracting out routine maintenance as well. Contracting out achieves the desired separation of client and producer, whereby the producer must produce satisfactory work before being paid.

Road Finance: An adequate road maintenance budget permits timely maintenance which reduces the need for premature rehabilitation and thereby minimizes the total cost of operating the road network. It is also important that the budget be relatively stable so that the contractors can maintain staff and purchase equipment with the knowledge that they will be able to compete for work every year. The Government is increasing the budget in stages to US\$10 million per annum which will provide funds to address the maintenance backlog.

Operations: Operational procedures and practices are being improved under the RMP, including the use of economic evaluation to determine how best to use limited resources, procurement practices based on competitive bidding, adequate quality control, and the application of new technologies.

Personnel Practices: The increased use of contracting reduces the requirement for Government staff, but requires additional skills. The RMP includes technical assistance in personnel policies and training.

Reducing road accidents requires a multidisciplinary approach, including identifying and preventing unlawful and drunk driving, improving the enforcement of traffic regulations, introducing and enforcing a vehicle inspection system, correcting unsafe places on the roads (black spots), improving access to medical help, education, and publicity campaigns. The Government is implementing a Road Safety Program, assisted by both IDA (three projects) and the EU. A Road Code approved in 1998 establishes safety standards for vehicles and roads, driving regulations and police controls procedures. Vehicle inspection centers have been established in Tirana with European Union (Phare) and IDA financing. The police have stepped up their enforcement of traffic regulations, and new drivers are gaining experience. An Inter-ministerial Committee for Road Safety was established in 2002. A high-level Road Safety Seminar was held in 2003 with IDA assistance, and the Government is carrying out a number of coordinated improvements. Further steps to be carried out

under the RMP should include the identification and improvement of accident black spots, the institutionalization of safety audits, further improvements in police enforcement, publicity campaigns, and deepening the involvement of RMG.

The assessment of Albanian Railways should be updated with a view to reaching a decision on whether or not to close the railway, and how to proceed. Various studies have analyzed Albanian Railways, most significantly the 1996 CIE study of the “Future Role of the Albanian Railways.” CIE based recommendations were approved by Council of Ministers at that time and include: the continuation of freight transport on the whole of the railway network; the termination of the highest loss-making passenger services and the closing of uneconomic lines and stations; the use of cost/benefit analysis for all investments; some investments for completion of the main East-West Corridor; the preparation of plans for restructuring and privatization; separation of infrastructure and operations; management improvements; and railway legislation. However, it should be noted that the CIE recommendations were based on a 2003 freight traffic forecast which was eight times the volume of freight actually transported (2.7 million tons versus 349,000 tons). Freight traffic is the primary source of railway revenue and the determinant of profitability (passenger traffic decreases profitability because it is subsidized). Circumstances have changed in significant ways since the CIE Study was carried out:

- The prospects for reviving mining exports are now clearer. Minerals were formerly the main source of railway traffic.
- There are new international agreements and studies available on developing Corridor 8. However, the prospects for building the missing rail link in Macedonia do not appear favorable because of its high construction cost and low prospective traffic volume.
- The cessation of hostilities in the region holds the prospect of normalizing international trade and transport patterns.
- Some railway reforms have been carried out.

A new study is needed to consider how funds from the sale of railway real estate and other assets could be used to help compensate redundant railway workers.

***Maritime transport:
There is a growing
need for specialization
of port facilities***

As traffic shifts from the traditional exportation of bulk mineral products to the importation of general cargo, and as RoRo⁵⁴ traffic develops, there is a growing need for the specialization of port facilities. The Durres Port currently handles only about 5,000 containers (TEU) per annum at present. However, discussions are under way with two containership feeder lines regarding the possibility of increasing this traffic to 80,000 TEU in the future (mostly imports).⁵⁵ The European Investment Bank (EIB) has agreed to finance the

⁵⁴ RoRo refers to *Roll on roll off*: trucks carried by ferries.

⁵⁵ The cost of shipping containers from GJao Tauro to Skopje is expected to be US\$500 via Durres versus US\$800 via Thessalonika, both based on inland transport by road.

construction of a container facility at Durres to handle this traffic. Oil-related activities in Durres have been identified as a safety and environmental hazard, port space is restricted, and it has been agreed that this activity should be relocated. The fishing facility in Durres also needs to be relocated before further developments of *RoRo* and passenger traffic start. In many cases, mixing fishing activity with modern commercial port operations poses problems as regards land access control through secured Customs controlled areas and ship movements. The shipyard, close to the fishing port, poses a similar problem but its existing and potential activity and its condition should be assessed first, before any conclusions are drawn.

The port sector should focus on the following activities:

- Improving and implementing the Port Law and finalizing the draft Maritime Code
- Creating other autonomous port authorities using the Landlord Port model
- Developing commercial training and encouraging the participation of the private sector in port development whenever possible; developing a reliable database on maritime trade, port activity and ship movements, so as to improve the quality of the development studies
- Avoiding duplicate port investments (in particular at Durres and Vlora, two ports less than 100 km apart); further reducing staff at Durres Port
- Adopting international accounting standards
- Giving priority to operational improvements, particularly training in indirect delivery, with the objective of improving the utilization of existing facilities before investing in new ones
- Completing the privatization/separation of the two stevedoring companies at Durres Port, and introducing a cargo tracking system to reduce smuggling.

CHAPTER 7: GOVERNANCE FRAMEWORK FOR GROWTH

For Albania to successfully address the constraints to competitiveness and to implement the various pillars of its growth strategy (trade and regional integration, investment, human capital), the Government should address issues of poor governance, dysfunctional institutions (rules of the game) and weak capacities (both organizational and individual), which are also major underlying causes of poor sectoral performance.⁵⁶ This chapter reviews these issues and suggests a framework for moving the reform agenda ahead.

1. Governance and institutional challenges

Despite recent progress, governance issues remain major constraints to growth

Various indicators point to a deterioration in governance in recent years. Despite the many efforts of donors and the government, the recent *Anti-Corruption in Transition 2* document, shows the following over the 1996-2002 period: (i) moderately reduced government effectiveness, (ii) significant reductions in regulatory quality and the rule of law, (iii) a dramatic reduction in the “control of corruption,” (iv) increases in bribe magnitudes, and (v) an increase in state capture. It is, of course, possible that these indicators could have worsened even more if the various governance strengthening and anti-corruption efforts had not been mounted.

A more mixed picture emerges on perceptions as to the effectiveness of government – which, according to the data, experienced a sharp (borderline statistically significant) decline between 1996 and 2000, but rebounded over the subsequent two years (almost to the level of 1996). These data locate Albania as performing better than countries of the former Soviet Union, but well below many other comparators (marginally poorer performing in 2002 than Romania, for example).

Modest steps have been taken in institutional building but backsliding has reduced or cancelled the modest progress made

The perception of Albanian government effectiveness as a glass which is perhaps half-full is consistent with some evidence. First, even after radical downsizing and restructuring in the aftermath of communism, Albania’s public bureaucracy has retained a baseline capability to set goals and implement them. Second, a Government program supported by the World Bank has proven quite effective in engendering meritocratic principles in the appointment of about 3,000 top-level civil servants, and restraining arbitrary politically-driven interventions (though this remains a continuing challenge). Third, there have been substantial gains over the past five years in expenditure management: a medium-term budgeting framework seems to be taking root reasonably effectively and an initiative to strengthen internal financial controls within executing ministries also seems to be making good progress.

⁵⁶ See Easterly, William and Ross Levine, *Tropics, Germs and Crops: How Endowments Influence Economic Development*, NBER Working Paper No. W9106 (August 2002), for evidence that good institutions are fundamental to economic growth.

In contrast with these apparent improvements in administrative practices, however, patronage-driven political appointments continue to be widespread, especially beyond the more senior cadres; and the procurement and contracting process is reputed to be riddled with abuse at all levels, in the form of bid-rigging up-front, and corner-cutting and the neglect of quality standards in contract execution. These two observations are consistent with the especially troubling evidence from the BEEPS data, which found that the perceptions of managers of private firms of the extent to which corruption was an obstacle to business was the highest in Central and Eastern Europe (CEE) in both 1999 and 2002.⁵⁷ Moreover, the problem goes well beyond bribe taking (administrative corruption) by public officials, to include state capture – that is, illegal action such as bribes to influence the formation of laws, regulations and other government policies. State capture has been identified as an especially severe problem for post-communist countries – and Albania ranks in the most recent data as the fourth worst of 26 surveyed countries in the ECA region (behind only Macedonia, Bosnia and Bulgaria).⁵⁸

Table 53: Corruption Index in SEE Countries, 2001-2002

Country	2002	2001
Albania	68.4	60.8
Romania	59.9	59.9
Bosnia and Herzegovina	48.3	47.6
Croatia	41.1	41.7
Serbia	37.3	37.2
Montenegro	35.9	30.8
Bulgaria	35.1	37.5
Macedonia	31.2	35.1

Source: "Corruption Indexes," Regional Corruption Monitoring, Center for the Study of Democracy and the International Legal Development Institute, Rome, April 2002.

Empirical studies indicate that corruption slows down economic growth through several channels

Corruption slows down economic growth in Albania in several ways. It negatively affects investment, public finance, and business development. Cross-country empirical studies show that there is a negative association between corruption perception indexes and levels of economic development (Tanzi et al., 2000). In Albania, survey results indicate that corruption has a negative impact on the ratio of investment to GDP. It also affects the composition of FDI. The higher levels of corruption observed in recent years tend to shift the composition of inward FDI towards joint ventures and away from wholly owned subsidiaries of foreign firms. Although there has not been any systematic investigation of the growth implications of this shift, empirical studies of other transition and OECD countries show that growth is likely to be lower if such a shift implies higher amounts of bribes to public officials and less financing available for the transfer

⁵⁷ Cheryl Gray, Joel Hellman and Randi Susan Ryterman, *Anticorruption in Transition 2: Corruption in Enterprise-State Interactions 1999-2002* (The World Bank: 2004), p. 12.

⁵⁸ *Anticorruption in Transition 2*, p. 25.

of technology and for productivity improvements. Furthermore, the unpredictable levels of corruption in Albania act as a random tax on the business sector.

Corruption is also associated with low productivity of public investment, low operations and maintenance expenditures, and poor quality of infrastructure (i.e., roads in poor condition, frequent power outages, inefficient telecommunication systems, etc.). By distorting the composition of public investment, corruption reduces private productivity or forces firms to make costly adjustments in their production chain, which reduces Albania's growth prospects.

Table 54: Tax Rates: Albania versus Other Transition Countries

	Personal Income Tax Rate (in range)	Social Contributions/Payroll tax rates										VAT	Corporate Income Tax Rate (in range)	
		Pension		Health Insurance		Unemployment		Other Social Contributions		Total				
		Employee	Employer	Employee	Employer	Employee	Employer	Employee	Employer	Employee	Employer			Total
Albania	5-25									11.2	30.7	41.9	20	25
Bosnia a/														
Federation BIH	10-25	17.0	7.0	13.0	4.0	2.0	0.5			32.0	11.5	43.5	10 and 20	30.0
Republic Srpska b	22.0	24.0		15.0		1.0				40.0		40.0	10 and 20	10.0
Croatia	15-45	20.0			15.0		1.7		0.5	20.0	17.2	37.2	22.0	20.0
Macedonia	15-18		21.2		9.2		1.6				32.0	32.0	5.0-18.0	15.0
Serbia	17.5/a	10.3	10.3	6.0	6.0	0.6	0.6			16.8	16.8	37.1	20.0 b/	14.0
Montenegro	17-25 /a	12.0	12.0	7.5	7.5	0.5	0.5			20.0	20.0	40.0	17.0	15 and 20
Slovenia	17-50	15.5	8.9	6.4	6.4	0.1	0.1	0.1	0.6	22.1	15.9	38.0		
<i>Other CEEC countries 2/3/</i>														
Bulgaria	15-29									11.2	30.7	41.9	20	23.5
Czech Republic	15-32	6.5	19.5	4.5	9.0	0.4	3.2	1.1	3.3	12.5	35.0	47.5	22.5	31
Hungary	20-40	8.0	22.0	3.0	11.0	1.5	3.0			12.5	36.0	48.5	25.12	18
Poland	19-40	9.8	9.8					9.0	6.9-14.6	18.8	16.6-24.4	35.4-43.1	22	27
Romania	18-40									18.8	33.7	52.5	19	25
Slovak Republic	10-38	5.9	21.6	3.7	10.0	1.0	3.0	1.4	3.4	12.0	38.0	50.0	20	25
EU 3/	5-55							14.6		12.9	23.6	36.5	19.4	32.5 a/
OECD 3/										8.6	16.2	24.8		

Notes: Bosnia-Her.: a/ PIT rate includes 5 % wage tax for the Federation and 10% for Republika. The two government entities have different tax rate systems. b/ Based on net wages for PIT and for social contribution tax. Croatia: the effective PIT is below 10%. Macedonia: a/ PIT: the 15% rate applies to taxable income below 30,000 MKD and the 18% rate applies to the part of income above 30,000 MKD. b/ Social contribution rates are applied based on gross income. Health insurance rate may be higher for certain occupations than the rate indicated in the table. c/ There are various tax expenditures used in both VAT and CIT for either selected goods and services or for new business and investment. Serbia: a/ Personal income tax system in Serbia is in fact dual: all the income recipients are liable to scheduler taxes, and a small number of taxpayers (8,266 for 2002) whose annual income (after deducting scheduler taxes paid) exceeds the prescribed threshold (867,225 dinars for 2003, that is EUR 12,000), are liable to a complementary annual income tax (of 10%). PIT also includes 3.5% of payroll rate. b/ Serbia did not introduce VAT yet, this is retail tax rate (which is applied to most of goods and services). Montenegro: a/ Personal income tax rates are 17, 21 and 25. Majority of tax payers are paying taxes of 17%. EU: a/ Top CIT rate on average. Sources: 1/ Ministries of Finance for Former Yugoslavia. 2/ IMF for PIT. 3/ International Bureau of Fiscal Documentation, and World Bank.

Corruption also affects growth through its effects on the fiscal deficit

The negative impact of corruption on Albania's tax structure is well documented. Various studies (FIAS 2003) have shown that, in addition to losses in tax collection, the more that bribes are collected, the more that some corrupt public officials can resort to extortion in order to collect even more. Table 54 confirms that Albania's tax rates are broadly in line with those of other SEE countries. But a distinction should be made between taxes collected by the administrators and taxes received by the treasury. Some of the taxes paid by Albanian taxpayers (especially in the business sector) are diverted towards the personal wealth of some public officials. Thus, the burden of taxation on the taxpayers is not reflected in the level of tax receipts of the Government. As a result, the tax system in practice becomes less progressive than it

may appear. Also, some taxes are not collected from some politically influential taxpayers—this leads to less neutrality in the tax system. Indeed, Albania’s low level of tax performance leads to sub-optimal public spending, which reduces productivity and the efficiency of public expenditures, and creates a higher fiscal deficit. The country’s higher deficit in turn lowers growth.

A recent IMF study notes that “Albania’s level of tax revenue is significantly lower than the regional average – by about 11 percentage points of nonagricultural GDP in 2001-02. Low collections of the personal income tax (PIT) and the social security tax (SST) more than account for the entire shortfall, although the revenue from excises is also below average (but counter-balanced by an above-average yield in tariff revenue). [Yet] an assessment of the structural designs of the major taxes (the value-added tax (VAT), profit tax, PIT, and SST) reveals no fundamental flaws, and the rate(s) of each tax is (are) also comparable to regional levels. A reasonable conclusion to be drawn is, therefore, that improvements in revenue administration (especially audit and enforcement), rather than changes in tax policy, are key to increasing total tax collections in a sustainable manner over time.” A survey of 2002 reported that private businesses reported US\$1.4 billion in unofficial payments (Table 55).

Table 55: Reported Unofficial Payments by Procedures

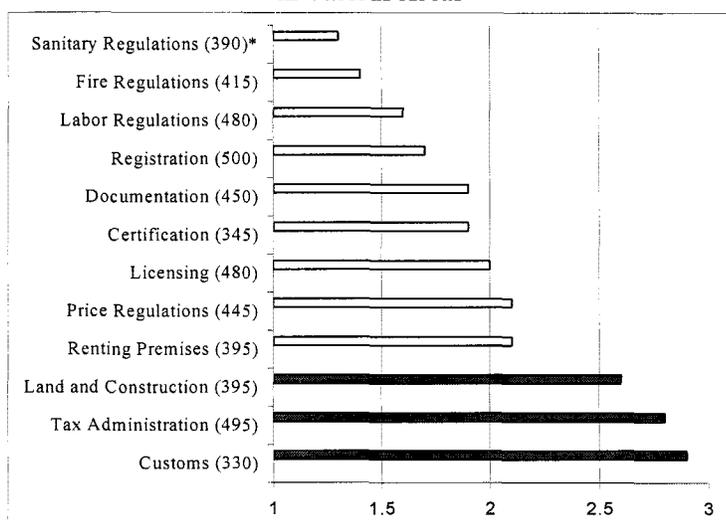
Procedure	Number of observations	Percentage of those who reported unofficial payments	Average amount of each payment (in US\$)
Customs: Import Clearance	184	36.0	167.70
Construction Permit	146	32.0	406.60
Tax Inspection	482	26.0	265.50
Business Licenses	263	11.6	108.00
Business Registration (Court)	137	9.5	173.10
Land Title Registration	244	5.7	225.10

Source: FIAS 2003.

Poor governance is often translated into dysfunctional public institutions, which negatively affects the performance of the business environment

In the framework of an Administrative and Regulatory Cost Survey (ARCS) covering 500 companies and a set of systematically designed (template) interviews with over 25 government authorities responsible for business regulation, FIAS (2003) reports that 50 percent of the respondents are found “somewhat dissatisfied,” “dissatisfied” or “very dissatisfied” with the overall regulatory and administrative requirement in Albania. An even large proportion (59 percent) of the respondents are found in the same way with the “bureaucratic behavior” of the overall government authorities in charge of the regulatory systems. The dissatisfaction level is especially high in Tirana, where 69 percent of the firms interviewed complain about the regulatory systems and 78 percent complain about the bureaucratic behavior.

Figure 38: Level of Obstacles Faced by Businesses in Albania in Various Areas



Legend: 1 = No obstacle; 2 = Minor obstacle; 3 = Moderate; 4 = Major obstacle.
Numbers in () are the number of respondents in the survey

In many specific procedural areas, the systems are found to be seriously flawed and characterized by lack of clarity, discretion, and transparency and by investor unfriendliness. Further investigation by the FIAS team revealed that bureaucratic delays, arbitrary treatment, and high costs (including frequent “unofficial payments”) were common across all areas examined. While these features are not unusual among transition economies in the region, their severity is remarkable when benchmarked against comparable country survey results (Table 56).

Table 56: Corruption Pressure Indicator (*)

Country	Customs officer		Municipal official		Judge		Tax official	
	2001	2002	2001	2002	2001	2002	2001	2002
Albania	55.60	54.88	52.50	50.67	53.10	44.31	56.80	50.43
Bosnia-Herz.	15.90	16.20	19.10	22.91	8.30	9.15	8.80	12.19
Bulgaria	15.80	18.55	10.30	9.96	9.10	7.80	8.30	5.29
Macedonia	21.80	25.32	11.90	19.67	13.70	15.53	8.90	24.08
Romania	20.50	29.60	26.90	19.70	16.60	13.70	10.60	7.98
Croatia	10.50	7.36	11.30	8.27	5.80	5.97	6.60	3.45
Serbia	42.80	52.60	27.20	25.12	19.30	26.24	22.00	23.49
Montenegro	21.60	29.67	19.30	20.79	7.00	7.65	13.30	17.24

(*) Relative share of those who have had contacts with the respective group and have been asked for cash, gifts or favors. Source: “Corruption Indexes,” Regional Corruption Monitoring, Center for the Study of Democracy and the International Legal Development Institute, Rome, April 2002.

According to the 2003 FIAS report, apart from possible broader social and political factors, the observed problems can be attributed to a combination of the following factors:

- *Poor implementation of regulations and operational guidelines.* Newly introduced laws are typically not supported by efforts setting out the necessary procedures, criteria and responsibilities. As such, the system permits the exercise of a high degree of administrative discretion by regulatory agencies and their officials, whose interpretations of the laws are frequently inconsistent and lack transparency. It also creates confusion among investors regarding their legitimate rights and obligations, as well as their means of compliance.

- *The lack of effective institutional structures,* with neither clear designation of individual agency responsibility and accountability, nor the required degree of cooperation between them. Investors often do not know exactly where to go for what, and government authorities also seem confused about who is responsible for what. For investors, this means a waste of time and unpredictability. For government authorities, this allows responsibility to be avoided when something needs to be done and allows “turf battles” to be waged when vested interests are threatened.

- *Ineffective enforcement of laws and regulations.* Complaints exist in almost all areas about ineffective dispute settlement mechanisms, within both public administration and the court system. Some officials with operational power are able to abuse their power without being held accountable. Private parties can move easily from legal to illegal practices (e.g., not using bank accounts, constructing without permits, smuggling, etc.), and, in some cases, seem to be driven of necessity to the latter since they are in competition with firms that engage in those practices. This is highly inequitable, since those who try to comply can be penalized most. It creates a vicious circle, in which fewer and fewer people, in both the public and the private sectors, are motivated to comply with the rule of law.

- *Insufficient skills of public officials at all levels.* In general, regulatory officials seem not to trust businesses. Many appear to see themselves as policemen, not service providers. It is a common perception that some abuse their position by seeking personal gain. Moreover, many authorities do not keep good records of their own performance; many cannot provide statistics on applications received, rejected, appealed, etc. Almost all authorities interviewed complained about resource constraints, and none had effective staff performance systems to reinforce good performance and dissuade poor performance.

Table 57: Institutional Indicators: Albania versus Other Transition Countries

	Rule of Law	Government Effectiveness	Regulatory Quality
Albania	-0.73	-0.53	-0.23
ECE Positive Growth	+0.39	+0.39	+0.55
ECE Negative Growth	-0.19	-0.30	+0.08
Baltics	+0.34	+0.42	+0.78
CIS	-0.84	-0.82	-0.99

Notes: Each indicator is measured on a scale of -2.5 to +2.5, with higher values indicating better governance. Source of data is Kaufmann, Kraay, and Mastruzzi (2003). Reported figures are averages for 1996-2002.

Recent limited progress in institutional building has not changed the overall public perception of poor performance

A few limited steps have also been taken in the area of public administration, and a comprehensive civil service law has been adopted. Legal and judicial capacities have been strengthened, accountability rules have been tightened, and an anti-corruption action plan is under implementation. Progress achieved in the modernization of the judicial system, such as the improvements in the salaries of judges and prosecutors, the adoption of a new law on advocacy, a new family code, the reforms in the criminal field, and in particular the establishment of courts for serious crimes, the adoption of legislation against money laundering and trafficking in human beings, legislation regarding witness protection and terrorism according to European standards, or the implementation of special investigation means. There have been modest developments in the fight against corruption, such as the initiation of the Triangle Committee procedures between the Prosecutor General's Office, the civil society and the Anti Corruption Unit. A draft amendment to the Criminal Code and Code of Criminal Procedure with relevance to corruption and economic crime offences is being discussed. However, the perception of Albania's institutions is still a matter of concern, especially when compared to other SEE countries (Table 58). Since weak human and institutional capacity affects regulatory quality as well as service delivery in the social sectors and contributes to poverty, much more remains to be done—especially in the implementation phase—to build credible institutions in Albania.

Table 58: Legal Effectiveness and Extensiveness Index

SEE Country	Protection of Property Rights		Corruption Perceptions		Legal effectiveness		Legal extensiveness	
	2003	1999	2003	1999	2002	1999	2002	1999
Albania	Low	Low	2.5	2.3	3	1.66	3	2
Bosnia & Herzegovina	Very low	Very low	3.3	..	3	1	3	2
Bulgaria	Moderate	Moderate	3.9	3.3	4	3.67	3.67	4
Croatia	Low	Low	3.7	2.7	3.3	2.67	3.3	4
FYR Macedonia	Low	.	2.3	3.3	3.67	3.67	3.3	3.67
Moldova	Moderate	Moderate	2.4	2.6	3.67	3	3.67	3.67
Romania	Low	Low	2.8	3.3	4	3.67	3.67	3.3
Serbia & Montenegro	Low	.	2.3	2	3	..	3	..

Source: Heritage Foundation, Transparency International, and EBRD Transition Report 2002. The indexes of legal effectiveness and extensiveness refer to commercial law only. Indicator ranges from 1 (commercial laws concerning pledge, bankruptcy and company are limited in scope, unclear and contradictory) to 4 (commercial laws concerning pledge, bankruptcy and company are comprehensive, clear and readily ascertainable). See EBRD Transition Report 2002, p.36-41.

Box 5: Human trafficking in the Balkans

Scope of the phenomenon. Like Moldova, Romania and Bulgaria, Albania is a country of origin for cross-border trafficking of human beings in South East Europe (SEE). Albanian victims tend to be trafficked primarily to Italy, but also to Belgium, Greece and, to a lesser extent, the Netherlands and the United Kingdom. According to the 2003 report of the Belgrade-based SEE Regional Clearing Point (RCP 2003), the number of Albanian trafficked victims identified and assisted between January 2000 and April 2003 in SEE was about 45 percent of the total number of identified and assisted victims from and in SEE (4,825). This includes identified and assisted Albanian women and girls trafficked for sexual exploitation (1,041), and 1,200 identified and assisted minors trafficked for purposes of begging and forced labor. According to specialized agencies (Europol 2001), the real number of victims may be much higher since only a few trafficked victims are adequately identified. In January 2002, the Government of Albania announced that over 100,000 Albanian children and women had been trafficked for sexual exploitation and other forms of forced labor.

Why it matters for long term development. The negative consequences of trafficking of women and children are difficult to document extensively (OSCE 2003). Some of its costs in countries like Albania include: a) depletion of human capital; b) loss of educational opportunities and foregone higher incomes for youth and minors; c) youth exclusion and crime, as unemployed young men engage in this type of illegal, profitable activity; d) increase in criminal activity; e) public health hazards (sexually transmitted diseases) with potential future economic and financial costs for the State; etc..

Policy directions. According to the US State Department (2003), the Government of Albania has demonstrated increased commitment and efforts to reduce the human trafficking. A National Strategy Against Trafficking in Human Beings was adopted by the Council of Ministers in 2002. The challenge is with the implementation of the strategy. Progress in areas such as crime control and border management are being closely monitored by the EC. A forthcoming World Bank study (Clert and Gomart) suggests the need for a more comprehensive strategy which takes into account the root causes of the problem (persisting high poverty levels in certain regions of the country, lack of local employment opportunities, the desire for a better life in the West, and the low status of women).

2. Policies to Improve Governance and Strengthen Institutions

The quality of institutions and governance permeates almost every dimension of the necessary future agenda in Albania. The country needs to strengthen its institutions in order to improve the sustainability of

policies. This is also a necessary condition for attracting export-generating FDI—a key to sustained growth and poverty reduction. Albania’s efforts over the past decade on this front suggest that a three-pronged approach will be required in order to significantly improve the impacts of those efforts: (i) redoubling efforts to ensure managerial integrity within the public administration; (ii) redoubling and diversifying efforts to ensure reliable, predictable and fair enforcement of the rule of law, including both rules governing the actions of public sector entities and their staff (in both their regulatory roles and their service provision roles) and rules governing private sector actors; and (iii) establishing and nurturing mechanisms that can facilitate a more effective service delivery voice – i.e., mechanisms that increase the odds that citizens and firms that are the direct targets of particular regulations or public services will know how to, and find it easy to, pressure the state to perform its regulatory and service delivery functions more fairly and effectively.

Ensure managerial integrity: Key elements of Albania’s efforts to enhance managerial integrity over the last six years or so include the following:

- Support for meritocratic insulation and competitive pay for a small senior managerial and policy cadre (i.e., the civil service)
- Targeted capacity building to strengthen budget formulation and execution systems, especially within the Ministry of Finance
- Targeted support for more competitive and transparent procurement.

Three sets of implementation issues have proven to be crucial for these reforms. First, for all of their seemingly technical character, each of these reforms was threatened by actions of political and bureaucratic leaders who prefer less transparency and more discretion. Second, while some of the reforms (a medium-term framework for budgeting, for example) are likely to become more or less self-enforcing in the wake of successful implementation, others (meritocracy, for example) are likely to continually come under threat, and confront a risk that hard-won gains could be lost. Third, even within this narrow menu, some areas have turned out to have stronger champions than others, making reform progress uneven.

Each of these efforts is far from having reached a point of irreversibility. Moreover, each is an essential building block of the sorts of institutions and governance practices required for sustained economic growth and poverty reduction. Therefore, Albania needs to redouble its efforts to reinforce and improve those reforms aimed at ensuring greater managerial integrity within its public administration.

Ensure reliable, predictable and fair enforcement of the rule of law: As was noted earlier, unpredictable, capricious or unfair application of laws and regulations or other rules governing either private sector actors

(e.g., firms, workers) or public bodies (e.g., regulatory bodies, service provision bodies) pose a serious impediment to both economic growth and efforts to ameliorate social problems or reduce poverty. Albania's governments have, over the last 5-6 years, undertaken various reforms aimed at ensuring more reliable, predictable and fair enforcement of the rule of law. Significant efforts have been undertaken under the Legal and Judicial Reform Project, as well as under the Public Administration Reform project to these ends. For example: an Administrative Procedures Law has been enacted; a Civil Service Commission has been established; etc. But these efforts are only the beginning. The Government needs to redouble and diversify its efforts to ensure reliable, predictable and fair enforcement of the rule of law, including both rules governing the actions of public sector entities and their staff (in both their regulatory roles and their service provision roles) and rules governing private sector actors.

Facilitate an effective service delivery voice: Efforts by Albania's governments over the last 5-6 years to ensure the managerial integrity of the public administration, as well as to establish a more reliable, predictable and fair rule of law, have, not surprisingly, met with resistance and setbacks. When political commitment has been strong, those impediments have been overcome and significant progress has been made. But political commitment is a precarious commodity, which needs continuous reinforcement from citizen demands. Albania's experience in undertaking these reforms suggests that a broad movement in favor of good governance capable of capturing the imagination and commitment of large numbers of citizens for sustained periods of time is unlikely to provide sufficient pressure to ensure the continuous, strong political commitment required to keep such reforms on track. In short, public goods such as good governance will continue to be undersupplied, because benefits are diffused among many individuals, while the costs of acting inevitably are concentrated among a small group. At the same time, individuals have an incentive to organize for rent-oriented state capture (for which benefits are concentrated, and costs diffused). Hence the lack of impact of, for example, campaigns which aim to improve governance by nurturing a crusade against corruption.

But this conclusion need not apply for all aspects of governance. A key for a revitalized governance strategy for Albania is to identify specific arenas of public action where there exist stakeholders with *high-powered incentives* to pressure the state for public performance – and to engage in these areas in ways which progressively 'crowd-in' and empower these stakeholders. In the short term, such engagement can foster pressure for better performance in key areas of public responsibility. Over the longer term, with the progressive strengthening of constituencies with interests in good public performance, in an open, competitive business environment, and in the rule of law more generally – and with the capacity to advocate effectively for these interests – a more profound transformation in state-society relationships could increasingly take hold.

Three sets of entry points seem especially promising in the Albanian context: (i) bottom-up initiatives to strengthen local governance and improve service delivery; (ii) initiatives to strengthen transparency in the public realm; and (iii) initiatives aimed-at crowding-in a productivity-oriented private sector, with an incentive in better public performance.

Bottom-up initiatives to strengthen local governance and improve service delivery can ‘crowd-in’ stakeholders with high-powered incentives to pressure for better public performance

For three reasons, a bottom-up approach to strengthening good governance seems to have substantial promise in Albania. First, these initiatives are close to the service delivery front-line, and so can leverage potential at the local level (where users live their lives) for collective action of the kind outlined above. Second, Albania is committed to an open society, a key pre-requisite to bottom-up accountability. And, third the “bedrock” of participatory governance at the local level – democratically elected local governments, assigned substantial local responsibilities, and resources to meet them – is in place in the country.

Table 59: Governance: Changing Roles for Major Stakeholders

	CURRENT STATUS	TRANSITIONAL STRATEGIES	LONG-RUN ROLE
Municipalities and communes	<ul style="list-style-type: none"> Basic institutional framework in place, but underfunded and not consistently and credibly downwardly accountable 	<ul style="list-style-type: none"> Link access to incremental resource-base (and added responsibilities) to achievement of capacity, transparency and participation benchmarks. Strengthen complaints windows, performance scorecards, civic associations etc 	<ul style="list-style-type: none"> Responsible for 40-60 percent of public investment (EU norm), funded through own-source revenues and transfers; High levels of civic participation in formulating local priorities and subsequent implementation; Performance-based competition among political rivals, underpinned by transparent information.
Albanian Development Fund	<ul style="list-style-type: none"> Dominant investor in local infrastructure in Albania (outside major municipalities) Since 1999, closer links to subnational governance (mayors on governing board; and investment in community-commune interaction), but still parallel structure, under chairmanship of central government. 	<ul style="list-style-type: none"> Link prioritization of ADF investments to achievement of capacity, transparency and participation benchmarks by local governments; Progressively shift oversight and control to local governments as benchmarks are achieved. Progressively roll ADF resources into bloc grants for local governments 	<ul style="list-style-type: none"> Specialist technical service organization; no direct investment role.
User associations	<ul style="list-style-type: none"> <i>Education:</i> ad-hoc; Board membership linked to gifts/contributions to school operation <i>Others:</i> (e.g. water users; natural resource management: apparently strong; needs follow-up; generally rural and small town) 	<ul style="list-style-type: none"> Provide some baseline facility-specific O&M financing, linked to constitution of participatory, transparent user group Capacity building for user associations; Open rehabilitation investment window thru local governments which achieve capacity, transparency and participation benchmarks 	<ul style="list-style-type: none"> Activated interest groups (both facility-specific participation, and umbrella organizations), which aggressively pursue interests of service segment, and engage multiple tiers of government in fulfilling promises and commitments.

Table 59 summarizes, for each of the local governments, the ADF and user groups, the current status of their role, a perspective on what that role might be in the long run, and some initial ideas for a transitional

strategy for getting from “here” to “there”. Two principles underlie the table. The first comprises the (increasingly) consensus view that, consistent with the logic of subsidiarity, in the long run, the principal responsibility for investment and operational resources at the local/facility level should rest with local governments. The second principle is that the prospect of access to additional resources (by local governments and user groups) can be an effective carrot for better bottom-up accountability. Taken together, these principles suggest that, over a transitional period, top priority should be given to initiatives (including approaches to public service delivery) which can accelerate the development of local participatory capabilities *in ways which align them to the emergent role of local governments*.

***Crowding-in a
productivity-oriented
private sector***

In general, the logic and evidence on state capture imply that a country’s private sector can be as much a part of a dysfunctional rent-creation and rent-extraction governance equilibrium as public officials. Incumbent firms generally benefit from the rent game, and hence are unlikely to be strong proponents of changing the rules; those precluded from the game lack the influence to effect reform. As has long been recognized among development practitioners, however, exporting firms⁵⁹ can be an important exception to this generally pessimistic view as to how much advocacy for good governance might be expected from the private sector.

Unlike firms competing domestically in nontradable markets, successful exporters, especially of light manufactures, need to operate at the highest levels of international performance: a supportive institutional environment and adequate infrastructure are necessary for their success; a dysfunctional domestic setting will spell their doom. In highlighting the potential benefits of an export sector – not only for sustainable growth, but also for the potential impact on governance -- the obvious question arises: in a difficult governance environment, what grounds are there for expecting such a sector to take root in the first place?

One answer is Albania-specific: *its proximity to Western Europe (notably Italy, a world leader in global garment and footwear export markets), the low unit costs of its literate and quite-skilled work force, its open and broadly stable economic policies, leaves Albania unusually well-positioned to penetrate international markets*. A second answer emerges directly from the comparative international experience. Many countries that have ridden to success on the basis of superior performance in manufactures exports (from Mauritius, to Tunisia, to Taiwan) began the process with dysfunctional domestic institutions. There exists a wealth of knowledge, experience, and instruments as to how to facilitate the emergence of exporter firms in difficult settings. This indicate that, if a productivity-oriented export sector were indeed to take root in Albania, it would effect a radical, enormously beneficial,

⁵⁹ Not all exporters, of course. Natural resources exporters earn their returns from rents, with corruption often a key currency for winning the right to export. The proposition applies most clearly to manufactures exporters but is also relevant to some exporters of services (e.g., tourism).

refocusing of business-government dialogue. Given the potential benefits, a pragmatic approach to a next generation of export facilitation surely seems warranted.

***Strengthening
transparency in the
use of public
resources***

Two key sets of questions need to be explored in assessing the potential for a focus on enhancing transparency in relation to the use of public resources to serve as an entry point for improved governance. First, do there exist the institutions and stakeholders capable of effecting an increase in transparency? Second, will an increase in transparency result in any changes in public behavior?

In relation to the first question, Albania seems quite well placed. For one thing, both citizens and public actors have growing expectations on how openly government should conduct its business. For another, the professionalization that seem to be taking root at the higher levels of the civil service (combined with recent pay increases at that level that have made earnings in the public sector comparable with the private sector) create both the space and the incentive for these leaders of the bureaucracy to operate in a transparent manner. Further, Albania's desire for EU accession, and its continuing strong engagement with the World Bank and other IFIs, implies that the country's development partners are in a position to push for continuing gains in transparency.

Whether increased transparency results in any changes in public behavior depends, first, on the quality and use of information as to government actions, and second, on the extent to which non-government stakeholders have the incentive and capability to act on the basis of the information which is made available. These issues of use and incentives can be addressed only in the context of specific transparency initiatives. Three such initiatives, currently on the agenda in Albania are considered here: asset declaration; ex post audits of public spending; and results-based monitoring.

Based on the criteria of usability and incentives, asset declaration is the initiative which seems to have the greatest potential in the short- to medium-term. The legal framework is in place requiring senior politicians and public officials to declare their assets and post their declarations on the web. The civil service rules provide the officials in the directorate responsible for certifying the accuracy of these declarations with the insulation they need to investigate thoroughly and impartially. While the directorate could be vulnerable to budget cutbacks, there are many ways through which Albania's development partners can help provide the requisite resource predictability.

Ex post auditing is the responsibility of Albania's independent High State Control authority, which reports at least annually to Parliament. Though the HSC has been given positive reviews by both Sigma and the Bank's CFAA, and its reports are explicit in their identification of

irregularities, three⁶⁰ obstacles limit the effectiveness of ex post auditing as a transparency and accountability mechanism. First, the parliamentary committee responsible for assimilating and using the HSC's findings seems to lack the capacity to do so effectively; the shortfall may not be only in skills, but also in a lack of incentive given the strong top-down nature of the two party political process. Second, perhaps in part because of weaknesses at the parliamentary level in effectively communicating the HSC's findings, the HSC does not enjoy a universal reputation within Albania of systematically providing competent audits, produced "above the fray" of partisan politics. Third, there is no systematic follow-up by Albania's justice system to HSC findings. One way forward may be for Albania's development partners themselves to be more pro-active in monitoring follow-up by the Albanian authorities to the HSC's reports.

The third area where transparency might potentially have an impact comprises results-based monitoring in the achievement of poverty reduction goals. The attractiveness of this approach is clear – what is achieved in reducing poverty matters a great deal more to Albania's citizens and development partners than compliance with process. Moreover, Albania's NSSD potentially provides the context of agreed-upon goals and targets within which such monitoring might proceed. Unhappily, however, results-based monitoring of the NSSD seems to meet neither the incentive nor the usability tests for effective transparency. There is currently no organized arena within which Albanian stakeholders work with government to review progress in meeting poverty targets. And even if such an arena were to emerge, it is not obvious that the relevant indicators could be made sufficiently precise – and sufficiently clearly linked to public action – to enable them to serve as a basis for the accountability of government for its performance on a year-to-year basis. Perhaps the most that can be expected from comprehensive results-based monitoring of the kind envisaged in the NSSD is that it provides a framework for organizing national consensus around longer-term goals, and for evaluating over the medium-term the performance of the government in power.

⁶⁰ A fourth issue which sometimes is raised is that the HSC focuses exclusively on financial rather than performance auditing. Though it is true that "best practice" Supreme Audit Institutions practice performance auditing, it is also true that this results-focus was built on a solid track record of financial reporting. In general, the advice is to "get the (financial) fundamentals right" before moving on to more advanced (and inherently less precise) areas.

CHAPTER 8: MACROECONOMIC FRAMEWORK FOR GROWTH

Sustained growth and improved competitiveness cannot be secured in Albania without continued progress on the macroeconomic front. Despite the country's overall good track record in stabilization and structural reforms, some major constraints and vulnerabilities must be addressed. This chapter reviews these constraints and outlines a macroeconomic policy framework for the medium term.

1. Macroeconomic and Financial Constraints

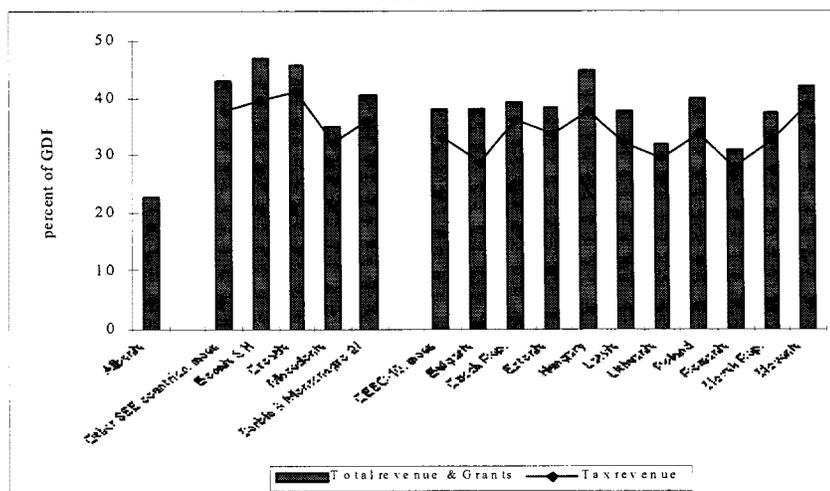
Government revenue is much lower than in any other SEE country

Fiscal sustainability is at risk because of low tax collection performance. Albania's weak performance started in 1991 with the overall systemic change implied by the collapse of the socialist system of automatic transfers to the budget. The country also lacks a historical tradition of tax collection. For almost 40 years, the communist regime declared an economy without taxes. Social security and retirement plans were deductible and the employees, all working at a state-owned form of property, never felt any payment obligation. No private sector and no private jobs were available.

Table 60: Government Revenue as Percentage of GDP, Southeast Europe

	1996	1997	1998	1999	2000	2001	2002
Albania	18.3	17.3	23.4	24.7	22.9	22.8	22.7
Bosnia Herzegovina	0.5	39.2	56.7	61.3	56.1	51.8	51.8
Bulgaria	31.7	30.7	38.0	38.7	38.7	37.7	36.5
Croatia	44.3	42.5	45.6	48.4	46.2	44.7	45.2
FYR Macedonia	35.7	34.8	33.3	35.4	36.6	34.4	35.9
Rumania	28.9	27.1	27.9	30.7	31.2	30.1	29.9
Serbia Montenegro	na	na	na	na	36.7	38.9	42.8

Figure 39: Government Revenue and Tax Revenue in a Sample of Countries



The base for income tax is very low

The informal sector is very large and favors tax evasion. Tax evasion and tax avoidance in the household sector are sizable. Undeclared household income is estimated at 52 percent of GDP, the largest among SEE and CEE countries. Albania's informal economy is estimated to be as large as 30 percent of its formal economy. Most of the economy is derived from agriculture and is therefore out of fiscal "control." The sector employs at least half of the labor force—people living often on subsistence farming and not reporting income. Tax administration is weak. Tax collection is often below targets and, according to surveys, tax harassment is considered a major issue for businesses. The social security contribution is still unsatisfactory (less than 35 percent of employees in the private firms are covered, and a collection is especially poor in the Central and Coastal regions).

The widespread informal economy is a key impediment to generating revenue from channels other than international trade

Table 61: Estimates of the Size of the Shadow Economy in Central and Southeast Europe

	Total household income as share of GDP	Statutory household tax rate	Total household tax revenue as share of GDP	Declared household income as share of GDP	Undeclared household income as share of GDP
<i>SEE Average</i>	<i>0.851</i>	<i>0.379</i>	<i>0.207</i>	<i>0.546</i>	<i>0.305</i>
Albania	0.875	0.302	0.107	0.353	0.522
Bosnia-Herzegovina	0.848	0.397	0.256	0.643	0.205
Bulgaria	0.782	0.383	0.166	0.441	0.341
Croatia	0.749	0.486	0.276	0.567	0.181
Macedonia	0.88	0.536	0.262	0.488	0.392
Romania	0.805	0.406	0.142	0.35	0.456
Serbia & Montenegro	0.848	0.362	0.238	0.658	0.192
<i>AC Average</i>	<i>0.725</i>	<i>0.44</i>	<i>0.222</i>	<i>0.502</i>	<i>0.221</i>
Czech Republic	0.667	0.391	0.185	0.483	0.184
Estonia	0.774	0.526	0.316	0.6	0.174
Hungary	0.695	0.453	0.222	0.49	0.209
Latvia	0.74	0.397	0.193	0.485	0.256
Lithuania	0.754	0.373	0.188	0.503	0.251
Poland	0.783	0.475	0.223	0.47	0.313
Slovakia	0.647	0.406	0.176	0.435	0.212
Slovenia	0.717	0.496	0.271	0.547	0.017

Source: Holzner and Christie, 2004.

Integration into the world economy through further liberalization of trade at the regional level with other SEE countries and with the

Furthermore, Albania will suffer substantial fiscal losses in the short and medium terms because of the impact of trade liberalization arrangements under the WTO, SAA negotiations with the EU, and bilateral free trade agreements with other SEE countries. Three scenarios are to be considered: (i) full liberalization of tariffs on imports from neighboring countries in South Eastern Europe in accordance with Albania's Free Trade Agreements; (ii) full implementation of the SAA

EU in the context of the SAP will entail short-term costs

with the EU⁶¹; and (iii) the adoption of the Common European Tariff on industrial products. Tables 62, 63, and 64 indicate the reduction in tariffs to be expected for Albania.

Table 62: Albanian Tariffs on Imports from the EU

	2002 Effective Tariffs (%)	SAA Tariffs (%)	Percentage Point Reduction	EU GSP Tariffs
Grains	7.6	3.6	4.0	4.7
Vegetables, Frutis, Other Agricultural Products	4.3	3.3	1.0	0.0
Livestock	10.7	5.3	5.4	2.5
Forestry	11.6	11.1	0.5	1.3
Fishing	11.6	11.1	0.5	1.3
Energy, Mining	2.1	0.0	2.1	0.0
Minerals nec	4.2	0.0	4.2	0.0
Food Products	10.3	5.1	5.2	0.7
Textiles, Clothing, Footwear	10.3	0.0	10.3	5.3
Wood, Paper products	8.1	0.0	8.1	0.0
Petroleum, Coke Products	7.2	0.0	7.2	0.0
Chemicals, Rubber, Plastic Products	6.6	0.0	6.6	0.0
Non-Metallic Mineral Products	11.7	0.0	11.7	0.7
Metals and Metal Products	10.2	0.0	10.2	0.2
Transport Equipment, Machinery and Equipment	5.4	0.0	5.4	0.2

Source: Albanian Customs Authorities.

Table 63: Albanian Tariffs on Imports from Neighboring Countries covered by FTAs

	2002 Effective Tariffs (%)	FTA Tariffs (%)	Percentage Point Reduction
Grains	2.8	1.2	1.6
Vegetables, Frutis, Other Agricultural Products	5.3	4.8	0.5
Livestock	8.1	6.0	2.1
Forestry	13.1	3.0	10.1
Fishing	13.1	3.0	10.1
Energy, Mining	2.0	0.0	2.0
Minerals nec	1.2	0.0	1.2
Food Products	8.6	2.7	5.9
Textiles, Clothing, Footwear	10.3	0.0	10.3
Wood, Paper products	9.5	0.0	9.5
Petroleum, Coke Products	9.1	0.0	9.1
Chemicals, Rubber, Plastic Products	5.3	0.0	5.3
Non-Metallic Mineral Products	9.8	0.0	9.8
Metals and Metal Products	7.2	0.0	7.2
Transport Equipment, Machinery and Equipment	4.5	0.0	4.5

Source: Albanian Customs Authorities.

⁶¹ With respect to the impact of the SAA (scenario 2), and in the absence of information about Albania's proposed tariff dismantling schedules under negotiation, we assumed that tariff reductions are similar to those applied by Croatia in its SAA with the EU. The final terms of Albania's SAA could differ from those adopted for Croatia. The CGE model could be updated to reflect the Albanian proposed tariff reductions.

Table 64: Albanian MFN Tariffs and the CET on Manufacturing Products

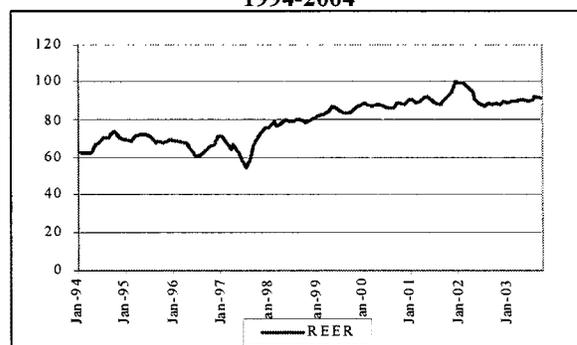
	2002 ROW Effective Tariffs (%)	CET (%)	Percentage Point Reduction
Grains	2.0		0.0
Vegetables, Fruits, Other Agricultural Products	2.8		0.0
Livestock	10.1		0.0
Forestry	7.3		0.0
Fishing	7.3		0.0
Energy, Mining	9.9	0.0	-9.9
Minerals nec	0.4	0.0	-0.4
Food Products	7.1		0
Textiles, Clothing, Footwear	12.3	10.3	-2.0
Wood, Paper products	5.6	0.7	-5.0
Petroleum, Coke Products	9.9	0.0	-9.9
Chemicals, Rubber, Plastic Products	6.2	3.3	-2.9
Non-Metallic Mineral Products	9.7	3.7	-6.1
Metals and Metal Products	11.7	1.9	-9.8
Transport Equipment, Machinery and Equipment	4.5	3.6	-0.9

Source: Albanian Customs Authorities.

There has been a significant appreciation of the Lek over recent years

In addition to the challenges of its delicate fiscal situation and the prospects for lower revenues from international trade in the short term, Albania faces a difficult decision on the monetary front. Different indicators of external competitiveness have been used by various authors to determine the extent of the appreciation of the Lek since the launching of the first stabilization program in the early 1990s (CPI-based real effective exchange rate, various measures of the relative price of nontradables to tradables, and even some dollar wage comparison)⁶². While the magnitude of the appreciation varies across empirical studies—which could simply be the effect of data limitations, the general trend is clear: Albania’s national currency has gained strength during most of the past decade, except for the 1997 dip owing to the pyramid scheme crisis (see Figure 40).

Figure 40: CPI-Based Real Effective Exchange Rate, 1994-2004

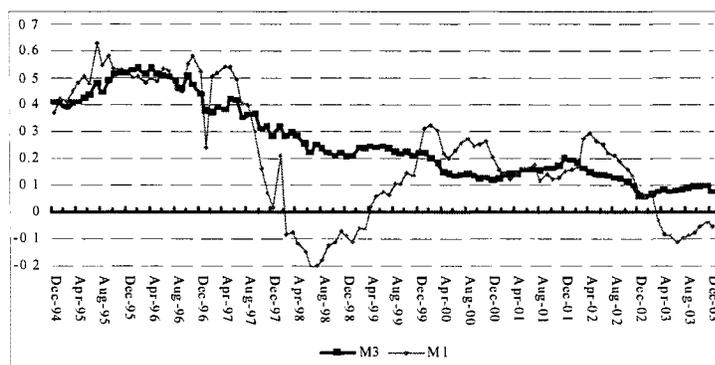


⁶² See Muco, Sanfey and Taci 2003, IMF (2003), Turner and Golub (1997), Marsh and Tokarick (1994), or Clark et al. (1994).

Several factors explain the real appreciation of the Lek, including the tight monetary policy, the large external financial inflows, some productivity growth, and reductions in price distortions. While it has been successful in creating a stable price environment, monetary policy has aimed at reducing the money supply during most of the transition (see Figure 41). Albania is also the country with the lowest level of bank credit to the private sector as a share of GDP (see Table 65). Although the exchange rate is set to float freely, the Bank of Albania occasionally intervenes to help maintain a certain level of imports or to keep export prices attractive, and to deter any speculative attack against the Lek. It should be noted that the effectiveness of monetary policy has been limited by several factors, including delays in banking sector reform, the slow development of capital markets, and the spread of the informal economy after the liberalization.

The money supply has been controlled for most of the past decade

Figure 41: Annual Growth Rate of the Money Supply, 1994-2003



Source: Bank of Albania.

Table 65: Bank Credit to the Private Sector, South East Europe (% of GDP)

Bank credit to the private sector is the lowest in the SEE countries

	1995	1996	1997	1998	1999	2000	2001	2002
Albania	3.6	3.9	3.9	0.6	2.1	2.9	3.8	4.7
Bosnia Herzegovina	na	na	na	na	8.9	7.4	9.5	12.0
Bulgaria	21.1	35.3	12.3	12.2	14.0	11.6	14.6	18.0
Croatia	22.9	21.4	25.3	26.6	22.1	27.8	34.2	45.0
FYR Macedonia	23.1	26.5	27.3	17.7	10.4	10.5	12.8	14.4
Rumania	7.8	11.5	8.4	11.6	8.1	7.2	7.7	8.4
Serbia Montenegro	na	9.2	10.8	11.2	9.8	7.6	5.6	na

Source: EBRD, Transition Report, 2003

Remittances and external aid contribute to the appreciation of the Lek

High volumes of remittances—most of which occur in cash, outside the banking system—large inflows of external financial assistance, and foreign direct investment most recently have fueled domestic consumption and investment, contributing to the strengthening of the Lek. The Bank of Albania estimates that remittances amounted to 600 million Lek in 2002, more than twice the volume recorded by the banking system. Indeed, Albania has the highest level of currency outside of the banking system in SEE countries (Table 66). Statistics from the Ministry of Economy's Department of Monitoring and

Evaluation indicate that, over the period 1991-2002, Albania received a total commitment of external assistance of around US \$3.9 billion (see Table 67).

Table 66: Currency Outside the Banking System, SEE, 1992-2002 (as a percentage of MS)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
SEEurope (average)	23.8	18.0	22.0	22.6	20.4	25.3	20.7	20.3	20.1	20.1	
Albania	34.4	35.7	39.0	39.0	30.9	36.6	28.5	27.8	30.2	30.3	31.4
Bulgaria	12.0	10.8	9.5	10.9	10.2	23.7	28.2	28.3	26.7	25.5	-
Croatia	-	13.7	15.0	13.5	11.9	10.5	10.0	10.6	9.1	8.0	-
Macedonia	-	6.3	25.9	28.9	31.3	27.1	24.4	22.0	20.8	23.4	-
Romania	25.0	23.5	20.7	20.8	17.8	28.6	12.5	13.0	13.9	13.2	-

Source: IFC.

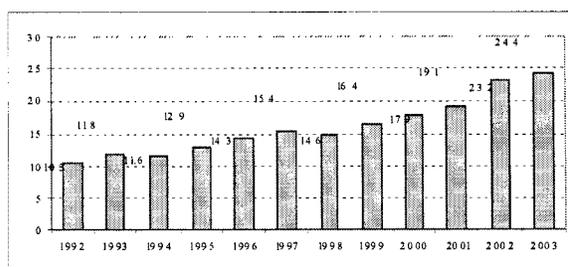
Table 67: External Assistance to Albania, 1991-2002

	Pre-1998	1998	1999	2000	2001	2002	Total
Commitments, in thousand \$	2,230,687	276,149	478,197	397,526	252,409	261,618	3,896,586
In % of GDP		8.4	12.7	9.37	5.43	5.0	
In % of Budget Expenditure		25.3	37.5	30.3	17.6	15.9	
Disbursement, in thousand \$	1,977,773	207,376	286,139	215,069	263,275	192,752	2,242,384
In % of GDP		6.3	7.6	5.1	5.7	3.7	
In % of Budget Expenditure		19.0	22.5	16.4	18.4	11.7	
Cumulative Disbursement Rate	48,3%						57,5%

Source: Ministry of Economy, Department of Monitoring and Evaluation.

While they are difficult to measure because of data limitations, productivity gains have also contributed to the appreciation of the Lek (Figure 42).

Figure 42: Labor Productivity , 1992-2003, Thousand Leks/Employee



According to the NSSED, labor productivity has shown an upward trend throughout the period of transition (except for the crisis year of 1997)

The appreciation of the Lek is a constraint to external competitiveness

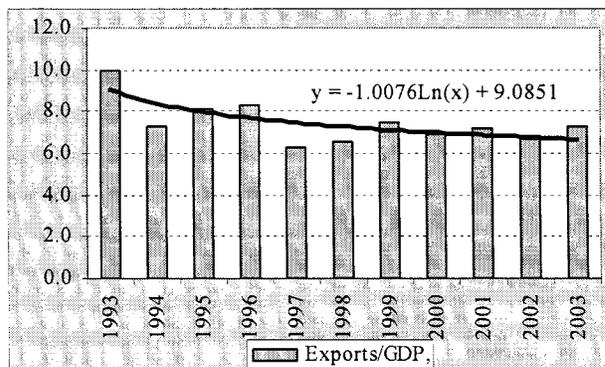
The strengthening of Albania's currency has been associated with slower export growth and a larger trade deficit. While Albania's import needs are consistent with the levels observed in open economies at similar levels of development—about 30 percent of GDP on average between 1993 and 2003—its exports remain low, at less than 10 percent of GDP. Thus, the trade deficit has remained high. The still manageable current account deficit (-7.6 percent of GDP in 2003) mostly reflects the large volumes of remittances flowing into the country. This is an indication that the appreciation of the Lek may be having a negative impact on the country's external competitiveness.

Table 68: Trade as a Share of GDP, 1998-2002 (percent)

Indicator	1998	1999	2000	2001	2002
Exports	7.4	7.7	7.1	7.2	6.8
Imports	30.2	33.2	29.6	31.2	31.1
Trade volume	37.6	40.9	36.7	38.4	37.9
Trade balance	-22.7	-25.5	-22.5	-24.1	-24.2

After an initial slump, exports have recovered during the past but have been tapering off or even declining as a share of GDP in recent years

Figure 43: exports to GDP, 1993-2003 (percent)



Foreign trade is firmly oriented towards closer cooperation and integration with the EU but the economy it is still vulnerable to external shocks

A further subject of concern is the high degree of concentration of Albania's trade. The EU currently absorbs more than 90 percent of its total exports and more than 70 percent of its total imports, albeit down from 83 percent in 1997 (Table 69). Greece and Italy have become Albania's major trading partners. These two countries accounted for 87 percent of Albania's exports and 53 percent of its imports in 2003.

Table 69: Geographic Pattern of Albania's Exports and Imports in 1996-2003 (in percent)

Exports	1996	1997	1998	1999	2000	2001	2002	2003
European Union (15)	86.0	87.5	92.5	94.9	92.9	91.0	92.3	93.3
Of which: Greece	13.0	20.5	19.8	13.5	12.7	12.7	13.3	12.8
Italy	57.8	49.4	60.1	69.5	70.6	71.0	71.4	74.9
Rest-of-World	14.0	12.5	7.5	5.1	7.1	9.0	7.7	6.7
Of which: SEE-8	3.8	6.9	0.8	1.4	1.5	2.2	1.7	0.8
Share of SEE-8 in ROW exports	27.4	55.0	10.3	26.7	21.5	23.9	21.9	12.3
Total (in million of US \$)	211	138	208	351	261	305	314	447
Imports	1996	1997	1998	1999	2000	2001	2002	2003
European Union (15)	76.0	83.4	81.6	76.6	74.4	74.3	71.2	67.9
Of which: Greece	20.3	26.0	27.5	23.2	26.4	25.8	21.7	20.0
Italy	40.3	45.9	43.2	33.5	35.2	31.9	34.5	33.5
Rest-of-World	24.0	16.6	18.4	23.4	25.6	25.7	28.8	32.1
Of which: SEE-8	9.7	5.5	3.7	5.8	6.3	5.4	6.3	4.9
Share of SEE-8 in ROW imports	40.4	33.3	20.3	24.6	24.6	21.0	22.0	15.4
Total (in million of US \$)	938.5	629.0	840.8	1154.4	1089.3	1330.6	1509.1	1863.8

Source: Based on Albania's data from UN COMTRADE Statistics.

2. Policies to maintain macroeconomic stabilization

Maintaining a stable macroeconomic framework is a pre-requisite to higher investment, improved competitiveness and sustained growth. The experience of transition has shown that macroeconomic instability or crisis causes investment to collapse and sets the growth trajectory back several years.

Improving public savings by curtailing quasi-fiscal expenditures on utilities. Given its huge development needs and the reliance on imported capital goods in the foreseeable future, Albania will face a serious savings/investment imbalance in the medium term. The expectation of policymakers is to continue to finance the current account deficit either (i) through non-debt creating financial flows (grants, concessional assistance), or (ii) through foreign direct investment. If not, the country may be forced to rely on traditional, expensive debt mechanisms. Official transfers to SEE countries have been declining over recent years and are often subject to political considerations—therefore, Option (i) may be an uncertain path. Furthermore, all countries in the region will have to compete in order to attract FDI; therefore, Option (ii) will require major and difficult structural reforms to improve the business climate. Given these constraints, one way to avoid unsustainable debt levels will be to raise public savings. This could be done by curtailing quasi-fiscal expenditures on utilities, that is, by limiting the amount of subsidies allocated to users of public utilities.

Continued adherence to fiscal discipline to further reduce the budget deficit will be necessary in the coming years. Because Albania's still high fiscal deficit (over 4 percent of GDP in 2003) is financed primarily through domestic borrowing, fiscal consolidation is important to make domestic savings available for private sector investment. As the private sector takes a more important role, public consumption should decline as a share of GDP and this would allow for a gradual shift away from external savings.

Given the country's tax collection performance, fiscal policy should also aim at a broader and more secure revenue base. A recent IMF report has recommended some specific measures to strengthen tax collection. They include changes in the value-added tax, changes in the coverage of the corporate income tax, the reduction of the number of personal income tax rates, and an increase in excises on alcoholic, tobacco, and petroleum products (see Box 6).

Box 6: Tax Reforms Proposed by the IMF

Value-added tax (VAT)

- Repeal the application of the VAT provision that imposes compulsory registration of wholesalers.
- Subject all sales of newly constructed buildings to tax, with a view to eventually eliminating the current practice of taxing embedded labor value during building

construction.

- Exempt rental payments generated from new residential building that are taxed on their sales.
- Consider adopting the deemed-VAT-on-indemnity-payment approach to taxing nonlife insurance.
- Remove the construction industry from the deferral scheme until the sale of new buildings becomes taxable.
- Repeal the application of the compensation scheme for certain small farmers or, at the very least, significantly reduce the rate of compensation.
- Harmonize the applicable scope of the VAT suspensive regime with that of the tariff suspensive regime.
- Resist pressures to introduce multiple rates or expand the scope of exemptions.

Profit tax

- Consider, as a medium-term objective, changing the applicable scope of the regular profit tax from one exclusively based on a business's turnover to one based also on its legal status as a juridical person.
- Lengthen the loss carry-forward period to 5 years.
- Apply the withholding tax on specified categories of income paid to payers of the regular profit tax, but allow a tax credit for the withholding tax against their profit tax liabilities.
- Replace Art. 32/1, para. 1.b in the income tax law by "is not registered and not obligated by law to be registered for VAT".
- Consider raising the simplified profit tax rate by one to two percentage points.
- Apply the withholding tax on specified categories of income paid to payers of the simplified profit tax, but allow a tax credit for the withholding tax against their profit tax liabilities.

PIT and SST

- Reduce the number of PIT rates to at most 5 by eliminating the 18 percent and 23 percent rate bands.
- Repeal the PIT deductibility of the obligatory SST.
- Harmonize the base of the SST with the base of the PIT on wage income.
- Remove, as a second-best option, certain categories of SST-excluded income that are prone to abuse, specifically merit payments from labor funds and cash bonuses.

Revenue mobilization

- Consider raising excises on alcoholic, tobacco, and petroleum products to bring their total tax burdens close to levels on a comparable basis in neighboring countries.
- Consider rationalizing the system of vehicle taxes and raising their overall excise burden on vehicles.

Major improvements are needed in public expenditure management. Key measures to be considered include the following:

- Ensuring that *the Medium-Term Expenditure Framework (MTEF), adopted in 2000, which aims to improve the strategic resource allocation and the efficiency of resource use, is fully integrated with the NSSSED process* and other initiatives, such as the Stabilization and Association process and the fiscal decentralization (see Box 7) In this regard, Albania may need to consider some of the fiscal rules observed by other successful transition economies (see Monga 1994).

- Adopting budget rules to improve allocative efficiency in sector where major investment projects are under consideration (transport, energy, water, social sectors); the authorities should strengthen the capacity of line ministries and agencies to establish priorities within the budget, to select investment projects on the basis of a transparent, economic rationale, to distribute resources on the basis of the Government's priorities and the program's effectiveness and to shift resources from old priorities to new ones or from less to more productive activities, in correspondence with the government's objectives
- Adopting rules to limit the growth of non-priority recurrent spending
- Strengthening transparency and auditing procedures and ensuring that the High Inspectorate
- Undertaking a comprehensive public expenditure review in order to analyze equity issues and the effectiveness of public resources.

Box 7: Strategic Directions on Decentralization

Albania is in the process of implementing a national strategy for decentralization to strengthen local fiscal autonomy, increase efficiency and accountability over public resource allocation, and improve public service delivery to the citizen. The Government has taken major strides on establishing a basic legal and institutional framework for local governance, but major implementation challenges still remains, owing to: (a) a fragmented structure of local administrative units; (b) a weak administrative capacity (both local and central); (c) an unclear assignment responsibilities and competences on *shared* functions (including education, health care, and social assistance); (d) an absence of well defined standards of services and of measurement criteria for the performance of service delivery; and (e) an inadequate degree of local revenue autonomy and predictability. Also, from the demand side, there is a sense of neglect and insufficient participation of the civil society in the decision making process.

Addressing these challenges under hard budget constraints is critical to sustain economic growth in Albania, since properly conducted decentralization can increase allocative efficiency, reduce waste and un-provision of essential services, while maintaining macroeconomic stability. In this regard, a participatory decision-making approach may complement bottom up the ongoing top down decentralization reforms, as an instrument to ensure awareness, transparency and accountability. Such an integrated approach may motivate the involvement of civil society and private sector on the management, provision and financing of public services, local infrastructures (including social) and utilities—which tends to expand the possibilities of local investment and growth. Nevertheless, decentralization have to move forward at the extent and speed which are practically feasible in each particular sector, given the current political circumstances as well as capacity and institutional building possibilities. Moreover, the principle that resources follow responsibilities should be always ensured, and responsibilities and competences should be assigned asymmetrically to local authorities according their respective capacity to deliver.

Strategic directions of decentralization in Albania essentially requires: (a) a clarification of the role of the Regions and of the specific responsibilities and competencies of local self-governments, especially on *shared* functions; (b) a re-designed intergovernmental fiscal relation system, on the basis of a closed system of local government finance, that factors in shared national taxes and explicit rules for the determination of the *size* and *distribution* of transfers (both conditional and unconditional); (c) an urgent implementation of a financially sustainable national training strategy for local government; and (d) a strengthened central coordination of the decentralization strategy.

There is room for further easing of monetary policy—though this should be done with caution

The still low level of credit to the private sector and the strength of the Lek indicate that there is a need to ease monetary policy. The strength of the Lek is one of the difficulties that Albanian exporters identify as a constraint to the development of their business. Given the still low inflation expectations (the prospects for this year's agricultural output are good and the weight of foodstuffs in the CPI-basket is 41 percent) and the comfortable level of reserve coverage, it appears that the policy of lower interest rates adopted by the Bank of Albania in recent months can be maintained. While the Albanian monetary authorities should closely monitor developments on international interest rates and energy prices which could spur inflation, and therefore, should undertake with caution any change in policy, their immediate objective should be to limit the appreciation of the Lek.

CHAPTER 9: CONCLUSION

Albania has been one of the growth success stories among transition economies during the past decade. Most of this growth has been driven by very substantial improvements in total factor productivity (TFP), as Albania has reallocated resources to more productive activities and has experienced substantial structural transformation in the aftermath of transition. Successful stabilization programs complemented by reforms aiming to liberalize the economy have also provided a sound macroeconomic framework for structural transformation. The agricultural sector still provides the income basis for almost half of the Albanian population and serves as an employment safety net for an even larger share. But there have been important developments in the construction and services sectors in recent years. Finally, growth has been fueled by high volumes of remittances from large numbers of Albanians who migrated in the 1990s (mostly to Greece and Italy) or work temporarily abroad.

Despite its remarkable macroeconomic performance, Albania is still one of the poorest countries in Europe (one-quarter of the population lives below the poverty line). Furthermore, the country faces several important structural challenges that are impeding its competitiveness and threatens the sustainability of growth. These constraints include: (i) macroeconomic and financial vulnerabilities; (ii) governance and institutional issues (various indicators show a deterioration of governance over the 1996-2002 period and Albania is still perceived as being corrupt, although the situation appears to have improved recently); and (iii), weak human capital and poor infrastructure.

On the sources of growth, an important question is whether the agriculture sector can remain a major contributor to economic growth in the face of increasing competitive pressures as Albania further integrates with its neighbors and with the EU. In fact, both agriculture and agro-processing face significant challenges to achieving regional standards, particularly in the areas of institutional capacity, technology, skills and know-how, access to resources and quality of inputs and outputs. In addition, the farming sector remains highly fragmented and burdened by restrictions in access to land and land use.

As Albania moves to the next phase of economic growth and seeks to improve its prospects for EU accession, it needs to raise its rates of physical and human capital accumulation and also generate improvements in TFP from alternative sources. Yet the evidence from the growth accounting exercise indicates that TFP growth deriving from substantial post-transition reallocation is gradually drawing to a close. At the same time, the contribution of capital accumulation has only picked up modestly. This suggests that in order to sustain high GDP growth going forward and to improve prospects for EU accession, Albania must forge ahead on two fronts: (i) raising the rate of capital accumulation; and (ii) accelerating structural reforms in order to

generate greater improvements in TFP from alternative sources. This would allow Albania to achieve the higher levels of investment, secondary school enrollment, and trade integration that are necessary for sustaining rapid growth.

In order to achieve these objectives, Albania must seek to raise its rate of investment, the quality of secondary education, and secondary school enrollment, especially in urban areas where employment opportunities exist. It must also improve its public infrastructure, institutional quality, and governance. The policy agenda for reaching these goals should include:

- Maintaining macroeconomic stability and completing the remaining structural reforms. This implies continued adherence to fiscal discipline, improving public expenditure management, and easing monetary policy.
- Improving governance. Three focus areas could be the basis for a revitalized governance strategy: First, consolidating the gains in public administrative reform, including maintaining pressure (including via the focus of quick-disbursing instruments) for meritocratic processes at the top levels of the civil service, and improving the transparency with which central government and its leadership operates, with special emphasis on asset declaration and (in partnership with the EU) the budget audit-parliamentary follow-up-prosecution cycle. Second, provide a coordinated operational platform for the multiplicity of initiatives aimed at helping develop bottom-up participation, harnessing these efforts to a common goal of nurturing participatory, downwardly accountable and high-performing local governments. Third, develop a pro-active private sector development strategy aimed at crowding-in an export- and hence productivity-oriented private sector.
- Expanding access to international trade. This would require more and different human capital than the average Albanian is now obtaining. The country will have to increase the quality and quantity of its human capital. It will also require a comprehensive strategy to improve infrastructure and removing administrative barriers to investment.

ANNEX

Table A*1. Real GDP Trajectories in Transition Economies (1990=100)

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Albania	100.0	72.5	67.3	73.8	80.7	87.9	95.9	89.2	96.2	103.2	111.2	118.4	124.0
Central and Eastern Europe (Negative Growth)													
Bulgaria	100.0	91.6	84.9	83.6	85.2	87.6	79.4	74.9	77.9	79.7	84.0	87.4	91.5
Croatia	100.0	78.9	69.7	64.1	67.8	72.5	76.8	82.0	84.0	83.7	86.8	90.4	95.1
Macedonia, FYR	100.0	101.6	94.9	87.8	86.3	85.3	86.3	87.5	90.5	94.4	98.7	94.7	95.4
Romania	100.0	87.1	79.4	80.7	83.8	89.8	93.3	87.7	83.0	82.0	83.4	87.9	91.6
Central and Eastern Europe (Positive Growth)													
Czech Republic	100.0	88.4	86.7	87.2	89.5	95.3	99.9	98.6	97.6	98.0	101.2	104.5	106.6
Hungary	100.0	88.1	85.4	84.9	87.4	88.7	89.9	94.0	98.6	102.7	108.0	112.1	115.8
Poland	100.0	93.0	95.4	99.0	104.2	111.5	118.2	126.2	132.3	137.7	143.2	144.6	146.7
Slovak Republic	100.0	85.4	79.7	76.7	80.7	85.9	91.0	96.1	99.9	101.2	103.4	106.8	111.5
Slovenia	100.0	91.1	86.2	88.6	93.3	97.1	100.5	105.1	109.1	114.8	120.1	123.7	127.3
Baltic Region Countries													
Estonia	100.0	92.0	72.5	66.5	65.1	67.9	70.6	77.5	81.1	80.6	86.3	90.7	96.1
Larvia	100.0	89.6	58.4	49.7	50.0	49.6	51.3	55.7	57.8	58.5	62.4	67.2	71.2
Lithuania	100.0	94.3	74.3	62.2	56.1	58.0	60.7	65.1	68.5	65.8	68.3	72.3	77.2
CIS Countries													
Armenia	100.0	88.3	51.4	46.9	49.4	52.8	55.9	57.8	62.0	64.0	67.9	74.4	84.0
Belarus	100.0	98.8	89.3	82.5	72.9	65.3	67.1	74.8	81.1	83.8	88.7	92.3	96.6
Georgia	100.0	78.9	43.5	30.7	27.5	28.3	31.4	34.8	35.8	36.8	37.5	39.2	41.4
Kazakhstan	100.0	89.0	84.3	76.5	66.9	61.4	61.7	62.8	61.6	63.2	69.4	78.6	86.3
Kyrgyz Republic	100.0	92.1	79.4	67.1	53.6	50.7	54.3	59.7	60.9	63.2	66.6	70.1	69.8
Moldova	100.0	84.0	59.6	58.8	40.7	40.1	37.7	38.4	35.8	34.6	35.4	37.5	40.2
Russian Federation	100.0	95.0	81.2	74.1	64.8	62.1	60.0	60.5	57.6	60.7	66.2	69.5	72.4
Tajikistan	100.0	92.9	66.0	55.1	43.4	38.0	31.7	32.2	33.9	35.2	38.1	42.0	45.8
Turkmenistan	100.0	95.3	90.2	81.2	67.2	62.3	58.2	51.6	55.2	64.6	75.9	91.5	105.2
Ukraine	100.0	91.6	82.7	71.0	54.7	48.0	43.2	41.9	41.1	41.0	43.4	47.4	49.6
Uzbekistan	100.0	99.5	88.4	86.3	81.8	81.1	82.5	86.8	90.5	94.4	98.0	102.4	106.7

Source: World Development Indicators, 2003.

Table A*2. Decline and Recovery in Transition Economies

Country	Cumulative Growth Between 1990-2002 (%)	Number of Years of Decline Before Initial Recovery	Total Number of Years of Decline Between 1990-2002	Cumulative Decline Before Initial Recovery (%)	Cumulative Growth Since Initial Recovery (%)	Average Annual Growth Since Initial Recovery (%)
Albania	24.0	2	3	-32.7	84.2	6.3
Central and Eastern Europe (Negative Growth)						
Bulgaria	-8.5	3	5	-16.4	9.4	1.0
Croatia	-4.9	3	4	-35.9	48.4	4.5
Macedonia, FYR	-4.6	4	5	-14.7	11.8	1.6
Romania	-8.4	2	5	-20.6	15.4	1.4
Mean	-6.6	3	4.75	-21.9	19.6	2.1
Central and Eastern Europe (Positive Growth)						
Czech Republic	6.6	2	4	-13.3	23.0	2.1
Hungary	15.8	3	3	-15.1	36.4	3.5
Poland	46.7	1	1	-7.0	57.7	4.2
Slovak Republic	11.5	3	3	-23.3	45.3	4.2
Slovenia	27.3	2	2	-13.8	47.8	4.0
Mean	21.6	2.2	2.6	-14.5	42.2	3.6
Baltic Region Countries						
Estonia	-3.9	4	5	-34.9	47.5	5.0
Latvia	-28.8	3	4	-50.3	43.4	4.1
Lithuania	-22.8	4	5	-43.9	37.4	4.1
Mean	-18.5	3.7	4.7	-43.0	43.0	4.4
CIS Countries						
Armenia	-16.0	3	3	-53.1	79.1	6.7
Belarus	-3.4	5	5	-34.7	48.0	5.8
Georgia	-58.6	4	4	-72.5	50.2	5.2
Kazakhstan	-13.7	5	6	-38.6	40.5	5.0
Kyrgyz Republic	-30.2	5	5	-49.3	37.7	4.7
Moldova	-59.8	6	7	-62.3	6.6	1.1
Russian Federation	-27.6	6	7	-40.0	20.7	3.2
Tajikistan	-54.2	6	6	-68.3	44.6	6.3
Turkmenistan	5.2	7	7	-48.4	103.8	15.3
Ukraine	-50.4	9	9	-59.0	21.0	6.6
Uzbekistan	6.7	5	5	-18.9	31.5	4.0
Mean	-27.5	5.5	5.8	-49.6	43.8	5.8

Source: Calculations based on Table 2.

Table A*3. Country List

Country	Real GDP per capita, 1980 (PPP based \$)	Growth Rate of Real GDP per capita, 1980-2000 (%)	Country	Real GDP per capita, 1980 (PPP based \$)	Growth Rate of Real GDP per capita, 1980-2000 (%)
Fast Growth Countries			Slower Growth Countries		
China	1072	6.26	Greece	11767	1.09
Korea	4830	5.95	Benin	996	0.99
Ireland	9978	4.86	Uruguay	7944	0.95
Thailand	2756	4.56	Malawi	648	0.95
Mauritius	5768	4.41	Switzerland	22320	0.84
India	1162	3.79	Trinidad and Tobago	9466	0.82
Hong Kong	12516	3.79	Mexico	7603	0.71
Uganda	442	3.77	Panama	5318	0.66
Malaysia	4905	3.53	Brazil	6327	0.64
Indonesia	1891	3.27	Ghana	1204	0.57
Sri Lanka	1782	3.08	Senegal	1465	0.51
Chile	5418	3.02	Guinea	2584	0.46
Dominican Rep.	2916	2.96	Costa Rica	5413	0.40
Portugal	9024	2.85	El Salvador	4160	0.32
Bangladesh	967	2.77	Jamaica	3470	0.31
Pakistan	1159	2.75	Paraguay	4449	0.26
Egypt	2419	2.74	Philippines	3275	0.22
Nepal	863	2.63	Argentina	10556	0.20
Norway	16772	2.39	Mali	948	0.11
Turkey	4325	2.29	Kenya	1231	0.06
Japan	15631	2.28	Ethiopia	641	-0.05
Spain	11520	2.25	Guatemala	4053	-0.17
Slower Growth Countries			Cameroon	2125	-0.20
United States	21337	2.23	Jordan	4051	-0.20
Tunisia	4354	2.21	South Africa	7892	-0.23
United Kingdom	14340	2.18	Gambia, The	1284	-0.27
Finland	15484	2.15	Zimbabwe	2627	-0.28
Guinea-Bissau	453	2.08	Peru	4866	-0.30
Austria	15706	2.05	Mozambique	1129	-0.43
Netherlands	16164	2.04	Honduras	2272	-0.50
Australia	17092	2.01	Bolivia	3046	-0.56
Israel	11394	1.98	Ecuador	4191	-0.95
Belgium	16303	1.89	Venezuela	7905	-1.04
Denmark	18282	1.88	Rwanda	1104	-1.04
Germany	15841	1.83	Tanzania	599	-1.09
Italy	15161	1.81	Niger	1111	-1.19
Canada	19022	1.74	Madagascar	1087	-1.31
France	16201	1.61	Cote d'Ivoire	2498	-1.45
Syrian Arab Rep.	2965	1.61	Zambia	1240	-1.65
Sweden	17179	1.60	Burundi	756	-1.83
New Zealand	14304	1.37	Togo	1370	-2.27
Morocco	2976	1.11	Nigeria	1209	-2.64
Colombia	4314	1.10	Nicaragua	3066	-2.76
Burkina Faso	769	1.10	Chad	1622	-2.89

Source: Penn World Tables

Table A*4. Country List—Similar Income Countries

Country	Real GDP per capita, 1980 (PPP based \$)	Growth Rate of Real GDP per capita, 1980- 2000 (%)
<i>Fast Growth Countries</i>		
Korea,	4830	5.95
Thailand	2756	4.56
Mauritius	5768	4.41
Malaysia	4905	3.53
Chile	5418	3.02
Dominican	2916	2.96
Egypt	2419	2.74
<i>Slower Growth Countries</i>		
Turkey	4325	2.29
Tunisia	4354	2.21
Syria	2965	1.61
Morocco	2976	1.11
Colombia	4314	1.10
Panama	5318	0.66
Brazil	6327	0.64
Guinea	2584	0.46
Costa Rica	5413	0.40
El Salvador	4160	0.32
Jamaica	3470	0.31
Paraguay	4449	0.26
Philippines	3275	0.22
Guatemala	4053	-0.17
Jordan	4051	-0.20
Zimbabwe	2627	-0.28
Peru	4866	-0.30
Honduras	2272	-0.50
Bolivia	3046	-0.56
Ecuador	4191	-0.95
Cote d'Ivoire	2498	-1.45
Nicaragua	3066	-2.76

Source: Penn World Tables

Figure A*5: Employment rate by residence, sex and age-group: 1989 and 2001
 (percentages out of the relevant population)

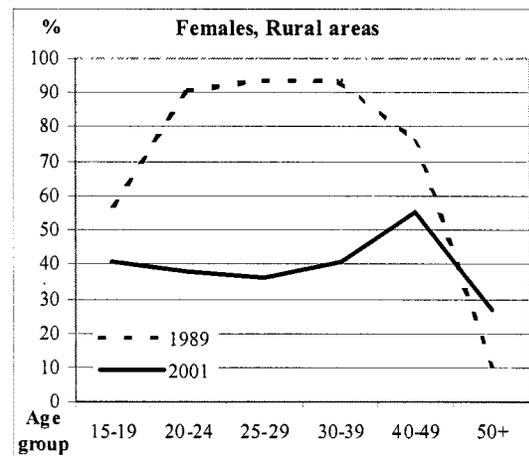
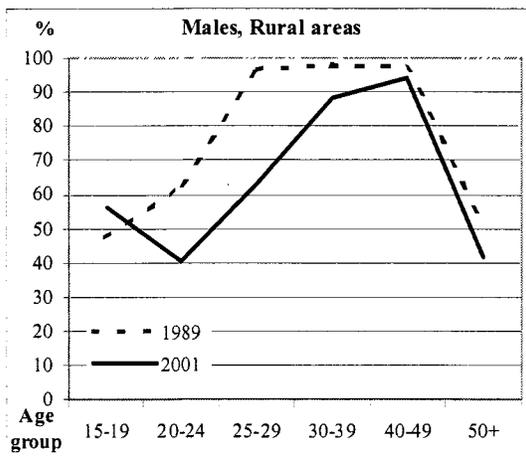
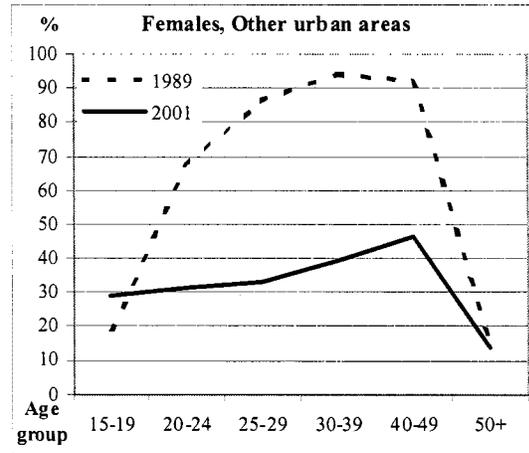
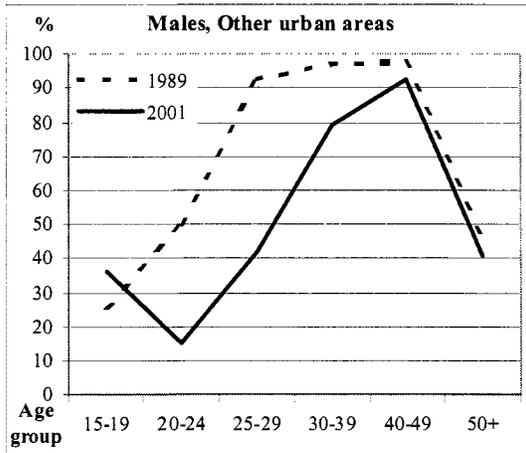
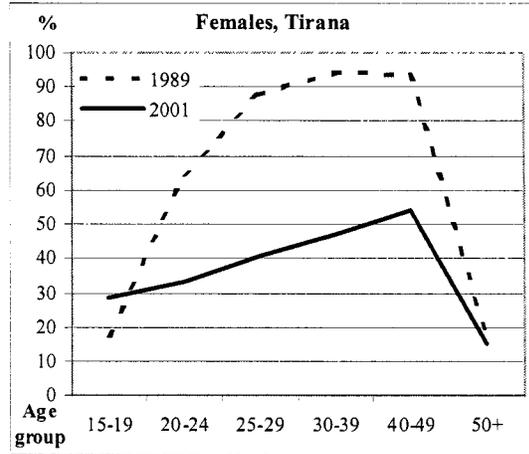
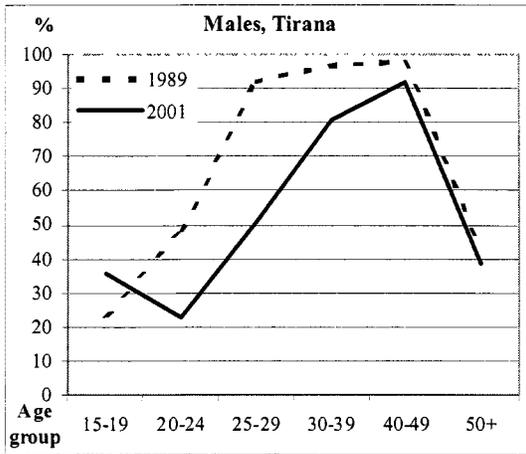


Table A*6: Sectoral Contribution to Growth

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
GDP Growth Rate	-9.6	-27.5	-7.2	9.6	9.4	8.9	9.1	-7.0	7.9	7.3	7.8	6.5	4.7	6.0
<i>Contribution of:</i>														
Agriculture	2.5	-4.7	4.9	3.1	2.2	5.9	0.1	-1.8	1.5	-1.0	1.9	-1.4	0.6	0.8
Industry	0.9	-17.2	-13.7	0.2	0.5	3.1	2.5	-2.8	-1.4	2.0	3.7	1.4	0.8	1.2
Construction		-0.9	0.2	0.9	0.5	1.0	0.7	-0.6	0.1	1.2	2.2	2.1	0.6	0.7
Manufacturing								-2.1	-1.3	0.6	1.4	-0.6	0.2	0.5
Services	-13.0	-5.6	1.6	6.3	6.7	0.0	6.5	-2.5	7.7	6.2	2.2	6.5	3.3	4.0
	1982-89	1990-92	1993-96	1998-01	2002-03									
GDP Growth Rate	2.2	-15.3	9.2	7.4	5.3									
<i>Contribution of:</i>														
Agriculture	0.5	0.8	2.8	0.3	0.7									
Industry	1.1	-10.3	1.6	1.4	1.0									
Construction		-0.2	0.8	1.4	0.7									
Manufacturing				0.0	0.3									
Services	0.7	-5.8	4.8	5.6	3.6									

REFERENCE

- Berryman, Sue E. (2000) *Albania's Education Sector: Problems and Promise*. Human Development Sector Unit, Europe and Central Asia Region, World Bank, Washington, D.C.
- Blanchard, Olivier and Michael Kremer (1997), "Disorganization," *Quarterly Journal of Economics*, November.
- Campos, Nauro and Fabrizio Coricelli (2002), "Growth in Transition: What We Know, What We Don't, and What We Should," *Journal of Economic Literature*, September.
- Chami, Ralph, Connel Fullenkamp, and Samir Jahjah (2003), *Are Immigrant Remittances Flows a Source of Capital for Development?*, Working Paper No. 03/189, Washington D.C., IMF.
- Civici, Adrian (2003.), *The situation and competitiveness level of the agro-food sector in Albania*, Albanian Center for International Trade. Tirana, Albania.
- Clert, Carine and Gomart, Elizabeth forthcoming, "Human trafficking in Southeastern Europe: Beyond Crime Control, an Agenda for Social Inclusion and Development", Social Development issue Paper, World Bank: Washington:DC.
- Crisan, Alexandru (2004), "Report on the Development of Albania's Curriculum." Tirana: Ministry of Education and Sciences.
- De Broeck, Mark and Vincent Koen (2000), *The Great Contractions in Russia, the Baltics, and the Other Countries of the former Soviet Union: A View from the Supply Side*, Working Paper 00/32, Washington D.C., IMF.
- Denizer, Cevdet (1997), "Stabilization, Adjustment and Growth Prospects in Transition Economies," World Bank Working Paper.
- Development Alternatives International/USAID (2003), *Economic Assessment of Investment Potential in the Albanian Agriculture Sector*, Washington, DC.
- Easterly, William (2001), *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics*, Cambridge, MA, MIT Press.
- Europol (2001-2000.), *Crime Assessment: Trafficking in Human Beings into the European Union*, The Hague: Europol.
- Falcetti, Elisabetta, Peter Sanfey and Anita Taci (2003), *Bridging the Gaps? Private Sector Development, Capital Flows and the Investment Climate in South-Eastern Europe*, Discussion Paper, European Bank for Reconstruction and Development, London, May.
- Fischer, Stanley, Ratna Sahay, and Carlos Vegh (1998), "Economies in Transition: The Beginnings of Growth," *American Economic Review Papers and Proceedings*.
- Franco, Ana, and Larus Blondal (2003). "Labour Force Survey Principal Results 2002. Acceding Countries," *Statistics in Focus, Population and Social Conditions*, Theme 3, 16/2003, Eurostat, Luxembourg.

Franco, Ana, and Silvaine Jouhette (2003). "Labour Force Survey Principal Results 2002. EU and EFTA Countries," *Statistics in Focus, Population and Social Conditions*, Theme 3, 15/2003, Eurostat, Luxembourg.

Galanxhi, Emira, Elena Misja, Desareta Lameborshi, Mathias Lerch, Philippe Wanner, and Janine Dahinden (2003), *Migration in Albania*. INSTAT and Swiss Forum for Migration and Population Studies. Tirana, Albania, and Neuchâtel, Switzerland.

Gray, Cheryl, Joel Hellman and Randi Susan Ryterman (2004), *Anticorruption in Transition 2: Corruption in Enterprise-State Interactions 1999-2002*, Washington D.C., World Bank: 2004).

Harrison, G., F.Rutherford, D.G.Tarr (1996a), Quantifying the Uruguay Round, in W. Martin and L.A. Winters (eds.), *The Uruguay Round and Developing Economies*, New York: Cambridge University Press.

Harrison, G., F.Rutherford, D.G.Tarr (1996b), Increased Competition and Completion of the Market in the European union, *Journal of Economic Integration*, 11(3), September, 332-365.

Heleniak, Timothy (2004), "Migration in the Europe and Central Asia Region," mimeo, UNICEF.

Horridge, Mark, 2002, Albanian input-output tables and Albanian CGE model, September 2002 (<http://www.monash.edu.au/policy/archivep.htm>).

Human Development Promotion Center (2004-2003), *Promoting Local Development through MDGs, Elbasani Region, Shkodra Region, Berati Region*, Tirana, UNDP.

IMF (2000), *Albania: Statistical Appendix*, Country Report No. 00/87, Washington D.C., July.

IMF (1994), Albania, *IMF Economic Review* 5.

Jarvis, Chris (1999), The Rise and Fall of Pyramid Schemes in Albania, Working Paper No. 99/98, Washington D.C., IMF.

Jungbluth, Frauke and David Lugg (2002), *Albania. Rural Development Strategy Underpinning Growth and Sustainable Development*, World Bank and Food and Agriculture Organization. Available online: http://siteresources.worldbank.org/INTALBANIA/Resources/Rural_Development_Strategy-Underpinning_Growth.pdf

Kaminski, Bartlomiej (2003), "Country Study: Albania," in *Trade Policies and Institutions in the countries of South Eastern Europe in the EU Association and Stabilization Process*, The World Bank Regional Report, Washington, D.C.

Kaminski, Bartlomiej and Manuel de la Rocha (2003), "Stabilization and Association Process in the Balkans: Integration Options and their Assessment," *Policy Research Working Papers Series 3108*, The World Bank, June 2003.

Kaminski, Bartlomiej and Beata Smarzynska (2001), "Integration into global production and distribution networks through FDI: The case of Poland." *Communist Economies & Economic Transformation*, Vol. 13. No. 4.

Kaminski, Bartłomiej and Francis Ng (2004), "Production Disintegration and Integration of Central Europe into Global Markets," *unpublished manuscript*, Washington D.C.

Kaminski, Bartłomiej and Francis Ng (2001), "Trade and Production Fragmentation: Central European Economies in EU Networks of Production and Marketing," *Policy Research Working Paper 2582*. World Bank, Development Research Group-Trade, Washington D.C. May.

Kaurmann, Daniel, A. Kraay and M. Mastruzzi (2003), *Governance Indicators for 1996-2002* (www.worldbank.org/wbi/governance, Washington D.C., World Bank.

Keyser, John C. (2004), *Phase I Synthesis Report. Regional Comparative Advantage Analysis*, IFAD.

Levine, Ross and David Renelt (1992), "A Sensitivity Analysis of Cross-Country Growth Regressions," *American Economic Review*, September.

Levy, Brian (2004), *Towards a Governance Strategy for Albania: A Draft Discussion Note*, Washington D.C., World Bank.

Mankiw, N. Gregory, David Romer, and David Weil (1992), "A Contribution to the Empirics of Economic Growth," *Quarterly Journal of Economics*, May.

Ministry of Agriculture and Food (2003), *Annual Report*, Tirana.

Ministry of Territory Adjustment and Tourism (2003), *Sector Strategy: Tourism Development in Albania*, Tirana.

Monga, Célestin (2004), *Latvia's Macroeconomic Options in the Medium Term: Fiscal and Monetary Challenges of European Union Membership*, Working Paper no. 3307, Washington D.C., World Bank.

Muca, Elda, Myhijidin Llagalami, Ilda Bozo, Giuseppe Gesano, Gianbattista Cantisani, Valeria Greco, and Giuseppe Loprete (2004). "People and Work in Albania. Labour Force, Employment and Unemployment in the Transition." ICSTAT, Roma – INSTAT, Tirana.

Muco, Marta, Peter Sanfey and Anita Taci (2003), "*Inflation Exchange Rates and the Role of Monetary Policy in Albania*" paper presented at Fourth International Conference: Albanian Economy, Performance and Policy Challenges, Bank of Albania, September.

Ng, Francis and Alexander Yeats (1999), "Production Sharing in East Asia: Who Does What for Whom, and Why?" *World Bank Policy Research Working Paper*, No. 2197, October.

Ninka, Eniel and Collana Appunti (2003), *Social and Economic Development in Transitional Countries: Territorial Differences in Albanian Districts*, Associazione Alessandro Bartolo, <http://www.reapbalk.unian.it/research/activities/ninka.pdf>

OECD (2000), *Literacy in the Information Age*. Paris: Organization for Economic Co-operation and Development. Canada: Human Resources Development Canada, and Statistics.

- OECD (2001), *Knowledge and Skills for Life*. First Results from PISA 2000. Paris: Organization for Economic Co-operation and Development.
- OECD (2002a), *International Mobility of the Highly Skilled*, Paris.
- OECD (2002b), *Financing Education*. Paris: OECD.
- OECD (2003a), *Education at a Glance: OECD Indicators, 2003*. Paris: OECD.
- OECD (2003b), *Labor Force Statistics: 1982-2002*. Paris: OECD.
- Rebis (2003)., *Regional Balkans Infrastructure Study*.
- Renton, Daniel (2001), "Child Trafficking in Albania," Save the Children, Tirana, Albania.
- Schwab, Klaus, Michael Porter, and Jeffrey Sachs, editors (2001). *The Global Competitiveness Report, 2001/2001*, Geneva, The World Economic Forum.
- UNICEF (2002), "Trafficking in Human Beings in Southeastern Europe: Current Situation and Responses to Trafficking in Human Beings in Albania, Bosnia and Herzegovina, Croatia, FRY, FYR Macedonia, Moldova, Romania," UNICEF, UNOHCHR, OSCE.
- U.S. Department of State (2003), *Trafficking in Persons Report*, Washington, DC: US Department of State.
- World Bank (2002), *Albania: Rural Development Strategy*, Washington D.C.
- World Bank (2003), *Albania Poverty Assessment*, Washington D.C.
- World Bank, *Global Economic Prospects 2004: Realizing the Promise of the Doha Agenda*.

